

Practical changes to NZ business law and
bureaucracy to help technology and growth
companies succeed

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SimmondsStewart

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Background

Simmonds Stewart is a niche commercial law firm based in Wellington.

We:

- > have large number of NZ technology and growth company clients, and an extensive network of contacts in this sector
- > represent a range of high net-worth private investors who actively invest in NZ technology and growth businesses
- > act for Government entities on a wide range of novel commercial and public law projects, with a growing emphasis on technology and innovation projects.

A significant part of our work involves assisting NZ early stage technology companies to raise capital in New Zealand and/or offshore, and assisting NZ and offshore investors with investments in the same category of company. We also help NZ technology companies to sell their business in NZ and/or offshore, and assist founders and investors to re-invest the proceeds of those sales in other NZ and offshore assets (including diversification of investments into land and agricultural assets).

Since 2000, there has been a significant level of investment in the technology and growth company sectors. Government programmes to support this sector have been refocused/expanded and new programmes created such as the NZ Venture Investment Funds. Many new technology and growth companies have been founded, and there are a growing number of specialist investors providing funding to those companies.

However, while some effort have been made to streamline legal processes to assist companies in this sector, there are still a range of legal and process changes that are needed to improve the environment for technology and growth companies. This is particularly the case given the difficulties that companies will face in raising capital over the next few years as the effects of the global credit crisis and recession deepen.

This paper sets out a number of changes that we think, from practical experience, will make a material difference for technology and growth companies.

1. Securities Act – employee share schemes

Employee share schemes are a standard feature of early stage and growth companies (ESG Co's) overseas, but not in NZ due to the likely application of the Securities Act to these schemes.

The problem

Employee share purchase schemes are a standard feature of US and UK ESG Co's and are generally mandatory when VC's invest. But in NZ many companies do not bother with these schemes due to (i) difficulty in determining whether or not the Securities Act applies and (ii) the complexity and cost of complying with the Act when it may/does apply. This reduces the ability of ESG Co's to incentivise and reward employees and reduces the opportunity for employees to participate in ESG Co success.

The solution

Create a statutory exemption in the Securities Act for employee share schemes in unlisted companies (possibly targeting ESG Co's, although there may be definitional problems).

Caps would be needed to ensure that these schemes are not used as a primary form of capital raising, e.g. the exemption could be capped at a % of a company's share capital (say 10 or 15%). The total amount able to be raised from each employee in any year could also be capped at a % of salary, with salary sacrifice or sweat equity calculated at market rate. Some information and minority shareholder protections may also be desirable.

Comment

The addition of the wealthy/experienced investor *bright line* exemption to the Securities Act has significantly improved the ability of ESG Co's to efficiently raise capital without fear of inadvertent Securities Act breach. There has been wide take up of this exemption through formal and informal angel investor networks. It has also grown the availability of capital in this sector.

We think introducing an exemption for ESG Co employee share schemes would have an equally significant impact.

2. Securities Act – rights issues

ESG Co's often need to raise capital from shareholders at short notice. A rights issue is the fairest way to do this, but the Securities Act often deters ESG Co's from making share offers to all shareholders.

The problem

When an ESG Co needs further capital to fund operations or move to the next stage of growth, the first place to look for that capital should be existing shareholders. Indeed, some companies are required to do so under the Companies Act or shareholders' agreements.

However, the Securities Act may apply to rights issues conducted by many ESG Co's and the cost, time and director liability risks involved in producing even a short form prospectus and investment statement deters ESG Co's from offering shares to all shareholders. This often means that smaller shareholders are excluded from capital raisings, in both up rounds and down rounds.

If a company is required (either under the Companies Act or a shareholders' agreement) to offer new shares pro-rata to existing shareholders, Securities Act compliance issues can make receivership or liquidation more attractive than carrying out a rights issue.

