SPEAKMAN LAW

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What's inside

Yesterday, the Reserve Bank increased the official cash rate (OCR) by 75 points in what was a record individual rate hike. This pushes the OCR up to 4.25% and is a response to continued high inflation (7.3% in Q2 and 7.2% in Q3). Worryingly, there is no sign of inflation materially abating and a further hike of 75 points is on the cards in February, when the OCR is next up for review.

Moreover, RBNZ's monetary policy statement predicts a recession in the middle of next year and the OCR peeking at 5.5%.

Meanwhile the property market has fallen, nationally by 8% from its high and sales for the year are tracking at their lowest level (65,000) since 2011, and third lowest in 30 years.

Fortunately unemployment rates remain low which is countering distress. Continued low unemployment rates will be key to economic recovery…..and now on with the news!

Do Business Restraints on Vendors in M&A Transactions Breach Cartel Prohibition?

Business and share sales expose purchasers to risk in the interim period from signing a sale and purchase agreement to settlement. That period can in some cases be quite lengthy, especially where regulatory consents are required.

Commonly, purchasers seek to bolster warranty protections, by imposing restraints on the vendor's activities during the interim period. For example, it is common to restrain the vendor from carrying on activities during the interim period that are not in the ordinary course of business, and to prevent vendors from acquiring new equipment or employing new staff without the purchaser's consent.

In some cases a purchaser might wish to go further and deny the vendor the right to change its prices or change the scope of its operations during the interim period. Where a purchaser wishes to do so, the purchaser must be mindful of the cartel provisions in the Commerce Act. These provisions make it a criminal offence to enter into cartel arrangements that are anti-competitive (controls on pricing being the most common and obvious example of anti-competitive behaviour).

In a 2019 Australian case (ACCC v Cryosite) a purchaser suffered a million dollar penalty for breach of the equivalent Australian cartel prohibitions. The purchaser's 'crime' had been to require the vendor to refer new sales enquiries to the purchaser prior to completion of the purchase transaction (referred to as gun-jumping). It follows that protections that a purchaser might seek during the period between signing and settlement must be balanced against the risk of anti-competitive gun-jumping and hefty penalties under the Commerce Act.

Similarly, a restraint of trade imposed on a vendor under a sale and purchase agreement has potential to breach the anti-competition provisions in the Commerce Act. Such a restraint must be reasonable in its scope. A restraint that is excessive (because of its duration, geographic region, or scope of operations) will offend the Commerce Act. First Gas recently experienced that and was ordered to pay $3.4m for having imposed an overly wide restraint on the vendor when it acquired the Bay of Plenty gas distribution business of Gas Net Limited.

Commerce Act considerations in a sale and purchase agreement are centrally important and arise more often than you may think as these cases illustrate.

Purchase Price Allocation Rules

Specific rules for purchase price allocations on business sales were introduced in July 2021. My observation is that most people remain unaware of them.

The rules were the brain child of Inland Revenue to prevent vendors and purchasers manipulating the allocation of the purchase price on a business sale in such a way that delivers an overall tax advantage. For example, a vendor with tax losses may be persuaded by the purchaser to allocate the majority of the purchase price to revenue account assets or depreciable property (e.g. buildings) and away from goodwill. This would offer a tax advantage to the purchaser either by way of an immediate deduction in the case of amounts paid for revenue account assets, or via the depreciation regime, in the case of depreciable property.

The tax benefit to the purchaser might then be shared with the vendor by way of an increase in the purchase price, at the cost of Inland Revenue. The purchase price allocation rules circumvent that.

A unique and problematic feature of the rules is that unless the parties can agree on the purchase price allocations the vendor takes prime position. This is reflected in the fact that the vendor has 3 months from completion of the transaction to choose how to allocate the purchase price and notify the purchaser of that allocation. Where the vendor does so, both parties must follow the vendor's chosen allocation when filing their returns. Only when the vendor does not exercise its allocation right during this 3 month period does a purchaser gain any rights.

Common practice where the parties cannot agree on the purchase price allocation is to agree that they be set by an independent valuation. It would be unreasonable for a vendor not to agree to that process.

There are some de minimis exceptions to the rules. They do not apply where:

a) the purchase price is less than $1m; or

b) the only property being sold is residential land and the consideration for the land is less than $7.5 million

Frucor – Supreme Court Adopts Economic Substance in Tax Avoidance

The Supreme Court recently issued its judgment in the tax avoidance saga surrounding Frucor's financing arrangement entered into all the way back in 2003, finding in favour of Inland Revenue. For taxpayers generally the result is unhelpful because it seriously erodes a taxpayers' right to choose to structure a genuine commercial arrangement in a way that delivers the most tax efficient outcome.

What was Frucor About?

