

## CASE NOTES

### ***Avoidance: Penny v Commissioner of Inland Revenue***

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#### I INTRODUCTION

It was once observed by Diplock LJ that “[t]here are few greater stimuli to human ingenuity than the prospect of avoiding fiscal liability”.<sup>1</sup> Tax avoidance is as much about simplicity as ingenuity. The rule against avoidance is known as the general anti-avoidance rule (GAAR). It simply states that “[a] tax avoidance arrangement is void as against the Commissioner for income tax purposes”, and, in a roundabout way, defines avoidance as avoidance.<sup>2</sup> Unsurprisingly, there has been much litigation over what is avoidance, and what is not. Diplock LJ had in mind the ingenuity of taxpayers. In *Penny v Commissioner of Inland Revenue*, the ingenuity came not from the taxpayers, but from the judges. The straightforward structures adopted by the taxpayers were “entirely lawful and unremarkable” in the eyes of the Supreme Court.<sup>3</sup> And yet the Court concluded that the *use* of those structures constituted avoidance. This note explains how the Court reasoned from one side of the GAAR to the other, and analyses the implications of its decision.

#### II THE FACTS

Penny and Hooper were orthopaedic surgeons who saw an opportunity to save six per cent in tax and took it. They initially practised on their own account, and all profits were part of their personal income. They each adopted structures which enabled them to take advantage of the difference between the top personal rate of tax (which in 2000 was raised from 33 per cent to 39 per cent) and the company and trustee rates (unchanged at 33

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1 *Commissioners of Customs and Excise v Top Ten Promotions Ltd* [1969] 3 All ER 39 (CA) at 69.

2 Income Tax Act 1994, ss BG 1 and OB 1 (this was the Act in force for the years in question; however the GAAR is substantially unchanged in the Income Tax Act 2007).

3 *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, (2010) NZTC 24 at [33] [*Penny* (SC)].

per cent). Each sold his business to an incorporated company (owned by trustees of family trusts), and then became an employee of the company, as well as its sole director. As employees, they received a salary well below what they had received before. Penny's income dropped from around \$300,000 to \$100,000. Hooper's dropped from \$650,000 to \$120,000. This reduced their personal income, and increased income derived by the company, which was taxed at the lower rate of 33 per cent (as company or trustee income). Trust income was used to fund their houses, and to advance loans and pay dividends to them and other family members. For each, the tax savings for the years in issue were around \$20,000–\$30,000 per annum. Their day-to-day work remained the same. Patients still relied on the surgeons' care and skill, but now paid their bills to the company.

The taxpayers made returns on these lower salaries. The Commissioner of Inland Revenue (the Commissioner) contended that their actions amounted to tax avoidance, and assessed their income at a "commercially realistic salary".

Penny and Hooper took their case to the High Court and won. Mackenzie J held that the taxpayers were entitled to make the choices they did, which resulted in a tax saving. Their choices were neither artificial nor contrived,<sup>4</sup> and the idea of a commercially realistic salary was alien to the scheme and purpose of the Act.<sup>5</sup>

The Commissioner appealed, and was successful. By a majority of two to one, the Court of Appeal decided that the case was "incontrovertibly one of tax avoidance";<sup>6</sup> that Penny and Hooper had "patently sought to avoid their lawful taxpaying obligations by a rather obvious, indeed blatant, stratagem".<sup>7</sup> The salaries adopted were contrived and artificial because they were so far removed from acceptable commercial practice.<sup>8</sup>

All judges accepted that the correct approach to questions of avoidance was found in the Supreme Court decision *Ben Nevis Ltd v Commissioner of Inland Revenue*.<sup>9</sup> *Ben Nevis* distinguished between impermissible tax advantages (which contravene the GAAR) and permissible tax advantages (which are outside its scope).

### III THE SUPREME COURT DECISION

The unanimous decision of the Court (which included Elias CJ, Tipping, McGrath and William Young JJ) was delivered by Blanchard J. He began by recognising that "[t]he adoption of such a familiar trading structure

4 *Penny v Commissioner of Inland Revenue* [2009] 3 NZLR 523 (HC) at [45] [*Penny* (HC)].

5 *Ibid.*, at [57].

6 *Commissioner of Inland Revenue v Penny* [2010] NZCA 231, [2010] 3 NZLR 360 at [158] [*Penny* (CA)].

7 *Penny* (CA), above n 6, at [161].

8 *Ibid.* at [122].

9 *Ben Nevis Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289.

cannot per se be said to involve tax avoidance. It was a choice the taxpayers were entitled to make.”<sup>10</sup> For its part, the Supreme Court had little choice. It had to remain faithful to *Ben Nevis*, which made it clear that tax efficient structures involving companies and trusts were legitimate choices contemplated by Parliament.<sup>11</sup> Nevertheless, these structures can form part of a tax avoidance arrangement. On the facts, the Court identified three potential purposes of the structure adopted. The first was that it might afford some protection against medical negligence claims. The Supreme Court and Court of Appeal agreed that the structure could never achieve this purpose.<sup>12</sup> The second was that a combination of the structure and lower-than-usual salaries allowed the taxpayers to benefit their families through family trusts. This, too, was held to have little force, as the same effect could be achieved by paying salaries at commercially realistic levels, which could then be applied to benefit the surgeons’ families.<sup>13</sup> The third purpose, which influenced the salary levels “in more than an incidental way”, was to gain a tax advantage.<sup>14</sup> Saving money on taxes was the only effective purpose.

The Court accepted that the structure was legitimate, but held that the only effective *use* of that structure was not permitted as it would amount to tax avoidance. The only permitted use would be to pay salaries that matched the surgeons’ position when they had practiced on their own account.<sup>15</sup> It would seem to be something of a hollow choice if the taxpayers are required to act as if the choice had not been made. Whatever its effect, the Court focused on the level of the salary the surgeons paid themselves. The Act does not contain an express provision for setting salaries at “commercially realistic” levels, so the Court had to ask itself whether, in applying s BG 1, “the use of the structure which was adopted when the salaries were fixed was beyond parliamentary contemplation and resulted in a tax avoidance arrangement”.<sup>16</sup>

The Court answered this question in the affirmative. Three pillars supported its decision that the salaries had to be commercially realistic. It first considered an Australian case from the 1960s which treated a similar arrangement as tax avoidance. Secondly, it considered whether setting artificially low salaries was contrary to the contemplation of Parliament (and whether specific rules enacted to prevent taxpayers taking advantage of the six per cent rate differential meant that the GAAR would not apply). Finally, it turned to New Zealand case law (*Hadlee v Commissioner of*

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10 *Penny* (SC), above n 3, at [33].

11 *Ben Nevis*, above n 19, at [111] and [193].

12 *Penny* (CA), above n 6, at [121]; *Penny* (SC), above n 3, at [36].

13 *Penny* (CA), above n 6, at [120]; *Penny* (SC) above n 3, at [36].

14 Blanchard J went so far as to say it went beyond “more than incidental” and was in fact the taxpayers’ “predominant purpose”: *Penny* (SC), above n 3 at [36].

15 This is explicit in *Penny* (CA), above n 6, at [120], and implicit in *Penny* (SC), above n 3, at [47], and its upholding of the decision of the Court of Appeal.

16 *Penny* (SC), above n 3 at [33].

*Inland Revenue and Loader v Commissioner of Inland Revenue*),<sup>17</sup> drawing strength from one, and distinguishing the other.

### *Peate v Commissioner of Taxation*

The Court sought support from the analogous Australian case *Peate*, in which the actions of a group of doctors who had used a similar structure and paid themselves uncommercial salaries were found to be a clear example of tax avoidance.<sup>18</sup> There, several doctors changed from a partnership structure to a one that involved several companies. Each of the doctors formed their own companies, and were employed by those companies (which were owned by family trusts) to provide medical services. These individual companies then supplied the doctors' services to a central company which took over the patients formerly served by the partnership. The fee paid from the central company to the individual companies (and in turn, distributed to the family trusts) far exceeded the salary paid to the doctors themselves. As in *Penny*, the doctors sought to take advantage of the difference between the trust and personal tax rate.

Factually, *Peate* is on all fours with *Penny*. The GAAR that applied in Australia at the time covered arrangements having "the purpose or effect ... of ... avoiding liability" (words substantially repeated in the New Zealand definition of "tax avoidance arrangement", found in s OB 1 of the Income Tax Act 1994). At the time *Peate* was decided, the approach to avoidance was Lord Denning's "ordinariness test" from *Newton v Federal Commissioner of Taxation*, whereby an arrangement would not amount to tax avoidance provided it was "capable of explanation by reference to ordinary business and family dealing".<sup>19</sup> This definition had one obvious flaw: as soon as arrangements became common, they ceased to qualify as avoidance. In 1976 Parliament quashed this test by widening the definition of avoidance to include an arrangement that has tax avoidance as one of its purposes or effects, irrespective of whether it is referable to ordinary business or family dealings.<sup>20</sup> While it is clear that the judges who decided *Peate* did so on the basis of the *Newton* ordinariness test (the arrangement was, in the eyes of Taylor J, "about as far removed as possible from any concept of ordinary business or family dealing"),<sup>21</sup> this does not preclude it from being applied in *Penny*.<sup>22</sup> For one thing, *Peate* considered the purpose and effect of the arrangements as well as their ordinariness. For another, the explicit removal of the "ordinariness test" served to widen the

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17 *Hadlee v Commissioner of Inland Revenue* [1989] 2 NZLR 447 (HC); *Loader v Commissioner of Inland Revenue* [1974] 2 NZLR 472 (SC).