The solution

Exclude rights issues raising less than a specified amount (e.g. \$0.5m or \$1m) from the prospectus and investment statement requirements of the Securities Act. Instead, require the board of the company to provide a statement regarding the company's financial prospects (i) if the rights issue is successful and (ii) if it is not successful, together with the most recent accounts of the company. Transfer of rights could be permitted between shareholders, but not to non-shareholders.

Comment

ESG Co's that have raised capital from US or UK VC's and *flipped* to those countries are particularly adverse to complying with NZ securities law just to include remaining NZ shareholders in capital raisings. This can be a significant disadvantage for those NZ shareholders.

3. Securities Act – liability regime

The civil liability regime in the Act is too punitive towards non-owner directors.

The problem

The civil liability regime in the Securities Act is a deterrent to high quality business and professional people taking up directorships with companies planning public share offers.

The solution

Reduce the civil liability of independent directors for breach of the Securities Act to their annual director fees x (say) 3 or the value of any shares held by the director in the company, whichever is higher. Remove the *automatic* 5 year director/management ban for directors convicted under section 59 of the Securities Act (misleading statements in a prospectus, investment statement or advertisement), as this is likely to be disproportional and is particularly harsh for independent or non-owner directors as it may destroy their livelihood.

Comment

Making it more attractive for quality business people and professionals to sit on the boards of companies will improve compliance with the Securities Act. The current civil and criminal liability regime does not deter reckless or dishonest owner directors from breaching the Act.

4. Takeovers Code

The Takeovers Code is primarily designed to regulate takeover activity in large companies with broad shareholder bases, but recent changes mean that it also applies to quite small companies.

The problem

Where the Code applies to an ESG Co, it is often impractical to carry out a rights issue to raise capital from existing large shareholders or to introduce new large shareholders due to the cost, time and complexity of complying with the Code.

The solution

An amendment to the Code is needed to override the recent Takeovers Panel ruling that each trustee of a family trust holding shares in a company counts as an individual shareholder when determining whether a company exceeds the 50 shareholder threshold for Code companies. This ruling has substantially increased the application of the Code so that it now catches many small, relatively tightly controlled private companies (many of which will have shareholder agreements addressing transfers of control).

We also think an amendment to the Code is needed to exempt unlisted companies with less than \$10m in assets (the old asset threshold) from the requirement to provide shareholders with an independent adviser's report when seeking shareholder approval for a pro-rata rights issue. This would make it more economic for small Code companies to carry out a rights issue in compliance with the Code.

Comment

Independent adviser reports cost at least \$25,000 plus GST. Coupled with legal expenses, it is uneconomic for most small Code companies to carry out rights issues. Even were this not the case, the time taken to raise new capital in compliance with the Code can be a killer for small companies.

5. Tax on FIF Income – fair dividend rate method

This tax disincentivises New Zealand investors from investing in New Zealand businesses that are flipped into offshore companies as part of an offshore venture capital raising.

The problem

The venture capital exemption from the FDR method of taxation is relatively narrow and will not apply to many NZ ESG Co's that are *flipped* to the US in order to raise VC funding. This tax is a deterrent to NZ shareholders investing more funds alongside US VC's in funding rounds and from retaining their holdings in these companies long term. This means that New Zealand has a reduced exposure to the equity upside being generated by New Zealand businesses that move offshore.

The solution

Ideally, this tax would be removed as part of the introduction of a broad based capital gains tax. However, assuming that this is off the agenda, we would like to see the exemption for NZ venture capital companies widened to apply for as long as there is a minimum % shareholding (say 10, 15 or 20%) held by NZ resident shareholders who were shareholders at the end of the first overseas capital raising. This would assist the introduction of some new NZ investors alongside the existing shareholders when the business is flipped to the US. Existing shareholders often look for in order to keep a greater level of control in NZ.

Comment

We think it is in New Zealand's economic interest for NZ founders and funders of ESG Co's to maintain a material holding in companies migrating to the US and elsewhere for as long as possible. We think this is more valuable than the current rules regarding retention of a fixed establishment and staff in NZ - that will happen naturally if it is the best commercial approach.

