SPEAKMAN LAW

November 2020

Issue 36

What's inside

Briefly

- The implementation date for the Trusts Act (30 January 2021) draws near, focus on trust reviews and whether or not to retain them is heightening;
- The flurry of company law cases continues with the decision in DTB Operations involving a statutory demand and counterargument that the debt claimed had been inflated.
- New Privacy Act gives people better protection and puts new obligations on businesses.
- Mainzeal – Court of Appeal decision expected in 2-3 months. Judgment delayed by the Supreme Court decision in Debut Homes (discussed in this newsletter) and counsel submissions in response to it.
- AB's loss in Brisbane after record breaking win in Sydney, pointing to the frailties of this team.

Want to know more about the new Trusts Act we can help

A year dominated by an unforeseen pandemic with unprecedented economic turmoil, the NZ political scene tipped on its head with farmers strategically voting Labour in order to fight off unwanted Greens policies and a US election with undercurrents of sinister division between the Republicans and Democrats and their supporters fuelling skyrocketing ammunition sales. This year has had it all from the good, to the bad, to the ugly. The topics that follow cover some of the areas that are recurrent. I hope you enjoy them.

Director's Liability

The decision of the Supreme Court in Debut Homes v Cooper in the last couple of months is applicable to many directors and emphatically establishes personal liability for them. The circumstances in that case entailed a director's decision to trade on past the point of no return and that proved fatal to him.

Key to the finding that the director was personally liable was:

(a) The director's knowledge that the company's fate was certain;

(b) The director's intention to complete existing projects thereby realising more value from them so as to achieve a better result for the creditors did not protect him.

As a decision of the Supreme Court, it puts a stake in the ground which will dictate the result for companies that are in the same position. It means that where a company cannot return to solvency, the company cannot continue to trade without the protection of an insolvency process that involves all classes of creditors and is fair to all of them.

Turning to the facts of the case, it involved a property development company that for many years had been insolvent and which was supported through that period by advances from time to time by the shareholder. Those advances facilitated payment of all debts as they fell due.

By late 2012, it had become certain that the company was destined to fail. At that time the company had four properties yet to be completed. The director sought and received accounting advice that confirmed that while completion of the development of the four properties would maximise value from them and benefit the secured creditor, the IRD would be out of pocket for GST of about $300,000 on sale of the properties. With the benefit of that advice, and believing he was doing the most sensible thing, the director chose to complete the work on the properties in order to achieve an improved outcome for the secured creditor (and for the creditors overall). He did so in the knowledge that the IRD would be disadvantaged. He hoped to separately come to an arrangement with the IRD to settle the debt but his offer to do so was rejected.

The judgment highlights that a distinction must be drawn between a company whose fate of insolvency is certain on the one hand in contrast to a company on the other hand where there remains the prospect to salvage it.

The Supreme Court's decision establishes that in relation to a company in the former position, the directors are not permitted to continue to trade it unless there is an insolvency process in place, such as a receivership, creditors' compromise, scheme of arrangement or voluntary administration. That will be the case regardless of good intentions and regardless of an outcome that is designed to benefit some of the creditors by providing higher returns than immediate liquidation would deliver.

I envisage many companies may find themselves in the situation described here. For them, the Debut Homes judgment provides clear direction that any director who chooses to trade on where there is no coming back from insolvency must have the shelter of an insolvency process.

Tax Avoidance – Frucor decision

Earlier this year, the Court of Appeal overturned the High Court decision in Frucor, ruling that the arrangements involving the issue of a convertible note by Frucor to Deutschebank in the sum of $204m constituted tax avoidance. The Court of Appeal's decision goes to the heart of the question to what extent is it permissible in relation to a commercially motivated transaction to insert steps that are themselves tax driven. The decision is a major obstacle to that.

Before delving into the facts of the case, and what the Court said about them, critics of the decision might suggest that it effectively requires taxpayers to choose a less tax efficient path over a more tax efficient path where there is more than one means to achieve the same outcome, but I don't think that is right. Instead the decision applies the test whether the transaction is one that Parliament would have intended is legitimate and, for my part, I believe the decision is correct.

Triggering the arrangements was Frucor's wish to improve its balance sheet by replacing foreign sourced debt owed to its ultimate parent in France with local debt. Substituting local debt for the foreign debt removed the non-resident withholding tax (NRWT) cost on the interest payable to the French parent. This offered a significant tax advantage to the group.

The method chosen to achieve this was for Frucor to issue a convertible note to Deutschebank (in New Zealand) in exchange for $204m, of which $144m was applied in fully repaying the debt owed to the French parent. The other $60m was paid to Frucor's immediate holding company, in Singapore, upon a repurchase of shares in Frucor.

What complicates the arrangements is the means by which Deutschebank funded the $204m that it applied in subscribing for the convertible note. It used only $55m of its own money to do so. The other $149m was circuitously provided to it by Frucor's parent in Singapore as a prepayment for the purchase of shares in Frucor that Deutschebank would come to own on maturity of the convertible note. Thus, in subscribing for the convertible note, Deutschebank at no time intended to exercise its conversion rights so as to acquire shares in Frucor for itself and instead intended only to act as a conduit for Frucor's parent in Singapore. Perhaps the most telling feature of the arrangements was the Singapore parent's agreement to:

(a) pay $149m to Deutschebank for shares in Frucor that it could, as the parent company, acquire directly in Frucor at any time;

(b) pay this sum in exchange for a parcel of shares whilst at the very same time it agreed to sell $60m of shares in Frucor (it is not explained why it would have wanted to acquire shares in its subsidiary at the very same time as it sold them);

(c) pay this sum immediately in exchange for delivery in 5 years' time.