18 *Peate v Commissioner of Taxation of the Commonwealth of Australia* (1964) 111 CLR 443, affirmed (1966) 116 CLR 38.

19 *Newton v Federal Commissioner of Taxation* (1958) 98 CLR 1 (PC) at 466.

20 Income Tax Act 1976, s 99(2)(b).

21 *Peate v Commissioner of Taxation of the Commonwealth of Australia* above n 18, at 475.

22 *Penny* (SC), above n 3 at [45]–[47].

definition of avoidance. Avoidance was found under the narrow definition on similar facts; a fortiori the same conclusion should be reached on a wider definition.

### Parliament's Intent

Next, the Supreme Court turned to whether fixing salaries at artificially low levels was within the contemplation of Parliament as falling under the GAAR. Quoting Woodhouse P in *Challenge Corporation v Commissioner of Inland Revenue*, the Court viewed the GAAR as a “reflection of the firm and understandable conclusion of Parliament that there must be a weapon able to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages”.<sup>23</sup> Setting the salary at an artificially low level was one such “contrived transaction”.<sup>24</sup> In structuring their businesses and family affairs in such a way as to control the level of salary (as both director of the employer, and the employee), and receive trust income as beneficiaries, Penny and Hooper suffered no actual loss of income but obtained a reduction in liability to tax as if they had.<sup>25</sup> The medical practices were as profitable as before, the surgeons worked just as much, and yet by rearranging their affairs they obtained a practical tax saving, by taking advantage of the lower trust and company rate.

Parliament had anticipated the risks of setting the top personal rate above these other rates. Its response was to include specific attribution rules for personal services (PSA rules). Needless to say, the structures adopted by the taxpayers complied with the rules. Ellen France J felt the rules were of “some importance”, as they were relevant to whether the transaction was a contrivance against the purpose of the Act: “what the taxpayers here have done has not required particular ‘ingenuity’ such that Parliament could not have contemplated the use of company structures in this way”.<sup>26</sup> In other words, we can read between the lines to find the intention of Parliament. The absence of any specific rules against such an obvious strategy might suggest it did not consider the taxpayers’ strategy to be objectionable. The Supreme Court preferred words found in the relevant select committee report which noted that the attribution rule “supports the general anti-avoidance provisions of the Income Tax Act 1994”.<sup>27</sup> The GAAR would act as a “sweeper”, doing the residual work of the PSA rules.<sup>28</sup>

23 *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA) at 532.

24 *Penny* (SC), above n 3 at [47].

25 Adapting Lord Templeman’s dictum in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 555 (PC) at 561.

26 *Penny* (CA), above n 6, at [168]. David Cunliffe MP is recorded as saying that the rule was “written in very, very tight terms” and reflected a “deliberate policy of closing a loophole”, which seems to support the view that the Government’s response to the specific issue of the rate differential was clearly delineated: (23 May 2000) 584 NZPD 2447–2448.

27 Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill (27–2) (select committee report) at 11, cited in *Penny* (SC), above n 3, at [48].

28 *Penny* (SC), above n 3, at [48].

The Court turned to address the taxpayers' final argument: "that there is no concept of a commercially realistic salary to be found in the Income Tax Act — that it does not require that any employee be remunerated on such a basis".<sup>29</sup> Blanchard J agreed that there was nothing specific in the Act requiring "commercially realistic salaries", but was still of the view that where a "salary is not commercially realistic or, objectively, is not motivated by a legitimate (that is, non-tax driven) reason, it will be open to the Commissioner to assert that it was, or was part of, a tax avoidance arrangement".<sup>30</sup> We are reminded that the GAAR only comes into play where the taxpayer has complied with the rest of the Act; it necessarily goes beyond its specific provisions.

### New Zealand Cases

The Court drew some comfort from *Hadlee*, a case that involved the assignment of a share of income of a continuing partnership of accountants.<sup>31</sup> In *Hadlee*, the assignment of personal services income was seen as tax avoidance. Penny and Hooper did not *assign* their income, rather they created new entities which themselves *derived* the income of the business — two very different concepts at law.<sup>32</sup> On this basis it was argued that *Hadlee* could not apply. Blanchard J accepted that "this criticism has some force" but nonetheless applied *Hadlee* "by way of analogy":<sup>33</sup>

[I]t would be strange if someone were not for tax purposes permitted to assign income of this kind but could still construct artificially a means of obtaining the same effect for a purpose of altering the incidence of taxation.

It would seem that for avoidance purposes, there is no distinction between assigning income, and deriving income. Even though the business income was derived by a separate legal person (the company), the Court will treat this in the same way as if it had been derived by the doctors personally, and then transferred to the company to obtain a tax advantage.<sup>34</sup> This is more than a little jarring in the tax context, where form comes before substance, unless the form is a "mere façade" or "sham".<sup>35</sup>

The Court was not so benevolently disposed towards *Loader* (decided

<sup>29</sup> *Ibid.*, at [49].

<sup>30</sup> *Ibid.*

<sup>31</sup> *Hadlee v Commissioner of Inland Revenue*, above n 17. Randerson J in the Court of Appeal focused not on whether income is "assigned" or "derived", but on "diverting or splitting income generated by the personal exertions of individuals": *Penny* (CA), above n 6, at [106]. This was an interpretation endorsed by the Inland Revenue Department in the media: "IRD promises 'measured approach' after Penny & Hooper victory" *The National Business Review* (New Zealand, 24 August 2011), quoting Acting Commissioner of Inland Revenue Mary Craig.

<sup>32</sup> *Penny* (HC), above n 4, at [36]; *Penny* (CA), above n 6, at [171].

<sup>33</sup> *Penny* (SC), above n 3, at [50].

<sup>34</sup> Compare *Penny* (HC), above n 4, at [27]–[29].

<sup>35</sup> *Commissioner of Inland Revenue v Wattie* (1997) 18 NZTC 13,297 (CA); [1999] 1 NZLR 529 (PC).

in light of the *Newton* ordinariness test). In that case, an earthmoving contractor who had operated as a sole trader transferred his business to a company owned by a family trust. He then became the company's employee. His salary and director's fees were fixed at a level that meant the company derived substantial profits that under the old structure would have been derived by the taxpayer personally. Cooke J held that "the incorporation of a company [and] establishment of a family trust" were "familiar types of transactions" which it would be "natural to adopt".<sup>36</sup> He further noted that "the fact that trust and company were designed to and did work hand-in-glove, and doubtless under the effective control of the [taxpayer]" did not mean that it was tax avoidance.<sup>37</sup> He concluded that "the situation does not appear abnormally artificial".<sup>38</sup>

While it dealt squarely with the treatment of income derived by different legal persons (as distinct from the transfer of that income), the Supreme Court distinguished *Loader* on the basis that there was not enough discussion of the setting of the salary and directors fees, and because there were "very solid non-tax related reasons for the restructuring" (having greater access to finance, for example).<sup>39</sup>

### III COMMENT

The effect of *Penny* is that, where a business is transferred to a company, and without sound non-tax reasons pays its employee an artificially low salary in order to obtain a tax advantage, that will in some circumstances amount to tax avoidance. There are three aspects of the case which bear commenting on. Is the decision revolutionary, or does it fit comfortably with the common law on avoidance to date? The same question is then asked but this time from the perspective of company law. Is the Court's interference with salary setting to counteract an illegitimate tax advantage an equally illegitimate piercing of the corporate veil? Finally: where does *Penny* leave the law on avoidance (and in whose hands)?

#### Revolution or Progression?

As for the first question, Blanchard J pointed to *Peate*, and issued something of a rebuke:<sup>40</sup>

If all this is now thought to be revolutionary by tax planners ... our

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<sup>36</sup> *Loader* at 478.

<sup>37</sup> *Ibid.*

<sup>38</sup> *Ibid.*, at 479.

<sup>39</sup> *Penny* (SC) at [53]; *Loader*, above n 17, at 476.

<sup>40</sup> *Penny* (SC), above n 3, at [37].

response is that nearly 50 years ago ... neither the High Court of Australia nor the Privy Council had any hesitation in finding that there was tax avoidance.

It was a rebuke aimed as much at Crown Law as counsel for the taxpayers. While it was referred to in the lower courts, *Peate* did not feature in either judgment; it appears that neither side attached any significance to it (before the Supreme Court hearing began, Dr Michael Littlewood rightly expressed concern over *Peate*'s absence).<sup>41</sup> We can only speculate as to why so little attention was paid to *Peate*. It cannot be seriously argued that it is distinguishable. It may, then, have been thought that it did not form part of the New Zealand common law on the GAAR. But *Peate* is no bolt from the blue. Within a few short years of being reported it had been applied by the Court of Appeal in *Elmiger v Commissioner of Inland Revenue*, which involved a scheme where "[t]here was no change in the practical operation of the partnership" but "by reason of the scheme the appellants cut almost in two the income which they had previously enjoyed from the business".<sup>42</sup> North P adopted the words of Kitto J: "The arrangement bears ex facie the stamp of tax avoidance".<sup>43</sup> Prior to *Penny*, *Peate* had been cited with approval at least seven times at first instance (most recently in 1993),<sup>44</sup> five times in the Court of Appeal,<sup>45</sup> and twice in the Privy Council.<sup>46</sup> Even if around half of these cases speak to the problem of defining avoidance, and the other half speak to the secondary "annihilation problem" (which relates to the basis for the commissioner's re-assessment after "annihilating" or voiding the taxpayer's scheme), it is clear that *Peate* has been brought into the fold of the New Zealand common law on the interpretation of the GAAR. There was no reason for our tax practitioners to have been caught off guard.