6. Government procurement policy – compulsory requirement for RFP’s

The tightening application of compulsory Government tenders encourages “box ticking” RFP’s.

The problem

With the tightening application of Government procurement policy, agencies have been forced to go out to tender despite having clear (and often justified) preferences as to the supplier they would like to use. This appears to have caused an increase in *box ticking* RFP’s, particularly for consultancy or advisory services. This is extremely unfair on unsuccessful participants, not to mention a waste of time and money for all concerned.

The solution

Encourage Government agencies not to conduct formal RFP’s for services below the mandatory threshold unless they cannot readily obtain sufficient market information to enable them to make a selective appointment.

Widen the compulsory tender exceptions in the policy to include situations where an agency is aware, after market research, that a particular provider has a significant advantage in terms of experience or expertise over the market generally. Encourage departments to consider using this exception in preference to conducting a RFP process where the result is most likely a foregone conclusion.

Comment

We think many service providers would prefer departments to have more discretion in procurement decisions, particularly for consultancy and advisory services which have a heavy personal element to them, even if it meant missing out on the opportunity to tender for work on occasion.

7. Government procurement policy - ICT

A heavy emphasis on pricing in RFPs leads to cut-price offers but causes problems for departments, suppliers and the industry as a whole.

The problem

Government procurement of ICT services has had a heavy emphasis on price, with RFP outcomes favouring lowest and *fixed price* proposals. This has a number of downsides:

- > in order to win tenders, ICT companies submit proposals with a narrow fixed scope caveated with assumptions that they know are likely to be incorrect. This results in significant commercial problems for Government and providers alike, because claims for additional payments for out of scope work are inevitable
- > large ICT companies can buy market share by submitting aggressively priced tenders. This has resulted in big cyclical swings in the success of the large suppliers but is followed by contract performance issues as the *in vogue* supplier struggles with capacity difficulties and marginal/unprofitable contracts
- > the profitability of many mid-tier NZ ICT companies has been badly squeezed, jeopardising the long term prospects for this segment of the industry.

The solution

The emphasis on price needs to be decreased in RFPs and tender evaluations.

Departments need to co-ordinate procurement processes to ensure that work is to some extent spread between the large providers, so that capacity constraints are avoided.

Comment

NZ IT companies are the production houses for our ICT entrepreneurs of the future. Stronger ICT service providers will boost innovation not only by those providers but also by the professionals that cut their teeth in those companies before leaving to start their own ventures. Strong NZ ICT companies also have the ability to compete internationally and there are a number of good examples of this already (e.g. Datacom had \$450m of offshore revenue last year). Also, vendors are reluctant to include quality components in their bids, even when they would assume a better outcome, for fear of losing business on price. A balance needs to be found between receiving a quality outcome and good price to ensure the best solution is received by Government.

8. Things to keep doing

Life isn't all bad. We think there are some good initiatives being undertaken and/or supported by Government.

“Knowledge wave”

We would like to see a continued focus on the *knowledge economy*, particularly the technology sector, as a critical component in the future growth of NZ's GDP and international competitiveness. A lack of quick and high profile successes after the promotion of the *knowledge wave* has led to some negative sentiment, but we think it has tremendous potential for NZ - it just requires long term commitment and patience.

NZVIF

The VIF and SCIF funds have been extremely influential in the development of the NZ venture capital and angel investment sector. This has provided significant impetus to ESG Co's, as well as significantly lifting the professionalism of investment structures and documentation. While the publicised results have been less than spectacular to date, investments in this sector take a long time to mature. There are many exciting VIF/SCIF supported ventures of which we are aware, and at least some of these will bear fruit in a major way.

We would like to see VIF and SCIF funded to keep co-investing for at least another 5 years.

NZTE Beachheads

We haven't had any personal involvement with this programme, but clients and contacts who have are extremely complimentary of the scheme and the assistance that it has provided as they take their businesses to the US.

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