IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

C.P. NO: 2939/88

BETWEEN FIRST FISHING COMPANY LIMITED a duly incorporated company having its registered office at Auckland, Investment Company

Plaintiff

A N D WAIRAU ENERGY CENTRE LIMITED a duly incorporated company having its registered office at 849 East Coast Road, Browns Bay, Motor Spirits Retailer

Defendant

Hearing: 11 July 1990

Counsel: G N Jenkins for plaintiff
N W Ingram for defendant

Judgment: 28 NOV 1990

JUDGMENT OF JEFFRIES J.

The issues in this proceeding concern a contract dated 14 September 1987 (hereafter referred to as the Agreement) for the sale and purchase of shares in the defendant company (hereafter referred to as Wairau). The Agreement itself was one of moderate complexity, and to an extent it is unclear the exact role played in the whole transaction by Cruise Corporation Limited (hereafter referred to as "Cruise") from whom the plaintiff took an assignment of a debt said to be owed by Wairau.

As its full name suggests Wairau is an energy centre operating on the North Shore at Auckland. The shares in Wairau were owned by 2 companies, Darlington Investments Ltd (139999) and Von Tempsky Nominees Ltd (1) and both executed the Agreement as vendors. For convenience I need not mention the latter company again. The purchaser was Shaun Stanley Patrick O'Malley of Auckland, service station proprietor, who had the right to nominate another as the purchaser. Cruise was party to the Agreement and described therein as the Covenantor. It is not entirely clear what part Cruise actually played in bringing about the sale and purchase and that issue will be returned to later. Before the assignment to the plaintiff it was Cruise that claimed to be entitled to a management fee having a total of $200,600 which is the sum at issue in these proceedings.

I return to details of the Agreement. The vendors agreed to sell and the purchasers to buy the shares in Wairau for the sum of $450,000. A deposit of $5,000 was to be paid on execution with a further sum of $45,000 in part payment on 30 September 1987. The date of settlement was set at 1 February 1988. The scheme of the Agreement was a short central document recording the main details of the contract and the machinery, so to speak, for implementation of the contract was contained in 9 separate schedules. The financial matters pertaining to the company were set out in the Fourth Schedule. The Fifth Schedule also contained important provisions regarding future business decisions of the company following the contract becoming unconditional. The contract did become unconditional. Of central importance in this case is the following provision contained in the Fifth Schedule:

> "5.12 The net profit of Wairau Energy Centre Limited for the year ended 31 March 1987 namely $253,231 and the net profit for the period 1 April 1987 to the date of settlement will be taken out of the books of the company on or prior to the date of settlement or as soon after the date of settlement as the net profit for the period to the date of settlement is established by the declaration of a

> dividend or dividends and/or by Cruise Corporation Limited charging a management or service fee to the intent that the shares are sold on the basis the Vendors and/or Cruise Corporation Limited shall be entitled to such net profits and that the Profit and Loss Appropriation Account shall be left with a credit balance of $11,777 being the amount standing to the credit of such Account at 31 March 1986."

By the date of the Agreement at 14 September 1987 the financial statements of Wairau were available for all to examine and no doubt the purchase price of the shares was at least partly based upon those statements. The net profit for the year 31 March 1987 was fixed at $253,231 and was to be taken out of the company by one of 2 methods. The method of a management or service fee was chosen. The intent of the clause is stated specifically in the clause so as to resolve doubt on questions of construction and is comprised in the final five lines. Furthermore any profits accruing to the company from 1 April 1987 to date of settlement were to be dealt with in a similar fashion. The Profit and Loss Appropriation Account was to show the same figure as it had stood at on 31 March 1986 namely $11,777 in credit. I think it is important to record here that the meaning or construction to be placed on that clause is not in issue. For reasons set out later in this judgment the purchasers of the shares do not admit liability to pay.

The transaction proceeded to settlement, but not without problems. On Friday 18 March 1988 I made several orders by consent arising out of a set of proceedings O'Malley & Others v Darlington Investments Ltd & Others (Auckland Registry, CP No 328/88). The orders made by me clearly enough represented interim settlement of an application brought by plaintiffs for interim injunctions.