Perhaps *Peate*'s omission might be explained (though not excused). It is not digitised on the two leading New Zealand legal research databases. Some online case citators only include recent cases or those from superior courts, and even then, list Privy Council decisions (including New Zealand cases citing *Peate*) under the "British" jurisdiction, making *Peate*'s adoption

41 Michael Littlewood "*Penny and Hooper* and stare decisis" [2010] NZLJ 404, cited in *ibid* at [38].

42 *Elmiger v Commissioner of Inland Revenue* [1967] NZLR 161 (CA) at 178–179 [*Elmiger* (CA)].

43 *Elmiger* (CA), above n 42, at 179.

44 *Elmiger v Commissioner of Inland Revenue* [1966] NZLR 683 (SC) at 693–694 [*Elmiger* (SC)]; *Govan v Commissioner of Inland Revenue* [1968] NZLR 163 (SC) at 165; *Marx v Commissioner of Inland Revenue* [1969] NZLR 464 (SC) at 470–471 and 473; *Udy v Commissioner of Inland Revenue* [1972] NZLR 714 (SC) at 721; *Dunn v Commissioner of Inland Revenue* [1975] 1 NZLR 465 (SC) at 468; *Hadlee v Commissioner of Inland Revenue*, above n 17, at 464; *Willis v Castelein* [1993] 3 NZLR 103 (HC) at 107 (where the Judge, discussing illegal contracts, noted *Peate* as one of several "well-known authorities on the legality of tax mitigation or avoidance" which "probably apply" in New Zealand).

45 *Elmiger* (CA), above n 42, at 178–179; *Marx v Commissioner of Inland Revenue* [1970] NZLR 182 (CA) at 205–206; *Wisheart, Macnab And Kidd v Commissioner of Inland Revenue* [1972] NZLR 319 (CA) at 325–326; *Commissioner of Inland Revenue v Gerard* [1974] 2 NZLR 279 (CA) at 284; *Challenge Corporation Ltd v Commissioner of Inland Revenue*, above n 23, at 547.

46 *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 (PC) at 593 and 596; *Ashton v Commissioner of Inland Revenue* [1975] 2 NZLR 717 (PC) at 723.

less obvious. In commentary, *Peate* tends to be omitted altogether,<sup>47</sup> or is only discussed in relation to the “annihilation problem”.<sup>48</sup> Whatever the explanation, *Peate* was of impeccable pedigree, and factually on point. “The facts speak not in a whisper but in a loud and clear voice”, just as they did in *Elmiger*.<sup>49</sup> It is unfortunate that *Peate* was apparently unknown to Penny and Hooper’s initial advisors, and not adequately made known to the Court at first instance or on appeal.

## Salary Setting

The fundamental issue in this case was the uncommercial salary paid by the companies to the doctors. If the salaries had been set at a commercial level, there would have been no avoidance. Aside from the difficulties in determining a “commercial” salary,<sup>50</sup> and drawing the line between those that are acceptable and those that are not, it would seem that the key question is whether the GAAR and associated provisions give the Commissioner and the courts the power to hold that companies must pay “commercially realistic salaries”.

This was the last point discussed in the judgment. With disarming simplicity, the taxpayer argued that because nothing in the Act specifically requires payment of a reasonable salary, companies should not be compelled to do so in order to incur a greater liability to tax. This is an argument that echoes Lord Tomlin’s speech in the *Duke of Westminster* case: “Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be.”<sup>51</sup> That approach fell out of favour long ago (and in the New Zealand context, would plainly render the GAAR a nullity). The taxpayer’s argument does, however, have a second forbear: the notion of separate corporate personality, recognised in *Salomon v A Salomon & Co Ltd*.<sup>52</sup>

The tension between maintaining the integrity of the tax base and the integrity of the corporate form is well illustrated in the 1930 Court of Appeal case, *Aspro Ltd v Commissioner of Taxes*.<sup>53</sup> Myers CJ was faced with facts not dissimilar to *Penny*. There, two directors sought to take advantage of the graduated income tax system. The structure of the tax system was such that a tax saving could be made by paying the directors an artificially high fee. It meant that the total tax paid by the company and by the directors personally was lower than it would have been had commercially realistic

47 It is not referenced in the 2011 editions of the *New Zealand Master Tax Guide*, or *Staples Tax Guide*.

48 See, for example the Brookers online commentary to the Income Tax Act 1994 at [ITA94C-GB 1 1.0] (available at <[www.brookersonline.co.nz](http://www.brookersonline.co.nz)>).

49 *Elmiger* (CA), above n 42 at 179.

50 *Penny* (HC), above n 4, at [57]–[61]; *Penny* (CA) at [183].

51 *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1 (HL) at 19.

52 *Salomon v A Salomon & Co Ltd* [1897] AC 22 [HL]. It is mentioned in *Penny* (HC), above n 4, at [27], and briefly mentioned in the transcript of the Supreme Court hearing at 46 and at 216–217.

53 *Aspro Ltd v Commissioner of Taxes* [1930] GLR 476 (CA) [*Aspro* (CA)].

fees been paid. They could do this because the two directors were also the only two shareholders. The Commissioner challenged the quantum of the fee. The Chief Justice, after citing *Salomon*, observed:<sup>54</sup>

[I]t is for the company, and the company alone, to say what amount it is to pay the directors as to their remuneration. The alternative is that the amount to be paid to the directors is in effect to be determined by the Commissioner of Taxes, and for this view I can find no statutory or other authority.

While the Chief Justice spoke in dissent, the majority agreed that the amount of the fee was a decision for the company, not the courts. One judge commented: “the inquisitorial powers vested in the taxing authorities ... cannot dictate to a taxpayer as to how he shall carry on his business”,<sup>55</sup> while the other noted that:<sup>56</sup>

“[I]n all cases where a company is paying for service whether that of directors or of ordinary employees of the company the question of *quantum* of payment is necessarily one of which the company must be the judge”.

*Aspro*, however, is not as helpful to the taxpayers as it might seem at first glance. For one thing, in spite of their trepidation over “piercing” the corporate veil, the majority did just that: they found in favour of the Commissioner and allowed the fees to be changed. This decision was confirmed by the Privy Council, which concluded that on the evidence, the fees were not payments incurred in the production of assessable income (and therefore not deductible) because there was no evidence of the involvement of the directors in the company, aside from the resolution fixing the directors’ fees.<sup>57</sup> In the second place, the judges determined that the uncommercial directors’ fees amounted to a “device for evading payment of tax”,<sup>58</sup> and that “these so-called directors’ fees are not what they purport to be, but are a method of distributing profits”.<sup>59</sup> It is interesting that in *Aspro* the scheme warranted a finding of evasion (a higher threshold), when the tax act in force at the time also included a GAAR.<sup>60</sup> However, in *Aspro* the payments were more “suspicious”<sup>61</sup> than “genuine”<sup>62</sup> (there is no suggestion of this in *Penny*), and at the time the Revenue was reluctant to invoke the GAAR.<sup>63</sup>

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54 *Ibid.*, at 479.

55 *Ibid.*, at 482.

56 *Ibid.*, at 485.

57 *Aspro Ltd v Commissioner of Taxes* (1932) NZPCC 630 at 634.

58 *Aspro* (CA), above n 53, at 482.

59 *Ibid.*, at 485.

60 Land and Income Tax Act 1923, s 170.

61 *Aspro* (CA), above n 53, at 482 and 484.

62 *Ibid.*, at 484 and 485.

63 Michael Littlewood “The Privy Council and the Australasian Anti-Avoidance Rules” [2007] BTR 175 at 188.

Myers CJ's concern for the corporate form did not mean he was blind to the tax avoidance opportunities that are available in closely held companies, with shareholders and directors closely linked. If anything, he was far-sighted:

[T]he Commissioner ought to have the power to review in the case of all private companies the payments made as remuneration ... and to disallow such payments to the extent that he might think them to be in excess of what should reasonably be paid. ... That power, however, in my opinion, he does not have at the present time.

He believed that without specific statutory permission, commercial decisions should be left to commercial actors — a sentiment alive and well today. One commentator notes: “I find the commissioner substituting his views for how people ought to behave commercially a little bit unsatisfactory”;<sup>64</sup> another describes the tax department as “riding roughshod” over personal business arrangements.<sup>65</sup> The simple fact is that the commissioner does, now, have the power envisaged by Myers CJ (though perhaps not couched in terms as specific as he might have liked).<sup>66</sup> The Commissioner's powers to “counteract any tax advantage” under s BG 1 “in the manner the Commissioner thinks appropriate” would seem to include an ability to set salaries. In *Miller v Commissioner of Inland Revenue*, Blanchard J observed:<sup>67</sup>

[The equivalent section in the 1976 Act] gives the Commissioner a wide reconstructive power. He ‘may’ have regard to the income which the person he is assessing would have or might be expected to have ... received but for the scheme ... making the assessment on the basis of the benefit directly or indirectly received by the taxpayer in question.

