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The recent collapse of Silicon Valley Bank, the 18th largest bank in America, has provided another dent in financial markets, the Bond Market already in freefall as interest rates continue to climb. The Bank's collapse rather highlights the need for a government guarantee on bank deposits and perhaps that will be one positive to emerge.

Litigation, both in the commercial area and relating to trusts continues to be busy and there is perhaps a surprisingly healthy flow of acquisition activity. As usual in this newsletter are items that have recently crossed my desk and which I hope will be of interest to you.

Corporate Trustees – Risks for Lenders and Creditors

The fact that a trustee is personally liable for debts incurred by a trust, means that creditors of a trust have recourse directly against the trustee. Trustees often seek to shelter themselves from personal liability by substituting a corporate trustee.

Use of a corporate trustee (with no substantive assets of its own) goes a long way towards sheltering a trustee against those debts. The individuals behind the corporate trustee will be protected except to the extent that liability attaches to them as a director of the corporate trustee and he or she has breached those duties, known as dogleg claims, though these are difficult (see below).

In circumstances where the corporate trustee has no assets of its own and liquidating the corporate trustee will serve little or no purpose, where does this leave the creditor? A creditor will want direct recourse to the assets of the trust. How does a creditor gain that recourse?

To do so, an unsecured creditor must access the trustee's right of indemnity. Trustees have always had a right of indemnity at law out of the trust fund for expenses and liabilities reasonably incurred by the trustee. Section 81(2) of the Trusts Act makes this explicit.

The steps for an unsecured creditor are to first sue the trustee and to then seek to enforce the right of indemnity. This results in the creditor's claims being subrogated to the trustee's right of indemnity. This right of subrogation effectively transfers the trustee's right of indemnity over to the creditor and is supported by an equitable lien over the trust assets.

A creditor's right of recourse (via the indemnity) is only as good as the rights held by the trustee. If, for example, the trustee has been grossly negligent, the trustee's rights under its indemnity will have become lost; in that case a beneficiary's claims will take priority. Section 86(2) of the Trusts Act does, however, improve the creditor's position in relation to the trustee's indemnity. That section applies where

- the creditor has given value;
- the trust has received a benefit from the transaction between the trustee and the creditor; and
- the creditor has acted in good faith.

Where this section applies, the creditor's claim gains priority ahead of beneficiaries, and it achieves that position even where the trustee is not fully entitled (i.e. where the trustee has lost its indemnity for breach).

These points reinforce the fact that where a lender deals with a trust, it is dealing with the trustee and the lender's recourse is either

a) under security held over an asset; or
b) via the trustee's right of indemnity, described above.

The right of indemnity (and its enhancement by section 86 of the Trusts Act) is of no value, however, where the trust has no assets. In this respect, a lender's risk is compounded by the absence of any restrictions on distributions of trust assets (in contrast to a company which imposes a solvency requirement in order for a distribution to be made, supported by clawback rules on liquidation).

The recent High Court case of Levin v Ikiua serves as an example where use of a corporate trustee can completely defeat a creditor's claims. That case involved a trust that had a contract to supply rehabilitation services to ACC. Each year the trust received payment for its services from ACC and it distributed those amounts to the beneficiaries. It later transpired that the trust had been overcharging ACC and there resulted a debt owed by the trust to ACC.

ACC pursued that debt but found that both the corporate trustee and the trust were empty shells. That was because all trust surpluses had been paid out to the beneficiaries. The directors had not breached any duties because they had at all times paid all creditors that they knew about and so had not traded recklessly.

This illustrates that, on occasion, recovery action by an unsecured creditor against trust assets may be fruitless. A lender should therefore always take security when dealing with a trust (and not having the benefit of liquidation laws – notably voidable preference laws – that apply when dealing with a company).

Even when taking security, a lender needs to carefully check that the trustee is granting it properly – for example, was the trustee properly appointed, are there any applicable limitations on the trustee's powers contained in the trust deed, if there is more than one trustee are the trustees in agreement and is unanimity required, is the trustee committing a breach of trust by entering into the transaction for which security is sought?

