SPEAKMAN LAW

Welcome to the last edition of Speakman Law Newsletter for 2017. A pot pourri of selected topical (hopefully also interesting!) issues follows. As with the last newsletter, I have written a tax edition and separately a commercial edition. Whilst both may be of interest, inevitably one will appeal to you more than the other.

And because it is nearing Christmas there is a bottle of pinot noir and a pinot gris for the first of you who can pick these lyrics.

"I've been to London, seen seven wonders. I know to trip is just to fall. I used to rock it, sometimes I'd roll it. I always knew what it was for."

All the best for the holiday season ahead!

Acquisitions: Conditions and how to manage them…

It is standard for a sale and purchase agreement (whether it be for shares or assets) to be subject to conditions. The most common of these are due diligence and shareholder (or third party) consents. Other conditions might be a sale or listing event, the need for the parties to agree the targeted working capital at completion and entry into transaction documents with related parties.

Each of these conditions requires careful management. Most important is a condition satisfaction date, otherwise known as a sunset clause. This is critical for a vendor. Without it, a vendor is locked in to the sales process indefinitely, to suit the purchaser. This can be both disruptive and damaging to the vendor's business if prolonged.

During this time the vendor has no certainty that the deal will proceed, which can affect staff morale and customer relationships. A solution is often for due diligence to be conducted on a "closed basis", ie away from the prying eyes (and knowledge) of staff and/or customers. A closed due diligence means having a tight timetable with due diligence data stored offsite in a data room. Only once due diligence is largely completed and confirmatory responses have been given by the purchaser might the purchaser then have access to the vendor's management team.

November 2017 – Commercial Edition

Issue 24

What's inside

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- AML: Court orders severe penalty
- Financial Markets Update - briefly
- Should you use a Company or a Limited Partnership
- Restraints of Trade

Briefly - sport

- ABs v France this weekend leaving me feeling uneasy (Battle of Nantes, the 2007 Cardiff collapse and the 1999 World Cup semi-final ambush feature large still)
- Virat Kohli enters list of top 10 highest century makers of all time (he is only 28!)
- Colin Munro now has 2 (of only 5) International T20 centuries for NZ (McCallum has 2, Guptill 1)
- US has 1, 2 and 3 in world golf rankings (1st time in a long time)

Briefly – Law/Special Interest

- Tax focal point of Labour led govt. Tax Working Group to be established and a 100 day plan. My pick is wide sweeping changes in the international tax arena and a return to targeted (ie housing) tax provisions
- Trust Bill still making its way through Parliament
- New Anti-cartel laws coming into effect, much broader and addressing output restrictions and allocating customers
- Severe penalties imposed in first case involving breach of anti-money laundering rules
- Stephen Hawking says artificial intelligence becoming smarter than us "If people design computer viruses, someone will design AI that improves and replicates itself. This will be a new form of life that out performs humans". My response, Trump will be our saviour, his obvious solution will be to sanction all computers.

The due diligence phase will inevitably require the seller to give up trade secrets, for example, manufacturing processes, supply arrangements, customer lists and pricing. This is often a major hurdle for vendors who would not want this sort of information to fall into the hands of a competitor, without the deal proceeding. A non-disclosure agreement (**NDA**) is the most obvious form of protection here. Protection can also be gained from a staged release of the information. This would entail non-harmful information about the business being released up front, whilst withholding sensitive information until the seller is satisfied about the purchaser's commitment to the deal.

A most effective protection for the vendor is a liquidated damages clause in the NDA. This entails inserting a fixed damages sum in the event the purchaser breaches its obligations under the NDA. Where the damages sum is high, a purchaser will be greatly discouraged from taking any action that may imperil a claim for damages.

AML: Court orders severe penalty…

A court ordered penalty of $5.29m has, in the last few weeks, been imposed under the Anti-Money Laundering and Countering Financing of Terrorism Act (AML Act).

The offending parties were Ping An Finance (Group) New Zealand Company Limited (Ping) and its director Mr Xiao. They were found to have "failed abysmally" to comply with their AML obligations over a period of just over a year, involving over 1500 transactions and $105m.

Mr Xiao was found to have demonstrated a complete disregard for the AML requirements "if not a wilful intention to flout them". Ping had, amongst other things:

- Failed to carry out customer identity and verification of identity checks as part of customer due diligence.
- Failed to adequately monitor accounts and transactions.
- Failed to keep transaction, CDD and other records.
- Failed to report suspicious transactions.

This case signals just how significant the penalty for non-compliance in this area can be and serves as a reminder to ensure you have your AML practices in place.

Financial Markets Update - Briefly…

Fanfare has escaped a significant development in this area. A Bill presently sits before Parliament which, if passed, will repeal the Financial Advisers Act 2008 (FA Act) and amend both the Financial Markets Conduct Act 2013 (FMCA Act) and the Financial Services Providers (Registration and Dispute Resolution Act) 2008 (FSP Act).

The explanatory note to the Bill describes its purpose being to "create a new regulatory regime for the provision of financial advice". The Bill addresses problems with the existing regime for financial advice, which hinder investor confidence and participation in financial markets.

Some of the more significant aspects of the Bill are listed here:

- All those giving financial advice to retail clients (rather than just some advisers, as under the FA Act) must ensure their clients understand any limitations on the nature and scope of the advice provided.
- The code of conduct must include minimum standards of competence, knowledge, and skill that apply to particular types of financial advice and products.
- All those giving financial advice to retail clients must operate under a licence under the FMCA.
- Financial advice may be able to be given directly via an on-line service or via a financial adviser.