The Taxation Review Authority decision *Case W33* (involving the restructure of a dental practice and the payment of artificially low salaries, which amounted to tax avoidance) confirmed that under the reconstruction provision, the Commissioner has the power to adjust incomes to allow for a “market salary”.<sup>68</sup>

A reference to *Salomon* or *Aspro* would not have changed the Supreme Court's decision. It would, however, have made for a more well-rounded precedent; one which recognised both the importance of the corporate form, but at the same the clear statutory powers available

64 Christopher Adams “Tougher line tipped after tax victory” *New Zealand Herald* (Auckland, 25 August 2011) at B1, quoting Neil Russ.

65 Patrick Smellie and Jazial Crossley “IRD's ‘huge stretch’ on Penny and Hooper” *The Dominion Post* (Wellington, 24 September 2011), quoting Jo Doolan.

66 See also *Hadlee v Commissioner of Inland Revenue*, above n 17, at 464.

67 *Miller v Commissioner of Inland Revenue* (1998) 18 NZTC 13,961 (CA) at 13,980.

68 *Case W33* (2004) 21 NZTC 11,321, briefly mentioned in *Penny* (HC), above n 4, at [79]–[80].

in very special circumstances, which allow the Commissioner to interfere in commercial decisions to counteract tax avoidance schemes. At the very least this would have deflected the business community's complaints to Parliament, the source of the power, shielding the Supreme Court's legitimate use of that power in this case.

## Effect

The effect of this judgment cannot be overstated. As tax practitioners await the Inland Revenue Department's promised interpretation statement on the GAAR, there is no shortage of information to fill the void. *Penny* has been variously described as establishing "a form of domestic transfer pricing" (which "promises to be a valuers' delight");<sup>69</sup> as stating that "[t]axpayers must pay themselves a market salary unless other objective factors make this unrealistic";<sup>70</sup> by the Inland Revenue as preventing taxpayers "generating the profits" from paying themselves "a reduced salary" to gain "financial benefit [for] themselves or their family";<sup>71</sup> and by the Supreme Court in a media statement as disallowing "the payment of salaries at artificially low levels" where "tax avoidance ... was more than a merely incidental purpose or effect".<sup>72</sup>

These statements were all made by individuals well aware of the nuances of the judgment; all would agree that a short quote can never capture the true position. However carefully worded the case might be, *Penny*'s practical effect is founded as much on these snippets reported in the national media as the case itself. New Zealand is a nation of small- to medium-sized enterprises; many of these adopt the "classic kiwi model" for owner-operated businesses, with a structure similar to *Penny*.<sup>73</sup> Operational decisions (on salaries and fees), which in aggregate could have profound economic effects, will not always be made with the benefit of legal advice. On one interpretation, *Penny* imposes an obligation to pay "reasonable remuneration" in ill-defined circumstances, with ill-defined exceptions, to ensure that any tax saving is not more than incidental. Inherent in the GAAR is "the problem of discovering the limits of any general embargo" (to borrow from Woodhouse J in *Elmiger*) "peculiarly complicated by the fact that nearly all dispositions of property or income must carry with them

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69 Catroina MacLennan "Courts now favour IRD's view on tax avoidance" [2011] (33) Law News, quoting Neil Russ.

70 Daniel Hunt "Hard line on tax avoidance" *Herald on Sunday* (New Zealand, 4 September 2011) at A54.

71 "IRD promises 'measured approach' after Penny & Hooper victory", above n 31, quoting Acting IRD Commissioner Mary Craig. "IRD promises 'measured approach' after Penny & Hooper victory" *The National Business Review* (New Zealand, 24 August 2011), quoting Acting Commissioner of Inland Revenue Mary Craig.

72 Supreme Court Media Release (24 August 2011) at 2.

73 *Penny* (CA), above 6, at [176].

some consequential effect upon income tax liabilities”.<sup>74</sup> To that end, the Inland Revenue has released a Revenue Alert noting:<sup>75</sup>

We are more likely to examine arrangements where the total remuneration and profit distributions received by the individual service provider is less than 80% of the total distributions received by the controller [or] associated entities.

#### IV CONCLUSION

Revenue Minister Peter Dunne welcomed *Penny* with the words “[i]t is important to the integrity of New Zealand’s tax system that everyone pays their fair share of tax”.<sup>76</sup> It is not hard to read a moral into the Supreme Court’s decision: rich men like Penny and Hooper should not be allowed to use the tools given to them by the law to shirk their fair share of the tax bill. On that interpretation the actions of the Supreme Court and the Inland Revenue align more with the words of a Minister than the words of the Act.<sup>77</sup> But then that has more to do with the nature of the GAAR than any mischief on the part of the Court.

The late arrival of *Peate*’s case on the scene was unfortunate. Counsel on both sides could be cast with little difficulty in a variety of roles, from King Canute to Admiral Nelson. Both are poor caricatures: it was more a question of weight and emphasis than wilful ignorance. *Penny* reminds us that the common law is an integrated whole, and that cases send ripples across countries and across time.

There is a lot of misinformation surrounding this decision. *Penny* does not mean that a company cannot make commercial decisions that reduce its tax liability. What it does mean is that if salary payments are made solely in order to reduce its tax bill, those payments must be commercially realistic. If they are not, then the Commissioner and the courts have the power to adjust the payments so that they are commercially realistic. While it might have been useful for the Court to make the tension between tax and company law more explicit (along with the tiebreaking effect of the reconstruction provisions), there is no question that this is an interference sanctioned by Parliament. Any grumbings over the extent of the Commissioner’s powers, and the uncertainty that this may create,

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74 *Elmiger* (SC), above n 44, at 688 (quoted in *Challenge Corporation v Commissioner of Inland Revenue*, above n 23, at 532–533).

75 Revenue Alert RA 11/02 (1 September 2011).

76 “Dunne pleased with Penny and Hooper decision” *The National Business Review* (New Zealand, 24 August 2011).

77 Tipping and McGrath JJ observed in *Ben Nevis*, above n 9, at [102] that decisions on avoidance must be made “through the application of a process of statutory construction focusing objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisors have set up” (noted in *Penny* (HC), above n 4, at [75]).

should be addressed to Parliament, not the Supreme Court (and certainly not to the High Court of Australia). All *Peate* did was to identify the actions of Penny and Hooper as tax avoidance (with some help from *Hadlee*). The power to set salaries came not from some half-century old Australian case, but from the New Zealand legislature.

The wider impact of *Penny* is a little harder to discern. It may be further evidence that the Supreme Court is taking a more expansive approach to avoidance than the Privy Council ever did. In time, it may supersede *Ben Nevis*. *Ben Nevis* involved a complicated structure set up purely for the purpose of reducing tax on other income. It was a scheme one step removed from the taxpayers' primary businesses, "bolted on" in order to obtain a tax advantage. Even so, it was considered a "hard case", and the Supreme Court's decision on avoidance was by no means straightforward (though there was some doubt as to whether the specific provisions of the tax act had been complied with — which was not an issue in *Penny*). *Penny*, on the other hand, did not involve some additional structure bolted on to a legitimate business. Rather, it was a genuine structure adopted for an existing business. The actions of the taxpayers in *Penny* were nowhere near as contrived as those of the taxpayers in *Ben Nevis*. And yet the Supreme Court reached its decision in *Penny* with comparative ease. *Penny* could therefore be seen as lowering the bar: scenarios like *Ben Nevis* will no longer be seen as "hard cases".

Perhaps the fault lies not with the taxpayers, but with the tax system. Penny and Hooper appealed their case to the Supreme Court as much to clarify the law on avoidance for others in like situations, as for their own benefit.<sup>78</sup> For their own case, they received a clear enough answer, but for all others, uncertainty over the extent of Commissioner's power remains. We might recall the prayer of Ajax, pleading with Zeus to lift the fog that had fallen over a battlefield near Gallipoli: "Ἐν δὲ φάει καὶ ὄλεσσοῦ".<sup>79</sup> The translation favoured by the High Court of Australia is "save us from this fog and give us a clear sky, so that we can use our eyes".<sup>80</sup> But the unobtrusive Scot, Lord Dunedin, provides the most assistance. He freely translated it as "[r]everse our judgment as it please you, but at least say something clear to help in the future".<sup>81</sup> If Parliament takes up the challenge of clarifying the law, it would appear to have three options. It can align the rates of tax, kill off trusts, or repeal the GAAR. It is for Parliament and Parliament alone to decide which would incur the least collateral damage.

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78 "We were naive" — Gary Hooper" *The National Business Review* (New Zealand, 24 August 2011).

79 It was noted in the tax case, *Sr Aubyn v Attorney-General* [1952] AC 15 (HL) at 45 (which concerned interpretation of a tax act of "unrivalled complexity").

80 *Graham Barclay Oysters Pty Ltd v Ryan* [2002] HCA 54, (2002) 211 CLR 540 at [211] citing Homer's *The Iliad*.

81 *Sorrell v Smith* [1925] AC 700 (HL) at 716.

## *Perlustration in the Pathless Woods: Hamed v R*

SAMUEL BESWICK\*

When retreating to a secluded forest one expects to escape the intrusions of modern society. At the same time, there is an acceptance that one's activities, not hidden behind walls or beneath covers, may still be observed by passersby. But what are the implications when one's activities are targeted and captured by unmanned surveillance cameras covertly installed by law enforcement officers?