Other means of accessing trust assets include claims under

- the Property Law Act;
- the Insolvency Act;
- the Property (Relationships) Act; and
- the Family Proceedings Act
  (the latter two do not apply to business creditors and are not discussed here)

Property Law Act

Sections 344 to 350 of the Property Law Act grant the Court power to set aside dispositions of property made to a trust, thereby enabling trust assets to be clawed back. The Court may do so where the disposition is made after 31 December 2007:

a) with intent to prejudice a creditor; or
b) by way of gift; or
c) without receiving equivalent value in exchange; and
d) the debtor was insolvent at the time, or became insolvent as a result of, making the disposition, or was engaged in, or about to engage in a transaction for which the remaining assets of the debtor were unreasonably small or otherwise the debtor intended to incur debts beyond the debtor's ability to pay.

Note that where a gift is made or inadequate consideration provided, the element of intent to prejudice creditors is not applicable.

Insolvency Act

The Insolvency Act contains similar provisions that apply to gifts. A gift made within 2 years of bankruptcy is voidable by the Official Assignee. The 2 year period is extended to 5 years if the bankrupt was unable to pay his or her debts at the time of making the gift.

Dog Leg Claims

These are claims brought by a beneficiary of a trust against the director of a corporate trustee of the trust. Such a claim asserts that the trustee has breached its duties to the trust and the director in turn has failed his or her duties to the company.

The argument is that the beneficiary essentially steps into the shoes of the company with the right to pursue the claim against the director and receive for itself any proceeds of the claim.

Underpinning this argument is the idea that the duty owed by the director of a corporate trustee is an asset of the trust, making the director liable to the beneficiaries for the corporate trustee's breach of trust. No dog leg claims have been successful in New Zealand, those that have been brought have been unsuccessful.

In the Review of the Law of Trusts, 2013, the Law Commission recommended a separate review of corporate trustees. For the moment, even if a director is found to have breached his or her directors duties, a right of indemnity will not be available; it is not a trustee duty that has been breached in that instance, instead it is a director duty that will have been breached and the right of indemnity under trust laws does not extend to that.

Multiple Trusteeships

There have been two important cases involving liquidation of a corporate trustee that has accepted trusteeship to multiple trusts. The first is CMS Trustees

Limited v CEVR, 2014, in which case the trustee company was operated by a law firm that acted for hundreds of trusts. Upon its liquidation, what is the position of the other trusts for which the trustee acted prior to its liquidation and was the cost of replacing the trustee (and updating titles) an incidental cost of trust administration or a professional breach?

The second case is Newmarket Trustees Limited v Commissioner of Inland Revenue, 2012. Newmarket Trustees Limited had been a trustee of 118 trusts. The High Court dismissed an application to liquidate it (as a consequence of a GST liability imposed on it as trustees of the trusts) on account of the inconvenience to the other trusts.

The Court of Appeal determined otherwise and approved the liquidation. Newmarket Trustees Ltd was essentially assetless hence it was arguable that liquidation was an unnecessary and pointless step. It was the legal proprietor of 145 properties as well as legal owner of shares in several companies. Liquidation of the company necessitated changes of ownership in each case.

There was no suggestion that, by liquidating Newmarket Trustees Ltd, IRD could access the assets of other trusts for which it was trustee in order to discharge the tax debt of the single defaulting trust. Nor were there circumstances to lay foundation for claims against directors for breach of their duties as directors of the company.

The Court recognised that use of a corporate trustee was standard practice having regard to the need to shelter independent professional trustees from personal liability for matters that cannot be contracted out of, such as rates and taxes. Nonetheless the application for liquidation was approved on the basis of public policy.

Companies – Risks for Lenders and Creditors

Where a creditor knows that its debtor is unable to meet its debts as they fall due, the creditor is in a catch 22 situation.

The creditor will naturally enough want to press for immediate payment. Doing so, however, may be the precipice for the company's liquidation. In that case, amounts repaid to the creditor at the creditor's behest will be voidable and at risk of being clawed back by the liquidator under the voidable preference provisions in the Companies Act. Although a creditor's risk in these respects is less than was previously the case prior to the clawback period having recently been scaled back from 2 years to 6 months (other than for arrangements with related parties), nonetheless it is invariably the last 6 months that is the window of greater concern. Hence creditor risk, both legally and pragmatically speaking, remains.

How might a creditor overcome the risk of suffering a voidable preference claim and having to return monies paid to it? A common solution is to obtain repayment from a third party instead of repayment directly from the debtor company. There are constraints, however, that mean this is not always a viable solution. No constraint exists where it is the debtor company's bank that makes the payment. On the other hand, where payment is made by a shareholder of the debtor company, the risk of clawback remains. That is because the shareholder will be treated as having effected repayment on behalf of the debtor company. So too does that risk remain where payment is made to the creditor by a third party who is itself indebted to the debtor company (e.g. a customer of the debtor). Payments from such persons are again, for purposes of the clawback provisions, treated as having been made on behalf of the debtor company.