It is expected that the Bill will, if supported by the new Government, be passed mid next year and come into force in the following year.

Should you use a Company or a Limited Partnership…

Given that both companies and limited partnerships (LPs) accord limited liability, it is a natural question to ask when might you use a company in preference to a limited partnership and vice versa.

Both structures have their advantages. Companies are the natural choice of structure where ownership is

widely held. LPs on the other hand are the natural choice of structure for private investment purposes. Other settings require a horses for courses approach.

The choice of a company entails:

- entrusting day to day management to the Board and a hands off approach for shareholders;
- application of comprehensive company laws broadly preferring the interests of the company over those of shareholders, whilst offering shareholders protections from rorts;
- tax on earnings at the 28% company tax rate; the ability to indefinitely defer the difference between that and shareholders' marginal tax rates (usually 33%) by delaying the declaration of dividends;
- comprehensive and complicated tax rules around distributions, including distributions of capital gains;
- prescribed rules dealing with the relations between shareholders on the one hand (established for example by their classes of shares and/or a shareholders agreement) and between the shareholders and the company (established by the constitution);
- limitations both on the ability for a company to carry forward losses and tax credits arising from tax payments on company earnings.

These features reflect commercial reality that company law must adequately deal with commercial ventures of a large and progressive nature on the one hand, yet retaining relevance alike for small ventures.

I believe it could be said that the smaller the venture, the less relevant and less desirable a company structure becomes. Simply, their complications and trappings are in many cases unwarranted for smaller commercial ventures.

- The choice of a LP on the other hand entails:
- entrusting day to day management of the LP in a general partner (but often with investors retaining governance control through ownership of the general partner);
- only a modicum of laws peculiar to the LP (company law is vastly broader and more well developed than is the law applicable to limited partnerships);
- tax on earnings at the partners' marginal tax rates, as and when the income is derived;
- straight forward tax rules around distributions – simply, unlike companies, distributions from a LP are not taxed (as the income is treated as having already been derived by the partners);
- rules to suit the owners to govern relations between them as partners and, similarly, between them on the one hand and the LP on the other;
- by comparison with a company, far simpler tax treatment (though for cross border LPs these tax rules can become complicated especially where multiple jurisdictions treat LPs differently).

An insight into the appropriate choice of structure might be evident from this example. Take a horticultural business with heavy expenditure resulting in bank funded losses in the early years. In later years (the profit years) the business derives sizeable profits.

Where a company is used in this fact setting, the company will be able to carry forward the early year losses (so long as 49% shareholder continuity prevails) and offset them against the profits in the profit years. The owners neither suffer nor gain any tax impact until the company declares a dividend.

In contrast, the tax position for partners in a LP in this setting may be markedly different. Although the partners will be attributed with the early year losses (for tax purposes), they will not immediately be able to claim a deduction for them (courtesy of a loss limitation rule that applies here because the losses are bank funded and not funded by the partners themselves). Upon the LP deriving profits in the profit years, the partners will have to pay tax on those profits according to their percentage interest in the LP. That will be so regardless of whether any distribution has been made to them (invariably the LP will not have made a distribution because the LP will need to retain the cash represented by those profits in order to make good the early year losses).

This result should not be problematic for a partner who is able to offset his or her share of the early year losses against the tax liability on the profits. However, for an incoming partner subsequent to the

losses having been incurred, he or she will not have any right to the early year losses. Such a partner will be left with a tax liability on the profits attributed to him or her without receiving any cash from the LP. This consequence would not apply to an incoming shareholder in a company.

As always it is best to take advice on the structure that best suits your purposes rather than assume there is a one size fits all solution.

Restraints of Trade…

Most purchasers require a restraint of trade from their vendor. This is a natural protection to guard the purchaser against putting money in the hands of the very person who has the knowhow and contacts to compete with the acquired business.

Restraints are seldom straight forward to negotiate however. Always relevant is their term. Anywhere from a few months to 5 years might be applicable. I have not seen any restraint purporting to extend beyond 5 years.

For a purchaser there is the risk of the length chosen being determined by a court to be unenforceable. That risk is usually overcome by way of an escalation clause which provides for one or more shorter periods in the event that the longer period is found to be unreasonable. For larger corporate transactions, expect the period of restraint to be nearer the 5 year end of the scale; for smaller commercial transactions, expect it to be 1-2 years.

The scope of the restraint can be difficult to negotiate. As to territory, variations are New Zealand, the North Island or a radius of so many kilometres from the business premises. To whom the restraint applies is the difficult bit in the context of scope. A purchaser will want to safeguard against the vendor circumventing the restraint by establishing a separate operating entity. Consequently, a purchaser will seek to encompass not only the vendor but any affiliate of the vendor amongst the restrained parties.

Who is an affiliate for these purposes? Obviously it includes financial structures controlled by the vendor. What about the vendor's family members, for example, his or her adult son or his or her father? Where this issue arises it is usual to limit the restraint to direct financial support given by the vendor to the family member.

Sometimes more difficult to agree is the business that is to be protected by the restraint. Is it to be limited to the business carried on by the vendor at the time of settlement? What if the target business is, at that time, well progressed in bringing new products to the market (patent pending, for example). Such products are not inherent in the business then being carried on but are invariably both foreseeable and valuable to the purchaser. Many purchasers overlook extension of a restraint to these items. Better to draft the restraint widely than narrow, if acting for a purchaser.

Our Website…

Read our newsletters online at www.speakmanlaw.co.nz.

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Merry Christmas
&
Happy New Year