SPEAKMAN LAW

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Issue 23

What's inside

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- Shareholder Loans
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Briefly - sport

- Australian cricketers pay dispute resolved, ashes to go ahead
- Alistair Cook's 4th double century, now 9th on all time run getter list; James Anderson 6th amongst bowlers
- Colin Meads felled, legend lives on
- John Graham's massive tribute; well done AGS for entire school Haka in salute
- AB's, well, they make me wonder…

Briefly – Law/Special Interest

- Commerce Act cartel changes now law. Much broader price fixing prohibitions
- Trusts: Estimated 300,000 to 500,000 in NZ. Trusts Bill now before Parliament
- New Contracts and Commercial Law Act becomes law from 1 September
- MH370: Precise location now thought to be identified.
- Donald Trump expresses view that North Korea threatened missile strike on Guam is good for tourism. Meanwhile at home, he says Klu Klux Klan not entirely at fault for white supremacists. Hmmm…
- Peter Dunne over and out, Andrew Little, needed more, Metiria Turei… well how would you fare if you stole from the public?
- Will Winston be grinning come September 23?

Some famous quotes:

- We are what we repeatedly do; excellence is not an act but a habit.
- You can do anything, but not everything.
- Live life, like someone left the gate open.
- Everyone is a genius at least once a year. The real geniuses simply have their bright ideas closer together

… and it makes me wonder.

Hope you enjoy these. I have divided this newsletter into two parts, a tax edition and separately a commercial edition. I encourage you to read whichever edition (or both) suits you best.

Best wishes

Redeemable Preference Shares…

In capitalising a company there are, broadly, two alternative capital structures:

The subscription for fully paid ordinary shares;

The subscription of redeemable preference shares (RPSs).

Historically, RPSs were often preferred in order to overcome restrictions on returning capital. The 1993 company law reforms have long since superseded those restrictions yet a preference for RPSs often remains.

The issue of RPSs is mostly used as a financing tool where the subscriber prefers a dividend return rather than interest and is unconcerned about ranking behind secured and unsecured creditors.

Usually the RPSs will carry a fixed rate of dividend and confer no voting rights. RPSs issued on these terms allow massive flexibility because they do not count in measuring ownership of the company. Consequently an issue of RPSs can be made without fear of breaching continuity rules where the issuing company has either tax losses or imputation credits.

The legislative authority for RPSs lies in sections 68-75 of the Companies Act. Those sections offer flexibility of terms, notably as to how and when capital on the RPSs is to be returned. Redemption may be at the option of the company or at the option of the holder (or both). More usual is redemption at the option of the company with a fixed date for redemption, if not earlier redeemed.

Compliance with the Companies Act requirements, either to issue RPSs or to redeem them is straight forward.

This all begs the question why an investor might prefer RPSs for the dividend return they proffer in preference to making a loan and obtaining an interest return.

Preference for a dividend return will lie either in a tax exemption for the holder or an issuer's wish to soak up imputation credits (or both).

Locally, dividends on RPSs will not attract tax exemption unless the RPSs are in the hands of the wholly owned parent. However, cross border dividends may attract tax exemption in the holder's jurisdiction. That might give a tax efficient return, especially where the effective rate of non-resident withholding tax on the dividend is zero, either because the dividend is fully imputed or a double tax treaty delivers that result. Inevitably the same result would not be achieved, upon an interest return.

If you would like further information on the suitability of RPSs for your capital structure, please contact me.

Shareholder Loans…

An extension to the subject above is the choice of shareholder loans over contributions of capital. The making of a shareholder advance generally offers greater flexibility than does a contribution of capital. That greater flexibility lies in the absence of restrictions on returning share capital and the absence of any restrictions regarding repayment of shareholder loans. Furthermore, returns of share capital generally require analysis of the tax consequences, whereas repayment of shareholder advances is straight forward in that respect.

At a commercial level, shareholder loans will rank in priority ahead of share capital. Practically this is, however, of limited significance given that a company's financiers will have priority by way of a general security deed and shareholders are often required to take a subordinated credit position on their advances.

Similarly, the tax preference for shareholder advances arising from the attractiveness of a deduction for the interest is often illusory. Cross border advances will inevitably trigger a withholding tax liability that now applies on related party debt regardless of whether the interest is accrued or paid. Moreover, where there is a need for additional funding it is often because losses have been incurred, in which case there may be no present need for an interest deduction.

In contrast, for reasons discussed in the article above, an investor may have a tax preference for a dividend return.

Like everything there is no "one size fits all" solution here. Preference one way or another as between shareholder loans on the one hand and share capital on the other is all a matter of circumstance.

Subscription Agreements…

These can be simple or complex. They will be complex where the issuer is a company whose shares are listed on the Stock Exchange (in which case warranties will be key), where the terms attaching to the shares are specific (RPSs with a fixed redemption date, for example) or there is a significant dilution effect (see below).