The Supreme Court 2019 decision in Robt Jones Holdings Limited v McCullach is illustrative. In that case, the debtor company, Northern Crest Investments Limited (Northern Crest), had become indebted to Robt Jones Holdings Ltd (RJH) for unpaid rent of approximately $756k.

At issue was part payment of the unpaid rent, not by Northern Crest but by its Australian subsidiary.

RJH argued, rather imaginatively, that the voidable preference provisions in the Companies Act did not represent a code. They argued although the legislation did not provide for it, nonetheless it was implicit that the voidable preference provisions only apply when a creditor payment causes a diminution in the debtor company's pool of assets available to the unsecured creditors. RJH argued that no such diminution of assets had been suffered by Northern Crest because the payment by the subsidiary:

a) was deemed to have been advanced by it to Northern Crest;
b) the amount was deemed to have been paid to RJH on Northern Crest's behalf; and
c) Northern Crest's overall debt position remained the same, the debt to RJH having been substituted for another, both of the same amount.

The Supreme Court did not agree that there existed any requirement for diminution of sums available to unsecured creditors and found against RJH.

Another case that is illustrative of the point involved Ebert Construction. In that case, a payment made on behalf of a developer to Ebert was made by the developer's bank. This was sufficient to safeguard the payment from being successfully clawed back.

Further points to note:

a) payments made by a voluntary administrator are not at risk of being clawed back and nor are amounts paid by a receiver in discharge of an amount for which the receiver is personally liable; and
b) amounts paid to suppliers who continue to supply to a company at the liquidator's request are also not at risk.

Business Structure Choices

This article addresses the circumstances in which companies, limited partnerships and trading trusts, respectively, are chosen for a business arrangement.

a) Companies

The tax rate, at 28%, for companies remains aligned with international norms and with the top individual rate now at 39%, trading through companies offers a significant tax advantage. That tax advantage represents a temporary advantage only where the shares are held by individuals and company profits are taxed in their hands at 39% upon the profits being distributed. The tax advantage is permanent where the shares are held by a trust, taxed at 33%, resulting in an effective tax benefit of 6% on the company's profits.

Revenue officials are acutely mindful of this benefit and IRD is considering dividend integrity measures to circumvent it. One possible measure is the return of an excess retention tax, which was repealed in 1989. An excess retention tax overcomes the benefit of deferring personal tax liability on dividend income by imposing an immediate tax liability where distribution of a company's profits is delayed. Perhaps this tax benefit will be short-lived, but for the moment, the tax benefit arising from the misalignment of the company tax rate and the top personal tax rate remains.

Companies also benefit from the absence of any thin capitalisation rules, other than for companies that are controlled from overseas. Thus, companies can be financed with whatever debt/equity balance is desired, often weighing in favour of shareholder loans in preference to paid up capital. This maximises flexibility in capital flows in and out of the company. It also permits transference of company profits by attaching interest to the shareholder loans.

There will be encouragement to fund a company by way of shareholder loans wherever a shareholder is exempt on its income (e.g. a charity) or has tax losses available to it. By attaching interest to the shareholders loan, taxation at the company level is reduced and where tax exemption or the availability of tax losses results in no tax being paid at the shareholder level, the overall tax burden is reduced.

A downside to using a company is the rules applying to distribution of capital gains. Other than for look through companies, capital gains can only be distributed tax free on liquidation. For property owning companies this often necessitates use of a separate company for each property ownership.

b) Limited Partnerships

The look through feature of limited partnerships for tax purposes makes them attractive where start up costs are expected to be high (facilitating immediate use of deductions at the ownership level, subject to loss limitation rules), capital gains are anticipated (overcoming the distribution rules for companies referred to above) and where the owners have different tax profiles, particularly where one or more of them is a non-resident.

The advantage of adopting a limited partnership structure where non-residents are involved is the absence of non-resident withholding tax on the limited partnership's income and consequently, only one level of taxation on that income (at the level of the limited partner). In contrast, investment in a company entails tax at the company level and then again at the shareholder level, subject to available credits or dividend exemption.

c) Trading Trusts with a Corporate Trustee

These offer the advantage of flexibility of distribution of income amongst the beneficiaries, whilst largely sheltering the trustee from risk, courtesy of the limited liability available to the corporate trustee. Often, the corporate trustee will have little or no assets of its own and, notably, no minimum capital requirements exist.