The Supreme Court says it was about an advance of $204m made by Deutsche Bank NZ to Danone Holdings NZ (which subsequently become Frucor and hence I refer to it as Frucor). That advance was for a term of 5 years and was comprised in a convertible note by which Deutsche Bank gained the option to obtain shares in Frucor. The key finding was that Frucor was denied interest deductions on this loan.

As the Supreme Court point out, Deutsche Bank never wanted shares in Frucor. Nor did Frucor's parent, DAP, want Deutsche Bank to gain a shareholding in Frucor. Why then was Deutsche Bank granted an option to acquire shares in Frucor via the convertible note?

The answer is that the convertible note was part of a wider arrangement that also involved Frucor's parent, DAP, based in Singapore. That wider arrangement made sure that the shares in Frucor would end up in DAP's hands, and not with Deutsche Bank.

Thus, in substance:

a) the optional convertible note issued to Deutsche Bank was not optional at all, and instead it was mandatory that Deutsche Bank exercise its conversion rights;
b) Deutsche Bank gained rights to shares in Frucor that it never wanted for itself and instead collaborated with DAP so that the Frucor shares would end up with DAP; and
c) Deutsche Bank was repaid its $204m advance in two parts, first as to $149m by DAP by way of the price paid to it by DAP for the Frucor shares and secondly as to the balance of $55m, by way of payments from Frucor for which it claimed an interest deduction.

Also material to the arrangements was:

a) The prior existence of a loan of $148m made by another Danone group company, Danone Finance, to Frucor (this had, materially funded DHNZ's acquisition of Frucor Beverages Group Ltd the year before); and
b) a share buyback by which Frucor (DHNZ at the time) returned $60m of capital to DAP, its parent. This was paid out of the $204m advance from Deutsche Bank. This had two paradoxical effects, first it illustrates that although Frucor (DHNZ at the time), borrowed $204m, in reality it only required $144m (i.e. $204m less $60m). Secondly, at the same as DAP accepted a reduction in its capital contribution in DHNZ (that reduction being the $60m returned to it on cancelling the shares upon the share repurchase), it agreed to increase its capital contribution in DHNZ by $149m by agreeing to acquire shares in DHNZ for that amount under its agreement with Deutsche Bank. This begs the question, why did DAP enter into arrangements to increase

its capital contribution in Frucor at the same time as entering into arrangements to decrease them?

Economic Substance Displaces Parliamentary Contemplation

Since the Ben Nevis judgment in 2008, whether or not tax avoidance applies to an arrangement has been established by asking the question whether the arrangement is one that Parliament would have contemplated. In a cross border financing setting we have a multitude of specific tax protective and the tax collection measures. For example, NZ subsidiaries of foreign parents cannot be excessively geared. In this way, the transfer of profits of the NZ subsidiary to its parent is regulated, tax wise, via the thin capitalisation rules. Similarly, transfer pricing rules guard against shifting NZ profits to a foreign jurisdiction (a tax haven for example) via excessive interest rates on loans made by a foreign parent to a NZ subsidary.

The combination of these rules (and others) has assured tax advisors that where Parliament sets thresholds and you remain within them, then Parliament must have contemplated that your arrangement is acceptable. Part of the equation here is the idea that Parliament will not have looked at the tax aspects in a vacuum and instead will have been careful in setting these thresholds so as to adequately protect the NZ tax base while at the same time appropriately incentivising foreign investment.

In my view there must have been a good chance that Frucor would have overcome the tax avoidance challenge against it had the Supreme Court continued to apply the Parliamentary contemplation test. That is because at the heart of the arrangement lay a genuine commercial purpose, namely to refinance DHNZ's debt incurred in funding the acquisition of Frucor, and the method of doing so (the convertible note arrangement with Deutsche Bank) was

a) a form of arrangement that is perfectly legitimate
b) the debt threshold assumed by Frucor remained within the prescribed thin capitalisation thresholds;
c) taxation treatment of convertible notes is prescribed and was followed to the letter;
d) tax risk applicable to the face value gain obtained by DAP in acquiring shares in Frucor for $149m whist the issue price for those shares was $204m was a matter of Singaporean tax law and not a risk to the NZ tax base.

The Supreme Court's substitution of an economic substance test for the previous Parliamentary contemplation test ignores these factors. On an economic substance test, the ultimate capitalisation of DHNZ's debt to Danone Finance (achieved by the issue of the note and DAP's acquisition of those shares) is displaced by the view that capitalisation of Frucor's balance sheet could more easily have been achieved by Frucor simply issuing shares to DAP (coupled with a novation of the debt owed by Frucor to Danone Finance so that it was assumed by DAP instead).

In other words, in the view of the Supreme Court, Frucor (and its parent) had an alternative, though less tax effective, refinancing route available to it. It was an act of tax avoidance to choose to instead adopt a more tax effective refinancing method. That is despite the fact that the alternative method was legitimate and complied with each of the specific tax protective measures that the Tax Act throws at cross border arrangements.