Subscription agreements are commonly evident amongst founders of a joint venture company. In that scenario the subscriptions fund the company's intended operations and the agreement binds each of the subscribers to contribute their capital. Such agreements invariably overlap with a shareholders agreement and will set out, amongst other things, the intended operation of the company.

A simple subscription agreement on the other hand will record the subscriber's agreement to subscribe for shares on a given date for an agreed subscription price and the company's agreement to issue the shares, provision for default by the subscriber, and any conditions. Confidentiality is usual.

Whenever issuing shares to a new shareholder, disclosure requirements under the Financial Markets Conduct Act and the dilution effect on existing shareholders need to be considered. As regards

disclosure, ordinarily any problems can be overcome by attracting one of the exemptions available to wholesale investors (a separate topic in itself). The dilution effect on existing shareholders on the other hand is more difficult to overcome. If existing shareholders wish to retain their percentage voting rights then the new shares issued will either need to carry no voting rights or the existing shareholders (or at least the concerned shareholders) will require top up shares. Often on funding a company, the contributions of seed capital are given what is called a "free carry", for example a right to top up shares whenever their shareholding would fall below, say 10% of the total share capital, as a result of a further (later) share issue. Disclosure of any such free carry arrangements is critical.

Eligible Investors…

The Financial Markets Conduct Act 2013 (FMCA) broadly governs and requires disclosures on the issue of securities. The FMCA creates exclusions from these disclosure requirements in a raft of situations, including offers to persons in a close relationship to the issuer, offers made under an employee share scheme, small offers of equity securities and offers to wholesale investors, to name a few.

Wholesale investors are excluded from the disclosure requirements based on the broad premise that they are sufficiently experienced in financial matters to properly form their own opinions.

There is a range of categories that a wholesale investor may come within. Relevant for present purposes is where the person is an "eligible investor".

These are investors who self-certify that on the basis of their own previous experience in financial matters they are able to properly assess the merits of the transaction, ie effectively they are a sophisticated investor. The specific requirements for an eligible investor are contained in clause 41 of Schedule 1 to the FMCA and require that the investor certify in writing, before the products are issued, that the investor has previous experience in acquiring or disposing of financial products that allows the investor to assess the merits of the transaction (or class of transaction) including assessing the value and risks of the financial products involved, and other matters.

Significantly, a written confirmation of the investors certificate is required form an authorised financial adviser, chartered accountant or lawyer. Anyone giving such confirmatory opinion must be satisfied that the investor has been advised of the consequences of their own certification. They must also be independent of the offeror and have no reason to believe that the investor's certificate is incorrect or that further information or investigation is required as to whether or not the certification is correct. Advisers can be liable where they fail to take adequate care in these respects, hence this is more than a rubber stamping exercise and needs to be treated accordingly.

Acquisitions: Warranty Thresholds and Knowledge Qualifiers…

Anyone involved in the sale of a business (or shares) will know full well the difficulty in striking a balance between a vendor's wish to secure a clean get away for themselves and a purchaser's wish for protection. The vendor remains on the hook to the extent of warranties given for the agreed warranty period. It is grist to the mill that a vendor will seek to minimise his or her exposure under the warranties as much as possible.

Limitation of the vendor's exposure is achieved in three ways:

a. By limiting warranties to the extent of the vendor's knowledge (termed knowledge qualifiers);

b. Caps and collars, ie capping a vendor's liability under the warranties and shielding a vendor from liability for small claims;

c. Warranty periods.

I am often asked what is usual in these respects. A pat answer to that is to say that every deal is different and parties' acceptance or rejection of risk is in every case different. Plainly that is right but some broad threads follow.

First, some knowledge qualifiers (KQs) are usual, particularly where the purchaser has carried out its own due diligence and therefore has a feel for the risk. KQs are never given for "title warranties" or fundamental warranties. They are usually accepted where the vendor could not be expected to know a matter without carrying out its own due diligence. Some purchasers on the other hand simply refuse to accept them. Alternatively, a purchaser may accept them only on the basis of an increased warranty cap.

Secondly, warranty caps are usually a percentage between 50% and 75% of the purchase price. I have been involved in many transactions where the cap has been set at two thirds of the purchase price. For smaller transactions the cap is sometimes 100% of the purchase price.

Thirdly, warranty collars are set at a dollar figure, $20,000 is low; $50,000 is common (assuming some size to the transaction) and $100,000 is high. Invariably where the collar is exceeded, the purchaser's claim is not limited to the amount in excess of the collar and is instead for the full amount of loss.

Fourthly, warranty periods usually differ as between tax matters and non-tax matters. For non-tax matters, a norm is 2 years. For tax matters a norm is 6 years. This is on the basis that Inland Revenue broadly has that period of time within which to re-open and increase an assessment. In reality whilst this seems a long period, Inland Revenue's ability to re-assess for the 5th income tax year preceding completion runs out only 1 year after completion; and as regards the 4th income tax year preceding completion, that right runs out only 2 years after completion and so forth.

Not mentioned above are other carve outs that are often negotiated from warranty claims. If interested please let me know and I will advise you of them.

Our Website…

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

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