Essentially there was only $55m of external funds raised and Inland Revenue successfully argued that interest deductions should be permitted only on this amount. The Court of Appeal concluded "it seems to us reasonably plain that the funding arrangement had tax avoidance as one of its purposes or effects and this was not merely incidental to some other purpose. The transaction was in many respects artificial and contrived."

The dismissive view of the Court of Appeal is summarised in their paragraph "It is hard to discern any rational commercial explanation for the artificial and contrived features of the arrangement, other than tax avoidance."

Shareholder Agreements – the Need for Drag Along Rights

A recent case highlights the care needed in ensuring your shareholder agreement appropriately protects you. The case involved three shareholders who together had founded Fullers Bay of Islands operating day cruises and ferry services and who subsequently established a like business in Queensland under the name Cruise Whitsundays.

Two of the shareholders held between them approximately 94% of the shares. The third, Mr Murphy, held 6%.

The operations in Queensland were tremendously successful, though tolling on the shareholders particularly Mr Murphy, who believed he had borne an unequal and unrewarded share of the effort in developing the business. After some time, the decision was made to offer the company for sale and a buyer was found. The price offered by the buyer was highly attractive, being at least $30m greater than any of the shareholders had ever imagined. Negotiations for sale were led by Mr Murphy on behalf of the 3 existing shareholders and time was of the essence.

With the deadline stipulated by the buyer for acceptance of the offer imminent, Mr Murphy confronted his fellow shareholders with an ultimatum requiring that they grant him an additional $5m out of the sale proceeds failing which he would refuse to sign the sale agreement, thereby stymying the deal.

His fellow shareholders had no option but to accept Mr Murphy's demands. Decidedly aggrieved, one of the majority shareholders then brought proceedings against Mr Murphy claiming that he had breached his obligations under the shareholders agreement.

His claim failed. He could not point to an obligation of good faith required of Mr Murphy and nor could he point to any other provision requiring Mr Murphy to sell his shares.

The claim would have been successful had the shareholders included drag along rights in the agreement by which the majority shareholders could require any minority holder to sell their shares on the same terms. Its exclusion was fatal.

What to look for in a Trust Review

I set out below the items you need to look for in reviewing your trust to ensure it complies with the new Trusts Act when that comes into force in late January.

Worry about the new Trusts Act centres around the beneficiaries' rights to information, and in particular the obligation to provide certain trust information to them. In many cases this will not trigger as much as a second thought. In some cases however it is acutely concerning. Where there is concern, a remedy is to remove from the class of beneficiaries, the person or group of persons in respect of whom disclosure of trust information is a concern. An alternative remedy is to nominate those beneficiaries to whom priority is intended. Such persons may be classified as primary beneficiaries and the settlor may give direction to the trustees (either by insertion of a specific clause in the trust deed to that effect, or by way of a memorandum of wishes) that trust information need only be given to the primary beneficiaries.

Moving on from these disclosure requirements and management of beneficiaries to suit, there is the need to modify the default duties.

(a) General duty of care – wherever there is a wish to accord trustees an absolute discretion in the way they make their decisions, the deed will need to expressly state that the duty of care in section 29 does not apply. It is rare to do this, however, as a duty of care is usually desired.

(b) Duty not to exercise power for own benefit – this is commonly reflected in a No Self Interest clause. There is a myriad of possible responses to this. The one I prefer is to retain power for a conflicted trustee to vote upon a matter provided there is also a trustee who is not conflicted who approves the matter. Your trust deed will inevitably need to be amended to adopt whichever of the myriad of possibilities open to you on this score, and record that it modifies the duty in the Act not to exercise a power for your own benefit.

(c) Duty to consider the exercise of power – are any beneficiaries to be given priority? This extends to priority given to a settlor to allow him or her to reside in the family home (rent free), where the home is owned by the trust. It also extends to trust owned companies, the investment in which might not be a natural choice, and which gives rise to the need for an anti-Bartlett (no duty to interfere in management) clause. Whenever a priority, such as those above is intended, the trust deed must prescribe that the duty to consider the exercise of trustees' powers is modified accordingly.

(d) Duty not to profit – where it is intended to allow trustees to be paid for their services or receive other benefits (i.e. a trustee is also a beneficiary) the deed must provide for it and it must state that the duty not to profit and the duty to act for no reward are each negated.

Review of the trust deed in other respects will include reviewing a trustee's liability for investment decisions, modifying the trustee limitation carve-outs, extending the life of the trust to 125 years where possible, establishing whether trustee decisions are to be made unanimously or by majority, inserting any intended minimum age for beneficiaries to benefit (18 years of age will apply absent any change to that) and reviewing who it is who holds the powers to appoint and replace trustees and beneficiaries.

Our Website…

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

Come visit…

Please feel free to pop in for a visit at Level 15, 36 Kitchener Street, Auckland.

Contact details

Peter Speakman

Principal

T: +64 9 973 0577

M: 021 854 642

www.speakmanlaw.co.nz