Between May 2006 and October 2007, New Zealand Police conducted an extensive investigation into alleged paramilitary training camps operating at various times and locations in the Urewera Ranges near Ruatoki. Throughout the investigation the police applied for warrants seeking, among other things, the authorisation of covert video surveillance. A number of search warrants were issued under s 198(1) of the Summary Proceedings Act 1957 (SPA).<sup>1</sup> Although the warrants did not authorise video surveillance explicitly, the police nevertheless installed motion-activated cameras in areas of land where they believed the camps were being held. All of the land targeted was private property. At various stages of the investigation the police would return to uplift any footage that had been captured.

The appellants were arrested at the termination of the operation. All faced firearms charges and some also faced charges of participation in an organised criminal group.<sup>2</sup> The Crown brought a pre-trial application to determine the admissibility of the covert video surveillance evidence at trial.<sup>3</sup>

The question of whether the evidence was improperly obtained raised two issues. The first issue was whether any of the evidence was obtained unlawfully: the appellants submitted that the surveillance activities were not authorised validly by the warrants or by any statute or common law principle. The second issue was whether the surveillance activities breached the appellants' right to be secure against unreasonable search or seizure under s 21 of the New Zealand Bill of Rights Act 1990 (NZBORA). In respect of evidence found to be improperly obtained, a third issue (not discussed in this case note) was whether exclusion of the evidence was proportionate to the impropriety.<sup>4</sup>

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\* BCom/LLB(Hons).

1 The police also obtained call data warrants and interception warrants: Telecommunications (Residual Provisions) Act 1987, ss 10A and 10B; Crimes Act 1961, ss 312CA–312CD.

2 Arms Act 1983, s 45(1)(b); Crimes Act 1961, 98A.

3 Crimes Act 1961, s 344A.

4 Evidence Act 2006, s 30(2)(b).

## I HIGH COURT (*R V BAILEY*)

Winkelmann J at first instance<sup>5</sup> assessed the lawfulness of the surveillance activities in the context of the then leading authority on covert video surveillance, *R v Fraser*.<sup>6</sup> In *Fraser*, the Court of Appeal held that s 198 of the SPA does not govern non-trespassory video surveillance because it is “directed to warrants for ‘entry’ to search for ‘things’”.<sup>7</sup> Although distinguishing *Fraser* on the facts, Winkelmann J agreed that s 198 applies only to in-person searches. The installation and use of unmanned visual surveillance devices was “clearly beyond what is contemplated” by the section because, if an occupier came across a stationary camera on their land, there could be no compliance with the s 198(8) requirement on officers to present a search warrant on request.<sup>8</sup> Interestingly, Winkelmann J considered that warrants could nevertheless legally authorise police to uplift surveillance cameras once placed, although the evidence obtained would be tainted by an illegal placement.<sup>9</sup>

Winkelmann J rejected the Crown’s argument that the police were acting pursuant to an implied licence to be on the land, holding that the installation of surveillance cameras was “far beyond any use of the land contemplated by the owners” or within the reasonable contemplation of others.<sup>10</sup> The police had therefore trespassed when installing cameras on the property.

Although finding that the video surveillance activities were unlawful, Winkelmann J did not accept that the activities were necessarily unreasonable searches under the NZBORA. Following *R v Williams*, she held that a search under s 21 occurs where there is an interference by the state with an individual’s reasonable expectation of privacy.<sup>11</sup> Winkelmann J found that an expectation of privacy could only reasonably be held by the appellants<sup>12</sup> in respect of activities conducted on land that was not open to use by the general public or in plain view of others on the land. In such circumstances she held that the police surveillance was unreasonable, involving as it did unauthorised entry onto private property. But where the appellants had no control over who entered the land, the video surveillance of their activity was not a search (and it was therefore unnecessary to determine whether it was unreasonable).<sup>13</sup>

It is difficult to reconcile Winkelmann J’s findings that video

5 *R v Bailey* HC Auckland CR1-2007-085-7842, 8 September 2009 at [98]–[100].

6 *R v Fraser* [1997] 2 NZLR 442 (CA).

7 *Ibid.*, at 452; see also *R v Gardiner* (1997) 15 CRNZ 131 (CA) at 136.

8 *R v Bailey*, above n 5, at [99].

9 *Ibid.*, at [106].

10 *Ibid.*, at [126].

11 *R v Williams* [2007] NZCA 52, [2007] 3 NZLR 207 at [48].

12 They were in fact the respondents in the High Court proceeding but were the appellants in the subsequent appeals.

13 *R v Bailey*, above n 5, at [158]–[165].

footage had been unlawfully obtained by trespass onto private property but the covert recording itself was not necessarily a search under s 21. Her conclusion arises from the distinction between the property-based definition of search under s 198 of the SPA and the privacy-based approach under s 21 of the NZBORA. Yet reasonable expectations of privacy exist on a continuum. Even a relatively low expectation of privacy, such as that subsisting in activities conducted in a (private) open field, falls on the continuum, and surveillance activities that interfere with that expectation might properly be considered searches.<sup>14</sup> If trespassory surveillance was in the circumstances relatively non-invasive, or urgent, that may indicate that it was not unreasonable. But it is still an assessment properly within the scope of s 21.

## II COURT OF APPEAL (*HUNT V R*)

The Court of Appeal disagreed with Winkelmann J's approach.<sup>15</sup> Departing from its reasoning in *Fraser*, the Court held that s 198 is capable of authorising the placement of unmanned surveillance cameras. The Court rejected a strictly literal interpretation of s 198(1) (focusing on a physical search) and held that the placement of surveillance devices could be considered activity associated with a search or seizure authorised by s 198. Indeed a seizure could include recovery of the camera footage.<sup>16</sup> The Court considered that:<sup>17</sup>

If the police can look personally (that is, conduct surveillance at the relevant location) there seems to us to be no logical reason why they cannot carry out the same sort of surveillance through surveillance cameras.

There are problems with that reasoning. First, the Court did not address the one factor that had persuaded Winkelmann J: the need for compliance with s 198(8). By equating surveillance activities to physical searches, the particular requirements of the general search warrant provision went unconsidered. Second, as the Court acknowledged, a literal interpretation of s 198(1) does not contemplate video surveillance. Third, in contrast to the comprehensive regimes that govern the use of tracking and interception devices,<sup>18</sup> no comparable legislation currently exists to regulate video

<sup>14</sup> *R v Williams*, above n 11, at [113]–[114].

<sup>15</sup> Although the Court did agree that there was no implied licence to conduct surveillance: *Hunt v R* [2010] NZCA 528, [2011] 2 NZLR 499 at [54].

<sup>16</sup> *Ibid*, at [38]–[40]; see *Hodgkinson v R* [2010] NZCA 457 at [42]–[45].

<sup>17</sup> *Hunt v R*, above n 15, at [41] per William Young P (for the Court).

<sup>18</sup> See Summary Proceedings Act 1957, ss 200A–200P; Crimes Act 1961, ss 312A–312Q; Misuse of Drugs Amendment Act 1978, ss 14–29.

surveillance. The threshold for granting warrants under s 198 is significantly lower compared to the strict requirements on other forms of electronic surveillance, which reflect a public interest in protecting individual privacy. More fundamentally, not only is a low threshold inconsistent with the surveillance regime proposed in the Search and Surveillance Bill,<sup>19</sup> but the very fact that the Bill proposes a specific regime suggests that Parliament did not intend the general search warrant provision to authorise covert video surveillance.<sup>20</sup>

The Court accepted that covert surveillance justifies “particular judicial scrutiny”.<sup>21</sup> Without expanding on the practical implications, the Court commented that the more a proposed surveillance operation engages privacy interests (for instance, surveillance of a bedroom compared to a yard), the greater the caution required of the warrant-issuer.

Such considerations should go not just to the lawfulness of the warrant, but also to the reasonableness of the surveillance activity under s 21 of the NZBORA. The Court declined to determine whether unmanned video surveillance is a search under s 21 (although it considered that the mere recording of activities occurring on a road in plain view is not properly described as a search).<sup>22</sup> In the circumstances, it concluded that as the surveillance had been conducted on open land, any reasonable expectations of privacy held by the appellants were limited.<sup>23</sup> Relying also on its finding that the warrants lawfully authorised the surveillance, the police activities were held not to be unreasonable.

### III SUPREME COURT (*HAMED V R*)

The Supreme Court unanimously overturned the Court of Appeal’s decision, both on the lawfulness and reasonableness of the covert surveillance.<sup>24</sup> Blanchard J, writing for the Court, held that s 198 is not capable of lawfully authorising video surveillance. The general search warrant provision governs the search and seizure of “things” that, at the time of applying for a warrant, are reasonably believed to be on property; whereas video surveillance is, by its very nature, prospective and the capturing of images of persons on land is not a search for “things”.<sup>25</sup> While largely affirming Winkelmann J’s decision on unlawfulness, Blanchard J rejected the

19 Search and Surveillance Bill 2010 (45-2), cls 42AA–61; see the discussion in Samuel Beswick “Targeted Visual Surveillance in New Zealand: An Analysis and Critique of the Search and Surveillance Bill” (2010) 2 NZLSJ 239.

20 *Hodgkinson v R*, above n 16, at [44].

21 *Hunt v R*, above n 15, at [42].