The first and second plaintiffs were required to procure a bond for $250,000 for the benefit of the first and second defendants. Upon receiving the bond the defendants (the

owners of Wairau shares) were to vacate the said premises of the energy centre and relinquish control to the defendant company Wairau. There were several other orders made connected with the orderly transference of the business to the new owners. Most importantly there was an order that the parties go to a single arbitrator to be agreed upon or nominated by the Court. Various terms of the arbitration were set out including a timetable. The central issue for the arbitrator was:

> "What is the balance purchase price payable as at the date of the arbitrator's determination in terms of the agreement."

The parties agreed upon Mr John C Hagen, a qualified chartered accountant to act as sole arbitrator and he entered upon his office and completed the arbitration. He made an award dated 19 May 1988. He determined the net assets to be $133,101, with the balance of the purchase price at $142,389. It is not necessary in this judgment to set out how that figure was reached. Of central importance in these proceedings is that the management fee payable to Cruise had become very much an item of dispute by the purchasers of the shares. Submissions were made to the Arbitrator and Cruise had been named as a third defendant in CP No. 328/88 and evidently took an active role in the arbitration. The most complete and satisfactory way of dealing with the Arbitrator's decision is to reproduce in its entirety the part of the Award wherein this issue is decided.

> "5. Management Fee
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> It is contended on the part of the purchaser that the deduction of a management fee as evidenced by the invoice dated 31 March 1987 included as Exhibit 11 is not a proper and justifiable charge and that such could or will lead to a significant tax liability should the Commissioner of Inland Revenue not permit the deduction thereof. Evidence was given that the vendor had purchased the shares effective 1 January 1987 although

settlement did not take place until sometime after 31 March 1987.

There was much argument as to what sort of evidence should be produced in support of the management charge and apart from providing a copy of the invoice mentioned above and a copy of the agreement known as the Russo agreement included as Exhibit 12 little was forthcoming.

It was submitted for the purchaser that in terms of Clause 5.13(f), 5.06 and 4.01 that the management fee should not be permitted as a deduction and consequent there upon a tax liability recognised and subtracted in the calculation of net assets. While such was argued strongly during the hearing it is noted that such a deduction was not included in the initial submission made by Mr Gosling and Mr Ramsay on behalf of the purchaser.

On the other hand Mr Spear for the vendor argued strongly in terms of Clause 5.12 which clearly provides for the payment of a dividend or management fee to the vendor such that the profit and loss appropriation account should be left with a credit balance of only $11,777, that being the balance outstanding at the beginning of the March 1987 year.

In fact the management fee removed left a slightly higher net asset position but neither party sought further adjustment for this sum.

With regard to the potential tax position Mr Spear for the vendor relied on the contents of Clause 5.04 which clearly indemnifies the purchaser for unknown liabilities including taxation and Clause 7.01 which again provides some protection for the purchaser.

However the basic reliance of the vendor is placed on Clause 5.12 and the submission is that the purchasers are attempting to rewrite the agreement to their advantage if the contents of this Clause are not accepted.

This is an extraordinarily complicated and vexed question with serious ramifications for both parties.

Given the submissions made to me and my knowledge of commercial transactions upon which I am entitled to draw I find that the management fee should be left as a charge in the financial statements and that the purchaser should rely upon

> the protective warranties included in the Agreement with respect to any future tax liability that may eventuate."

With the reproduction of the Arbitrator's finding on the issue the exegesis of the issue really ends apart from an observation or two. The Court is not informed about the nature of the events before or after the Agreement dated 14 September 1987. In fact there is much the Court does not know about the whole transaction but it is in the hands of the parties and they must accept responsibility for the way the case has been shaped for the Court's consideration. Both parties have chosen to narrow the focus largely to Clause 5.12 of the Agreement with possible tax liabilities and for the Court to make the decision whether the management fee is payable or not. The Award states "The vendor had purchased the shares effective 1 January 1987 although settlement did not take place until sometime after 31 March 1987." The vendor was identified in the Award as Cruise and O'Malley as the purchaser. However, as the vital date was 18 December 1987 the settlement date of the contract apparently had been departed from by agreement. From the Arbitrator's Award it appears the principal objection raised by the purchaser was the possible tax implications and the Arbitrator thought they could be satisfactorily managed in another way as he stated. In any event his award is clear and it was that the management fee should be left as a charge in the financial statements of Wairau.