It is particularly difficult for a beneficiary to bring a dog leg claim against the directors of a corporate trustee, as the directors duties are made to the company and not to the beneficiaries, hence use of a corporate trustee with minimal assets of its own will usually afford effective protection against trading liabilities that fall on the trustee.

From a tax perspective, although trading trusts cannot be used to pass losses onto a beneficiary, their tax appeal remains strong. That is because the trustee income can be retained in the trust and taxed at 33%, with no additional tax on distribution to the beneficiaries. Alternatively, the income can be distributed immediately to the beneficiaries and, subject to duties of impartiality and the like, freely distributed amongst those beneficiaries in a way that makes use of a low marginal tax rate applicable to one beneficiary ahead of another beneficiary on a higher marginal tax rate.

A further advantage of a trading trust is the absence of any registration requirement, other than for the corporate trustee.

Amalgamations

The means for two or more companies to merge by way of amalgamation is specifically provided for in the Companies Act. Available only to solvent companies, amalgamations are a convenient means of merging two or more companies.

Their convenience lies in the streamlined manner in which assets, liabilities and business contracts are transferred to the amalgamated (continuing company) and the tax concessions generally available on transfer. For example, there is no need to enter into an assignment of lease of premises or other contractual rights; the underlying contracts will instead become automatically assumed by the amalgamated company. Similarly, there is no requirement for share transfers for each of the amalgamating companies; instead the shareholdings in the amalgamated company will be recorded in the amalgamation proposal that is lodged with the Companies Office.

Employment contracts, because they are personal, are an exception – new employment contracts will need to be written in the new name of the amalgamated company.

Procedurally, for company groups steps to implement an amalgamation could not be much simpler. In those circumstances there are 3 pre-requisites:

- the Board of each amalgamating company must approve the amalgamation having first satisfied itself on reasonable grounds that the amalgamated company will, immediately after the amalgamation becomes effective, satisfy the solvency test;
- the shares of each amalgamating company, other than shares in the amalgamated company must be cancelled without payment or other consideration; and
- at least 20 working days notice of the proposed amalgamation must be given to secured creditors.

The effect of the amalgamation is that each amalgamating company, other than the amalgamated company if it is a continuing company, is removed from the register. The amalgamated company succeeds to all the property, rights, powers and privileges of each of the amalgamating companies and takes on their liabilities and obligations.

Where the amalgamating companies are not related, procedurally, a great deal more is required (specifically, a long form amalgamation proposal must be submitted to the shareholders for approval by special resolution). Nonetheless, even in these circumstances amalgamation remains a convenient merger mechanism.

Practical consequences of amalgamations are:

- an amalgamation effects a transfer of all assets and liabilities of the amalgamating companies without the need to obtain third party consents (underpinning this is the idea that all creditors are protected by application of the solvency test to amalgamation).
- directors are required to certify that the amalgamation is in the best interest of the company and this will require them to make extensive enquiries of each other amalgamating company. The scope of enquiries must extend to the solvency of the amalgamated company.
- in the case of a long form amalgamation proposal, minority buyout rights will be available to dissenting shareholders. Exercise of these buyout rights may, depending on the

level of dissent, have a significant impact on the solvency of the amalgamated company. For this reason, directors embarking upon a long form amalgamation proposal may choose to stipulate a minimum approval threshold that is higher than 75% or otherwise may stipulate a condition on there being minimal exercise by dissenting shareholders of their buyout rights.

- no goodwill arises in consolidation. This assists the attractiveness of amalgamation as a form of acquisition because goodwill (and particularly the practice of writing it off over time) is generally unattractive to investors given its detrimental effect on the company's dividend fund.

Tax concessions upon an amalgamation are dependent on the amalgamating companies each being resident in New Zealand and not treated under, and for purposes of a double tax agreement, as resident in another country. Moreover, tax concessions are not available where one of the amalgamated companies derives only exempt income. The tax concessions generally result in no dividend implications arising, no taxable gains on share sales arising and, similarly, property is generally transferred to the amalgamated company tax free.

Care is required in the case of imputation credits and tax losses. These may be forfeited if continuity and requisite grouping requirements are not maintained. In the usual course, these issues can be worked through, but it is critically important to review and consider any tax implications.

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