22 *Ibid*, at [49], [69]; see *Tararo v R* [2010] NZCA 287, (2010) 24 CRNZ 888 at [53]–[61].

23 *Hunt v R*, above n 15, at [42], [92](a).

24 *Hamed v R* [2011] NZSC 101 at [6]–[8] per Elias CJ, [149] and [178] per Blanchard J, [209] and [227] per Tipping J, [263] per McGrath J, [281] per Gault J.

25 *Ibid*, at [146], [150].

proposition that the police action in retrieving the video cameras could fall within the proper scope of s 198: the retrieval of an object by the person who placed it on land is neither a search for, nor a seizure of, that object.

The Court concurred with the lower Courts that the police had no implied licence to enter the land for the purpose of covert surveillance.<sup>26</sup> The police activities were therefore an unlawful trespass. In her minority decision, Elias CJ went further, holding that video surveillance (or indeed any action undertaken by the state) is unlawful in the absence of positive authority for it.<sup>27</sup> This abrogation of the “third source” theory of government power — obiter dicta in her judgment — was not accepted by the four other members of the Court.

While the Court unanimously agreed that the concept of search under the NZBORA is more extensive than its counterpart under s 198 of the SPA, the Judges were divided in their approach to s 21.<sup>28</sup> Blanchard J, for the majority, held that a search under s 21 occurs where there is an invasion of a person’s subjectively held expectation of privacy, which society is prepared to recognise as reasonable.<sup>29</sup> People do not have a reasonable expectation of privacy in open spaces where anyone is free to observe, and video surveillance that merely enhances visual observation does not convert such observation into a search.<sup>30</sup>

Video surveillance may constitute a search, depending upon the place which is the subject of the surveillance. If the surveillance is of a public place, it should generally not be regarded as a search (or a seizure, by capture of the image) because, objectively, it will not involve any state intrusion into privacy.

Whether a search is unreasonable is assessed having regard to “the nature of the place or object which was being searched, the degree of intrusiveness into the privacy of the person or persons affected and the reason why the search was occurring”.<sup>31</sup> Blanchard J held that an unlawful search will typically be unreasonable except where the breach was “minor or technical or perhaps where the police had a reasonable (although erroneous) belief that they were acting lawfully”.<sup>32</sup>

Tipping J, in a partial dissent, disagreed that an assessment of reasonableness has any bearing on the first stage of the s 21 inquiry. He

26 Ibid, at [7] per Elias CJ, [156]–[157] per Blanchard J, [219] per Tipping J.

27 Ibid, at [17]–[47]; cf [167] per Blanchard J, [217] per Tipping J. Compare *R v Ngan* [2007] NZSC 105, [2008] 2 NZLR 48 at [13], [45]–[52], [93]–[100]; Bruce Harris “The ‘Third Source’ of Authority for Government Action Revisited” (2007) 123 LQR 225.

28 Section 21 is not limited to a physical search for “things”: *ibid*, at [11] per Elias CJ, [164] per Blanchard J, [220] per Tipping J.

29 *Ibid*, at [163], citing *Katz v United States* 389 US 347 (1967) at 361 per Harlan J.

30 *Hamed v R*, above n 24, at [167]. Although Blanchard J considered that the position may be different when using equipment that captures images not able to be seen by the naked eye, such as infra-red cameras: see *Kyllo v United States* 533 US 27 (2001).

31 *Hamed v R*, above n 24, at [172].

32 *Ibid*, at [174], confirming *R v Williams*, above n 11, at [21]–[22] and [228].

favoured a liberal approach to the definition of search and considered that s 21 is “wide enough to cover watching persons or places by means of technological devices”.<sup>33</sup> For Tipping J, the cornerstone of s 21 is the reasonableness of the state activity. Even surveillance in a public place can constitute a search “but its reasonableness would be influenced by the public nature of the target area”.<sup>34</sup> So too the use of modern technology that is covert, intrusive and sustained affects the reasonableness of surveillance. Tipping J did, however, agree with the majority that the unlawfulness of a search is distinct from unreasonableness, reasoning that to hold otherwise would effectively substitute unlawfulness as the test under s 21.<sup>35</sup>

Elias CJ advanced a purposive approach to s 21 that focused on its underlying values. In her judgement, the right “to be *secure* against unreasonable search or seizure”<sup>36</sup> guarantees “security against unreasonable intrusion by State agencies into the personal space within which freedom to be private is recognised as an aspect of human dignity”.<sup>37</sup> The s 21 right protects not just privacy but a “right to be let alone” by the state.<sup>38</sup> That right can, contrary to the reasoning of the majority, extend to surveillance of activities conducted in public spaces.<sup>39</sup>

[I]n an age when technology makes surveillance impossible to resist, anywhere, the human right described in s 21 would be substantially obliterated if its scope is limited to what cannot be seen or heard by State agencies from public space.

Elias CJ similarly favoured an expansive approach to unreasonableness. Her Honour held that an unlawful search must necessarily be unreasonable because it cannot be reasonable for law enforcement officers to act unlawfully. Answering Tipping J’s reservations on the point, Elias CJ considered that lawfulness is a necessary but not determinative condition of reasonableness, and considerations such as whether a breach was technical or inadvertent are better taken into account when considering whether exclusion of evidence is proportionate to the impropriety.<sup>40</sup>

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33 *Hamed v R*, above n 24, at [220].

34 *Ibid*, at [222].

35 *Ibid*, at [226].

36 New Zealand Bill of Rights Act 1990, s 21 (emphasis added).

37 *Hamed v R*, above n 24, at [11].

38 *Ibid*, at [10], quoting *Olmstead v United States* 277 US 438 (1928) at 478 per Brandeis J.

39 *Hamed v R*, above n 24, at [12].

40 *Ibid*, at [48]–[51], referring to Evidence Act 2006, s 30(2)(b).

## IV DISCUSSION

The Supreme Court's decision on the unlawfulness of the video surveillance is incontrovertible. The regulation of covert video surveillance could not have been envisaged by the general search warrant provision enacted over 53 years ago. Neither the text nor the purpose of s 198 of the SPA indicates that it governs electronic surveillance. While the Court of Appeal's interpretation may have been an attempt to remedy an unsatisfactory deficiency in the law, the creation of intrusive state powers is a matter for Parliament to address, not the courts.<sup>41</sup>

It is similarly clear that the police could have had no implied licence to trespass onto private property for the purpose of conducting covert surveillance.

The Courts' reasoning under s 21 of the NZBORA is less straightforward. Given the broad impact of the judgment on search and seizure law, it is unfortunate that the Judges were unable to present a unified approach to the proper interpretation and application of s 21. The Judges' separate decisions on what it means "to be secure against unreasonable search or seizure" reflect fundamentally different perspectives on s 21.

The majority judgment of Blanchard J treats the definition of search as a threshold test, whereby an individual must have had a reasonable expectation of privacy before the courts will consider whether the police conduct in question was unreasonable. While ostensibly the orthodox approach to s 21, the reasonable expectation of privacy test is problematic when applied to electronic surveillance. Both branches of the test tend to narrow unduly the scope of s 21. Objective expectations of privacy are eroding gradually with growing public awareness of the availability and use of invasive surveillance technologies.<sup>42</sup> Likewise, an assessment of whether an expectation is subjectively held counter-intuitively penalises individuals who take steps to safeguard their privacy, as doing so may evince a belief that they are being watched and therefore have no expectation of privacy.<sup>43</sup>

Perhaps most problematic is Blanchard J's conclusion that when construing "search" under s 21, the covert nature of the surveillance is irrelevant, but instead what matters is "whether the subject of the surveillance was a place within public view".<sup>44</sup> His reasoning is premised on the assumption that video surveillance in public places simply enhances permissible visual observation. Yet it may be overly simplistic to analogise surveillance devices to human senses. The accuracy and targeted nature of surveillance devices, and the permanence of recordings, rarely make them

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41 *Hamed v R*, above n 24, at [1] per Elias CJ, [146] per Blanchard J.

42 *Moreton v Police* [2002] 2 NZLR 234 (HC) at [22]–[23].

43 *R v Gardiner*, above n 7, at 136–137.

44 *Hamed v R*, above n 24, at [168].

comparable to human perception and memory.<sup>45</sup> While the approach appears to align the definition of search with the warrant conditions proposed in the Search and Surveillance Bill,<sup>46</sup> it substantially restricts the scope of s 21. In essence, it shifts the focus away from privacy considerations in a return to a property-based inquiry, with the consequence that people are afforded no protection under s 21 except within constitutionally protected areas, regardless of the invasiveness of any surveillance devices employed by the state.<sup>47</sup>

Tipping J, on the other hand, was content to interpret search broadly because, in his view, the critical assessment under s 21 is the reasonableness of the state's intrusion.<sup>48</sup> The merit of this approach is that it bypasses the difficulties inherent in the reasonable expectation of privacy test. But because search is not defined in his judgment it leaves lower courts with little guidance on the scope of s 21.