It is perhaps appropriate to mention here that the new owners of Wairau have challenged the Arbitrator's Award by proceedings in this Court but no progress has been made on their disposal and apparently Wairau is even in default in time on interlocutory orders in those proceedings.

It is now possible to face the proceedings before the Court for decision. Plaintiff as assignee of Cruise's chose in action seeks to recover the sum of $200,600 from Wairau made up as follows:

Management fee	$179,599
GST	$ 17,950
Disbursements	$ 3,150
	$200,600

The quantum of the claim itself is not disputed but on behalf of the defendant it is alleged it is not payable at all. The defences will be dealt with hereafter.

Plaintiff filed several affidavits covering the matters dealt with to this point in the judgment. The plaintiff's claim may be stated quite simply and it is that there was a contract entered into between the parties wherein a management fee was agreed to be paid in terms of Clause 5.12 of the agreement. The terms of the Clause are unmistakably clear on this issue. The invoice for the management fee was rendered on 31 March 1987 and has not been paid. The date of the invoice is almost 6 months before the date of the agreement. At the hearing Mr Jenkins for the plaintiff called Mr John Hagen for cross-examination on his affidavit which had annexed to it his Award. Also called was Mr R M Hayward, a chartered accountant who had filed 2 affidavits. At the material time he was an executive of Cruise and had been responsible for rendering the invoice to Wairau and had performed certain work connected with the sale and purchase. No other witnesses were called at the hearing and argument proceeded on the affidavits. It is convenient to mention here plaintiff had sought to obtain a summary judgment but after a hearing before Master R P Towle on 17 July 1989 he reserved his decision but dismissed the application and the case proceeded to a substantive hearing before me. All affidavits filed in the summary judgment application were available to me.

Under cross-examination Mr Hagen seemed to the Court to summarise the position on the management fee with this reply:

> "That clause to me quite clearly contemplated that there would be in commercial terms a clearing out of Wairau

> Energy Centre to the level agreed between the purchaser and vendor as evidenced in Clause 5.12."

Mr Hagen's evidence was that it was a normal commercial transaction to transfer profits or resources from one company to another by way of management fee. He also said it was quite common in situations such as this one where a company is being sold, for resources to be transferred either in or out by way of management fee to ensure that at settlement date there is the agreed amount of shareholders funds. He clearly regarded tax consequences as a separate issue entirely from arriving at the amount of the shareholders funds to be left in a company as agreed between the parties. He did not deny that the tax implications had to be squarely faced but as a separate issue presumably in the ultimate between a taxpayer and the Commissioner. I quote again from his evidence:

> "It seemed to me provided that purchaser was protected by way of indemnities with regard to potential tax liability, that the purchaser was no worse off regardless of how the vendor transferred funds."

Mr Hayward's evidence was along the lines that management fees in circumstances as revealed by the evidence in this case are a common commercial practice and separate from taxation issues.

The history of this somewhat complex transaction has certainly not been placed before the Court in a convenient or easily assimilable form. This criticism is directed to both sides of this case. The Court also noted in the affidavit of Graham Chandler McHardy prepared for opposition to the summary judgment application an explicit reluctance to give evidence and the affidavit apparently was only supplied under threat of subpoena.

Mr McHardy stated that he and a partner named Paul Antonio Russo had for approximately 8 years prior to August 1987 been

the only 2 directors of Wairau and the actual managers of the business. The shareholders in Wairau were 2 companies beneficially owned by family trusts of the 2 directors. In April 1987 the shares in Wairau were sold to a company called AJS Brown Ltd but at settlement on 8 August 1987 the purchaser was Darlington, as previously mentioned. The purpose of Mr McHardy's affidavit was to state Cruise had never in that period, one assumes to 8 August 1987, been involved in any capacity as a manager providing services to Wairau.