The Danger of Taxing by Economic Substance

The Supreme Court arrived at its conclusion that the Frucor arrangements amounted to tax avoidance by applying economic substance to substitute the actual arrangements entered into with a set of facts that the Supreme Court said applied in economic terms.

Just what the Supreme Court's authority for doing so is something of a mystery as it runs counter to that Court's own Parliamentary Contemplation test and is not supported by any Parliamentary direction to do so. Nonetheless, that is what the majority of the Supreme Court did (Justice Glazebrook dissenting strongly). This approach endangers taxpayers to be taxed on a set of facts that did not apply to them at all wherever an arrangement that is chosen delivers a more efficient tax result whilst achieving the same economic result.

Fortunately, Inland Revenue has responded to the Frucor decision to confine it to its facts and has confirmed its support for the Parliamentary contemplation test that has operated since 2008.

Can Beneficiaries of a Trust be Freely Removed?

One of the great advantages underscoring the use of trusts is their flexibility, including substituting beneficiaries to suit changing circumstances, for example, upon husband and wife becoming separated, or upon a fallout with a member of the family.

Whenever proposing to remove a beneficiary, the first step is to review the trust deed in order to ascertain whether the settlor has imposed limits on removing beneficiaries. Assuming there are no such limits, the next step is to identify in whom the power of appointment and removal of beneficiaries resides.

Most often it resides in the trustees, but it is not unusual for this power to reside in a third-party appointer or protector.

Putting aside for the moment in whom the power of appointment or removal resides, exercise of the power to remove a beneficiary is a big step that is plainly impactful for the beneficiary who is removed. This brings into question the motivation for the appointment or removal and whether it can be challenged for breach of duties.

This was tested in the Courts recently in a case by the name of Pollock v Pollock. That case centred around an unfortunate fallout between father and son leading to the father removing his son, Steven, as beneficiary of the trust which the father had settled. He also removed Steven from his will.

Steven challenged these actions, arguing that his father (as trustee) owed him a fiduciary duty in exercising the power of removal. The Court of Appeal confirmed that trustees owe fiduciary obligations to a beneficiary whom they propose to remove but nonetheless came down on the side of the father, whom they found had no improper purpose in removing Steven and so his removal was confirmed.

In contrast, in another relatively recent case resulting from a family fallout, by the name of McLaren v McLaren, the removal of beneficiaries from a family trust was overturned. Again, the Court found that trustee (and appointor in this case) owed a fiduciary duty to beneficiaries when considering their removal. In this case the Court determined that duty had been breached.

These two cases reinforce the point that appointment or removal of beneficiaries must be done for a proper purpose and may be overturned when no proper purpose is established. That is possible regardless of whether it is the trustee or a third-party appointor who exercises the power of appointment or removal.

Eligible Investor Certificates

Common practice for private companies wishing to raise capital is to rely on eligible investor certification to overcome the need for a full public disclosure statement (PDS). The legal costs of a PDS can easily reach $50,000 or more, making the issue of a PDS prohibitive for small offerings.

The Financial Market Conduct Act (FMCA), balances this by establishing a number of exemptions from the requirement for an issuer of shares or debt securities to issue a PDS. The mechanism for eligible investor certification is one exemption and is perhaps the one that is most commonly relied on and usually makes capital raising for private companies cost effective.

The eligible investor certificate process requires the investor to self-certify that he or she has the requisite experience in order to understand the merits of an offering.

The investor is required to set out the grounds for that certificate and a financial adviser, qualified statutory accountant or lawyer must independently confirm the certification.

The Financial Markets Authority (FMA), which has oversight of the FMCA, has found problems in this area. The FMA has identified multiple instances where either eligible investor certificates have been incomplete or did not adequately set out the grounds for the investor's certificate.

The FMA has issued a report. Importantly, it states "the investor must ensure the experience (i.e. that stated as held by an investor in his or her certificate) is relevant, and where the grounds stated are not capable of supporting the matters certified they should be disregarded when deciding whether or not to rely on the certificate. A certificate that does not meet the requirements of clause 41(1) in Schedule 1 of the Act will mean the person does not qualify as an eligible investor."

One key observation by the FMA is the widespread use of 'tick-box' options for would-be eligible investors to select from when stating the grounds for their certification. The FMA believes listing of options that an investor may simply tick so as to confirm his or her experience and understanding of financial offers is inappropriate and manipulates the end result.

It is plain that the FMA is on watch for practices employed in this area. My strong recommendation to private companies when raising capital in reliance upon the eligible investor status is to take care to confirm the investor's status. It is best not to adopt the tick the box formulaic approach. Instead it is best to require the investor to insert in his or her own words just what experience they have that enables them to assess the merits of an offering.

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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