The problem with defining search in terms of a reasonable expectation of privacy is that one's motivation for exercising the s 21 right is substituted for the right itself. Conversely, Elias CJ's purposive approach centres on what it means to be *secure* under s 21, which is synonymous with a right to exclude the state.<sup>49</sup> A broad interpretation of search is ascertained by considering the actions undertaken by the state, as well as the reasonable expectations of individuals, and determining whether in the circumstances the state has intruded upon personal freedom and dignity. From a human rights perspective, the benefit of this broad approach is that it is wide enough to cover invasive surveillance both of people in public places (even where they have no expectation of privacy) and of their private property in their absence.<sup>50</sup> As with Tipping J, Elias CJ's approach reconciles the inconsistencies between the broad definition of search under s 21 of the NZBORA and the more narrow definition in s 198 of the SPA. Both Judges' approaches to unreasonableness under s 21 also reinforce the onus on the state to prove compliance with the NZBORA,<sup>51</sup> by focusing the inquiry on the nature and intrusiveness of the state's actions rather than on individuals' expectations of privacy.

It is, however, Blanchard J's decision that forms the ratio of the Court's judgment. While the pathless woods may provide seclusion, they offer no guarantee to individuals seeking protection from unwanted intrusion by the state. In the context of covert video surveillance, protection under the law will arise where either unlawful trespass or the amorphous

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45 Krista Boa "Privacy Outside the Castle: Surveillance Technologies and Reasonable Expectations of Privacy in Canadian Judicial Reasoning" (2007) 4 *Surveillance & Society* 329 at 338–339.

46 See Search and Surveillance Bill 2010 (45-2), cl 42(c)–(d).

47 See Thomas Clancy "What does the Fourth Amendment Protect: Property, Privacy, or Security?" (1998) 33 *Wake Forest L Rev* 307 at 316–327.

48 Consistent with *R v A* [1994] 1 NZLR 429 (CA) at 433–434 per Richardson J.

49 A similar approach is explored in Clancy, above n 49, at 344–366.

50 *Ibid.*, at 361–366.

51 *R v Te Kira* [1993] 3 NZLR 257 (CA) at 261, 273–274 and 277.

threshold of a reasonable expectation of privacy is established. When undertaking that inquiry, the courts should remain cautious of adopting an approach that unduly hampers the s 21 right.

## V RESPONSE

Within days of the public release of the judgment, the Government announced its intention to pass urgent “temporary legislation suspending the effect” of the Supreme Court’s decision.<sup>52</sup> The Government’s concern was that the Court’s ruling on the unlawfulness of trespassory video surveillance would jeopardise ongoing police investigations and proceedings currently before the courts. Despite compelling criticisms of its proposal,<sup>53</sup> the Video Camera Surveillance (Temporary Measures) Act 2011 was passed under parliamentary urgency. The effect of the Act is that the use of covert video surveillance as part of, or in connection with, the execution of a search warrant, or the use of non-trespassory video surveillance, does not of itself render a search by the state unlawful. The Act is a temporary measure only, intended to expire once Parliament passes the more comprehensive surveillance warrant regime in the Search and Surveillance Bill. Section 21 of the NZBORA remains undisturbed by the Act, and the courts thus retain discretion to find a breach of s 21 where a lawful search was nonetheless “carried out in an unreasonable manner” or where “the circumstances giving rise to it make the search itself unreasonable”.<sup>54</sup>

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52 Claire Trevett “Urgent new law after Urewera case” *The New Zealand Herald* (New Zealand, 19 September 2011).

53 See, for example, Rodney Harrison “Why Govt plan to overrule top court is wrong” *The New Zealand Herald* (New Zealand, 23 September 2011); Andrew Geddis “Too many problems, why am I here?” (2011) <[www.pundit.co.nz](http://www.pundit.co.nz)>; Dean Knight “Covert video surveillance and the (c)overt erosion of the Rule of Law” LAWS179 Elephants and the Law (2011) <[www.laws179.co.nz](http://www.laws179.co.nz)>.

54 *R v Grayson and Taylor* [1997] 1 NZLR 399 (CA) at 407; see *R v Williams*, above n 11, at [24] and [227].

## *R v Steigrad*

BRADLEY ABURN\*

### I INTRODUCTION

In *R v Steigrad*,<sup>1</sup> the Court of Appeal examined the liability of directors, under s 58 of the Securities Act 1978 (the Act) for issuing a prospectus that subsequently became untrue due to a change in circumstances. The Court decided that the underlying purpose of the Act, which is investor protection, was best served by extending liability under s 58 to include subsequently false statements, subject to the common law defence of “no fault”. The case is relevant for all company directors who are involved in issuing securities to the public. Such directors should be on notice that their obligation to their investors to provide accurate information is a continuing obligation.

### II BACKGROUND

Peter Steigrad was a director of Bridgecorp Ltd. On 21 December 2006, Bridgecorp registered a prospectus, which Steigrad signed as a director, containing the statement that “Bridgecorp had never missed an interest payment or, when due, a repayment of principal”.<sup>2</sup> At the date of registration this statement was true. However, on 7 February 2007, Bridgecorp defaulted on a payment. The prospectus in its original form, now inaccurate, remained in the public domain. The Crown charged Steigrad under 58(3) of the Securities Act,<sup>3</sup> which provides:

Subject to subsection (4) of this section, where a registered prospectus that includes an untrue statement is distributed, every person who signed the prospectus, or on whose behalf the registered prospectus was signed for the purposes of section 41(1)(b) of this Act, commits an offence.

Although it seems clear that the truth must be assessed at the point in time when the registered prospectus is distributed, it is unclear when a prospectus is, in fact, “distributed”.

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1 *R v Steigrad* [2011] NZCA 304, [2011] NZCCLR 24.

2 *R v Petricevic* HC Auckland CRI-2008-004-29179, 25 March 2011 at [18].

3 In total, the five directors of Bridgecorp were charged with 18 counts under the Securities Act 1978, the Crimes Act 1961 and the Companies Act 1993.

### III THE HIGH COURT DECISION

Steigrad applied to the High Court to be discharged under s 347 of the Crimes Act 1961 in relation to the counts laid under s 58 of the Securities Act. Steigrad argued that s 58 does not impose criminal liability upon a director where the statements made in the prospectus were accurate when it was *first* distributed but may have become untrue because of an intervening change in circumstances.<sup>4</sup>

The Crown argued that because the prospectus was available to members of the public from 7 February 2007, when the statement became untrue, until 30 March 2007 it was continually “distributed” during that period.

In the High Court, Venning J held that s 58 required a positive act of distribution by the issuer or its director(s).<sup>5</sup> According to Venning J, a director is only liable under s 58 when there is an untrue statement in a prospectus at the time when it is first issued or at the time when an extension certificate is signed allowing the prospectus to remain in the public domain.<sup>6</sup> Venning J thus discharged Steigrad on the s 58 counts.

### IV ANALYSIS OF STEIGRAD’S ARGUMENTS

The Crown appealed to the Court of Appeal which stated the issue as follows:<sup>7</sup>

[W]hether, to attract criminal liability under s 58, a statement must be untrue at the time of first distribution or whether criminal liability can attach with regard to a statement that becomes untrue later.

Although it was the Crown that appealed to the Court of Appeal, the case is best analysed through a discussion of how the Court dealt with the arguments that Steigrad raised in support of Venning J’s interpretation. In delivering the Court of Appeal’s judgment allowing the Crown’s appeal, Glazebrook J addressed these three arguments in turn.

#### **Word Must Have Same Meaning Throughout a Section**

Steigrad’s first argument was that the terms “distributed” and “distribution” as used in s 58 should be interpreted as “first distributed” and “first distribution”.<sup>8</sup>

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4 *R v Steigrad*, above n 1, at [3].

5 *R v Petricevic*, above n 2.

6 *Ibid*, at [45].

7 *R v Steigrad*, above n 1, at [41].

8 *Ibid*, at [47].

The Court held that as a matter of statutory interpretation the term must have the same meaning throughout s 58. If this was not Parliament's intention, different terms could have been used in each subsection.<sup>9</sup> In particular, the meaning of "distributed" must be the same in relation to advertisements<sup>10</sup> and prospectuses.<sup>11</sup> The Court noted that under Steigrad's interpretation it would be difficult to assess when the various types of advertisements are "first distributed" as there is no formal registration process for advertisements (unlike the registration of a prospectus).<sup>12</sup>

The simple case of an investment statement, which must be sent to an investor before she subscribes for securities,<sup>13</sup> illustrates this point. The requirement that each investor receive an investment statement before subscription implies an individual communication to each prospective investor. Such a communication amounts to a distribution<sup>14</sup> and is thus caught by s 58. The Court held that it would be nonsensical to confine s 58 to the initial communication to the first potential subscriber who received that investment statement. If restricting the analysis to the first communication of an investment statement is inappropriate, then it follows that it is also inappropriate to limit the assessment of the prospectus to when it was first registered.

### Relevance of Signature

Steigrad next argued that the reference in s 58(3) to "every person who signed the prospectus" must define the scope of "registered prospectus that includes an untrue statement", because one cannot sign a prospectus that includes an untrue statement if at the time of signing the statement was, in fact, true.<sup>15</sup>

The Court rejected this argument. Section 58(3) first sets out when the offence is committed (when the prospectus is distributed), and then sets out those who are liable (the signatories) for the offence.<sup>16</sup>

### Relationship Between s 58 and s 59

Steigrad further submitted that Parliament intended s 58 to address initial distribution and that s 59 should be left to deal with statements that subsequently become false.<sup>17</sup> Section 59(1) provides:

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9 Ibid, at [48].

10 Dealt with in Securities Act 1978, s 58(1).

11 Dealt with in Securities Act 1978, s 58(3).

12 *R v Steigrad*, above n 1, at [49].