The focus of attention now shifts to Cruise itself. This company was not incorporated until 18 December 1986. However, it seems from a letter dated 12 April 1988 addressed to Mr Hagen and clearly for the purposes of the arbitration he was conducting that a Mr K White on behalf of Cruise was the man who approached Messrs McHardy and Russo to purchase the business of Wairau. Apparently at date of incorporation of Cruise the land on which the Wairau service station operated was then owned by that company. That letter indicates that it was Cruise's intention at the time the purchase of Wairau shares from Messrs McHardy and Russo took place to involve itself in several aspects of the motor world. The actual purchaser of the shares from those 2 was in effect Darlington but the precise relationship of Darlington to Cruise was not directly revealed. One assumes it was close because of the Agreement dated 14 September 1987 that included 5.12 which gave to Cruise the management fee. From the material placed before the Court it is a reasonable inference that Cruise was instrumental in the purchase from McHardy and Russo and the on sale to O'Malley. It may be that McHardy is correct that he personally was not subject to any management decisions of Cruise on the station forecourt, as he says in his affidavit, but that does not conclude the matter against Cruise. It seems one of the problems of this case is a language one. As far as this Court is aware the

term "management fee" is not a term with a precise and fixed meaning. In its literal and perhaps traditional sense it was a fee paid for management services provided to a business. The services were usually direct involvement with that business's decisions. With the development of investment companies whose involvement in commercial enterprises which are targeted (often unknown to the target) for future investment, one way or another expend resources in several ways which must ultimately be recovered. That was Mr Hayward's evidence under cross-examination. Mr Ingram's approach throughout the hearing has been to conduct defendant's case on the traditional meaning of management fee and the plaintiff's case has been on the expanded meaning of the term as evidenced by business practice. Although he did not state his views in that way I think that in substance was Mr Hagen's approach in the decision he made on the arbitration and when he gave his evidence.

I turn now to the defences pleaded and argued. There were basically 2 defences advanced and each one had its variations. The first defence was that there was no agreement between Cruise and Wairau whereby Cruise would supply management services. The variation was that if an agreement to that effect could be implied then it was to pay Cruise a fee for services performed and as none were performed nothing is payable to Cruise's assignee. The second defence was that the whole arrangement was a fraud of the revenue, illegal and against public policy. An alternative defence was advanced that if the claim was for a sum representing a dividend then set off was claimed. The pleading of plaintiff never raised dividend and this issue may be put to one side. There was also a claim for set off even if plaintiff is entitled to a management fee.

I deal with the first defence that there was no agreement between Cruise and Wairau that a management fee be paid to Cruise. The Agreement of 14 September 1987 was bilateral in the sense that Mr O'Malley was the purchaser of the shares in

what appeared at that time to have been a desirable and worthwhile motor trade business. The other side comprised the owner of the shares, Darlington and an associated company being Cruise that seemed to have the role of éminence grise. It was a share sale and purchase which had been agreed upon between the parties. That is sometimes avoided in purchases of businesses mainly because of latent tax liabilities which might exist in the subject company. However, it was considered acceptable and the terms of the agreement covered the tax issues, as Mr Hagen pointed out. The purchase price was fixed at $450,000 and a special and central term (set out earlier in the judgment) was agreed upon that the Profit and Loss Appropriation Account would be lowered from $253,231 as at 31 March 1987 to its 1986 figure at that date of $11,777. Why the money was not taken from the company in the short period of Darlington's ownership is not disclosed but there would certainly have been a good reason. One should not oversimplify an issue if it brings distortion but it would appear there was an agreement entered into whereby Mr O'Malley would purchase the shares in the company for $450,000 which means he would get the assets he bargained for with the Profit and Loss Appropriation Account standing at the sum of $11,777 when he became the owner of the shares. The agreement he entered into was that as the future owner of the shares he understood the the company had a liability to meet a debt which was for the sake of commercial convenience called a management fee. He was binding himself as shareholder and the company so that at the moment he became owner of the shares the company had that liability to meet from the shareholders' funds. That was the way the deal was structured. No doubt it was partly on that basis the value of the shares was fixed at $450,000.

When the parties executed the Agreement dated 14 September 1987 there was clarity in that all parties knew what their obligations were. Mr O'Malley does not complain he did not know of or understand the terms of the agreement or they were not clear. He might have other complaints to be dealt with

in other proceedings but that is not an issue here. It seems to me that on the foregoing analysis in these proceedings Mr Ingram's argument based upon a very narrow definition of management fee in the way it has been earlier referred to in this judgment, does not meet the factual situation disclosed by the evidence.

I turn now to the argument based upon tax liabilities. Insofar as the argument is concerned with the possible tax implications of the arrangement might affect adversely Wairau, I put to one side on exactly the same grounds as Mr Hagen did which is basically one of relevance. If ultimately it does create problems for Wairau then it will have to look to its warranties.

I turn to the other argument advanced that the whole scheme was one to defraud the revenue and is therefore illegal and a nullity. On the evidence before the Court in these proceedings no such declaration will be made. Just as firmly the Court states it is giving no blanket approval for indiscriminate and improper schemes using so called management fees as a device to defraud the revenue. I believe the situation is helpfully stated in this extract from the cross-examination of Mr Hagen:

> "There is evidence before the Court from Mr McHardy who is one of the directors and shareholders of Wairau. Mr McHardy's evidence is to the effect that no management services were performed for Wairau by Cruise and there was no agreement to perform such services. If His Honour is to accept that evidence of Mr McHardy would that affect your evidence concerning the correctness of the management fee in these circumstances? It would depend whether the question is directed to the correctness of the charge for tax purposes or whether its an acceptable commercial device, in my view its an acceptable commercial device. Also in my view it is not an acceptable taxation device."

I think Mr Hagen's evidence is putting the issue correctly. He seems to be saying the management fee is accepted in the business and commercial world basically on the broadened

approach outlined earlier in this judgment. What is not acceptable is if it is used without any justification in fact and simply as a device to avoid properly payable taxes. Again the question and answer recorded above illustrates the fundamentally different approach of the lawyer for his client, and the witness as to the factual position before the Court. The evidence upon which the Court acts in making its decision is contained in the answer not in the question.

There was an affidavit filed by Mr Hayward in answer to Mr McHardy's affidavit of 20 March 1989. Mr Hayward in his former capacity as a director of Cruise and as part of his duties prepared a tax return for Wairau as one of Cruise's subsidiaries. He included in the accounts of that company which accompanied the return the management fee of $179,500 plus disbursements of $3150.00. That return has been assessed and those deductions allowed by the Inland Revenue Department as evidenced by the statement issued by the Department and annexed to his affidavit. Mr Hayward also said that the management fee and disbursements were deductible for Wairau and assessable income for Cruise and that that is how they have been treated by the Inland Revenue Department.

In the first amended statement of defence filed just prior to the hearing there is an allegation that the return referred to above for taxation purposes has not been prepared on a correct and proper basis. The averment further proceeds that the proper way to treat the management fee was on the basis of a dividend which would create a consequent tax liability to the defendant of $96,288 (at the rate of 48 cents in the dollar) plus 10% penalty interest. There was no evidence before the Court this scenario has actually occurred and when and if it does then Wairau can take the action it considers appropriate. It is not an issue in these proceedings. There was a further argument about treatment of stock reserve and resultant tax liability. In the Court's opinion there is at present in these proceedings no basis for the matters alleged

in defences (iv) and (v) in the first amended statement of defence. It would appear there is an attempt to alter the tax return already lodged with the Department by Cruise. The only comment the Court makes is that is not a part of these proceedings. It would appear there might be still issues outstanding between some parties but they may be decided in the proceedings P 328/88 (Auckland Registry) already mentioned, or by fresh proceedings. As far as the Court is aware there has not been a proposal to consolidate the 2 sets of proceedings.

There will be judgment for the plaintiff in the sum of $200,600 plus interest at 11% from 19 May 1988 being the date of the Award, to settlement. There will also be an order for costs according to scale and disbursements. Plaintiff is also entitled to the costs of $1000 fixed by the Master in the summary judgment proceedings.

Solicitors for Plaintiff: Mervyn Schamroth & Partners, Auckland

Solicitors for Defendant: Turner Hopkins, Auckland