13 Securities Act 1978, s 2A(2)(b).

14 See also the definition for "distribute" in Securities Act 1978, s 2, which contemplates individual communication.

15 *R v Steigrad*, above n 1, at [52].

16 Ibid, at [53].

17 Ibid, at [67].

Subject to subsection (2) of this section, if an offer of a security is made to the public, or a registered prospectus relating to a security is distributed, or a security is allotted, in contravention of this Act,

... ,—

- (d) every person who has authorised himself or herself to be named and is named in any advertisement or registered prospectus relating to the security as a director of the issuer or having agreed to become a director either immediately or after an interval of time—

... commits an offence.

Steigrad made this argument because unlike s 58, a breach of s 59 cannot result in imprisonment.<sup>18</sup>

The Court rejected Steigrad's argument for three reasons. First, if this was Parliament's intention, the distinction between the two sections would have been explicitly stated.<sup>19</sup> Instead both sections use the term "is distributed" in relation to prospectuses.

Secondly, s 59 does not expressly deal with advertisements. If the distinction argued was intended it is unclear why an advertisement would not be subject to the same two-standard test as a prospectus.<sup>20</sup>

Thirdly, s 59 creates a summary-only offence, and thus the Crown could not charge a director in the alternative (that is, that the statement was untrue or at least became untrue subsequently) unless it proceeded with the prosecution summarily. This would have the peculiar result of the gravity of offending not being able to be considered in deciding how to lay charges. A director, who was merely negligent in believing that the statement was initially true, could be charged under s 58 whereas another director (in another case) may find out later that the statement had subsequently become untrue and leave the misleading statement in the public domain with actual knowledge. In the latter case the Crown could only charge the director under s 59, despite the offending being more serious.<sup>21</sup>

The Court held that the true difference between ss 58 and 59 is that s 58 is for breaches of the Securities Act that are, in essence, caused by untrue statements being placed in the public domain, whereas s 59 is reserved for all other breaches of the Act.<sup>22</sup>

<sup>18</sup> Compare Securities Act 1978, ss 58(5) and 59(1).

<sup>19</sup> *R v Steigrad*, above n 1, at [68].

<sup>20</sup> *Ibid*, at [69], although the Court did note that it is plausible that advertisements are covered by s 59 of the Securities Act 1978 by virtue of advertisements constituting an offer to the public. If this was the intention it seems odd that prospectuses are singled out for mention.

<sup>21</sup> *Ibid*, at [71].

<sup>22</sup> *Ibid*, at [73].

## V ADDITIONAL JUSTIFICATIONS FOR THE COURT'S INTERPRETATION

Two additional justifications were given by the Court for its interpretation.

### **Crown Interpretation More Consistent with Defences**

It is a complete defence if the signatory believed, on reasonable grounds, that the statement was true.<sup>23</sup> If Steigrad's interpretation were adopted, consider the case of a director, who signed a prospectus containing a false statement, which the director reasonably believed was true. That director would be absolved of all liability. But, as soon as that director discovered, or ought to have discovered, that the statement was false she is permitted to mislead the market. It is illogical that the director would only be liable if she applied for, and was granted, an extension certificate.

The Crown's interpretation prevents a director from continuing to mislead the market once they know, or ought reasonably to have known, that the statement was false. This approach is consistent with the investor-protection purpose of the Act.

### **Purpose of the Securities Act**

The Securities Act does not have an express purpose provision. The Court re-emphasised the purpose identified by Richardson J in *Re AIC Merchant Finances Ltd*:<sup>24</sup> the protection of investors through the timely disclosure of material information.<sup>25</sup> The Crown's interpretation, that disclosure includes passively making a prospectus available after its initial registration, is more consistent with this purpose. There is no guarantee, and it is rarely the case outside of institutional investors, that a prospective investor reads the registered prospectus on the exact date it is released. It is illogical that an investor who reads the prospectus on day one is able to rely on the prospectus' information being true (and can be confident that if it is untrue there will be criminal liability on the part of the directors), yet an investor who reads it on day two cannot be so assured and will therefore discount her offer price to reflect her insecurity about the information. Efficient markets require perfect, or in practice, near perfect information. For this to occur, all investors need to be able to rely on the same prospectus regardless of when they read it. As a result, a director who signs a prospectus containing a statement that is initially false should be treated the same as someone who signs a prospectus containing a statement that subsequently becomes

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<sup>23</sup> See Securities Act 1978, ss 58(2) (for advertisements) and 58(4) (for prospectuses).

<sup>24</sup> *Re AIC Merchant Finances Ltd* [1990] 2 NZLR 385 (CA) at 391–392 per Richardson J.

<sup>25</sup> *R v Steigrad*, above n 1, at [74].

false. Only this result will give prospective investors, and the market, the confidence they require to make sound investment decisions.

## V CURING THE POTENTIAL PROBLEMS WITH THE CROWN'S INTERPRETATION

The Court did recognise, however, that its interpretation of s 58 may be problematic.

### The Retiring Director

The first problematic case is the director who signs a prospectus and then resigns, after which a statement becomes untrue.<sup>26</sup> The Court held, obiter, that in this case the retired director's reasonable belief in the statement's truth should be judged at the time of her resignation.<sup>27</sup> Alternatively, the retired director may avail herself of the common law "no fault" defence.<sup>28</sup> This concession is pragmatic given that a retired director is unlikely to be able to access the information that would be required continually to assess the validity of the company's claims in a prospectus.

### Distributing Prospectus is an Act of the Company

The second problem is that the continuing distribution is necessarily an act of the company and not that of a director, and thus the director may be unable to prevent its continual distribution.<sup>29</sup> Venning J at first instance thought that even if a director brought the matter to the attention of the Securities Commission there would still be liability for the period between the director learning about the falsity of the statement and the (now) Financial Markets Authority taking action to suspend the prospectus.<sup>30</sup> In other words, there could still be liability without any defence being available. The Court of Appeal rejected this approach and claimed that the common law defence of "no fault" would be available.<sup>31</sup> In order to claim the defence, the director must have done everything possible to prevent the false statement remaining in the public domain, including alerting the Financial Markets Authority.<sup>32</sup>

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26 Ibid. at [110].

27 Ibid. at [111].

28 Ibid. This defence is theoretically sound in this case as a fault standard less than full mens rea is justified by the need for investor-protection. Furthermore, absolute liability would not be appropriate due to the injustice it would create. The result is strict liability and a no fault defence. See further *Millar v Ministry of Transport* [1986] 1 NZLR 660 (CA).

29 *R v Steigrad*, above n 1, at [112].

30 *R v Petricevic*, above n 2, at [57].

31 *R v Steigrad*, above n 1, at [113].

32 Ibid.

## Cost of Increased Monitoring

The third problem is that the interpretation adopted by the Court of Appeal would lead to difficulties for directors “in monitoring the continuing truthfulness of all statements made”.<sup>33</sup> The Court rightly dismissed this concern because, first, directors voluntarily assume the position of director and, secondly, the statute only requires reasonable monitoring to ensure compliance with the Act.<sup>34</sup>

## VI CONCLUSION

The Court of Appeal allowed the Crown’s appeal. *Steigrad* thus stands for the following proposition:<sup>35</sup>

The requirement for liability under s 58(1) and s 58(3) of the [Act] that an advertisement or registered prospectus is distributed arises where, at any time the advertisement or registered prospectus is before the public, it contains an untrue statement. This applies whether that statement was untrue at inception or became so subsequently.

This case should be welcomed by investors. Now that directors know that they can, and will, be held liable for statements that subsequently become untrue, they will, or at least should, increase their monitoring of their companies to avoid potential liability and the possibility of imprisonment.

It is of interest that despite securities law being, in truth, a subset of the contract law *genus* the Court did not draw upon any contract law principles in deciding the case. On the face of it, the Court of Appeal’s interpretation is consistent with *With v O’Flanagan*, which confirms that subsequent falsity can ground a claim to misrepresentation.<sup>36</sup> To that extent this case is unremarkable. However, one must not forget that under the Securities Act a director can still be held liable even if all the investors subscribed on the basis of the statement when it was still true. It is this anomaly that perhaps underpinned the direction that Venning J took in the High Court. Although the “no fault” defence may decrease the harshness of the Court of Appeal’s interpretation, it will not absolve directors of liability simply because the subsequent falsity of the statement had no real impact on the market. This will have to be left to the legislature and its review of securities law to be rectified. It is likely that the impracticality of proving

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33 *Ibid.*, at [114].

34 *Ibid.*, at [114]–[115].

35 *Ibid.*, at [119].

36 *With v O’Flanagan* [1936] Ch 575 (CA).

exactly when an investor read and relied on the statement will mean that this inherent harshness will remain as the better of two evils.

Steigrad's fate will remain unknown until the determination of the substantive proceedings. At time of writing, the accused had not ruled out appeal to the Supreme Court.<sup>37</sup> It also remains to be seen whether the legislature, in its current review of the Securities Act, will respond to *Steigrad* or address any of the problems with the Court of Appeal's interpretation, as averted to in its judgment.

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37 Fiona Rotherham "Appeal upheld against Bridgecorp director" (5 July 2011) Business Day <[www.stuff.co.nz](http://www.stuff.co.nz)>.

## *Morse v Police*

JUSTIN HARDER\*

### I INTRODUCTION

In *Morse v Police*,<sup>1</sup> the Supreme Court re-examined the tension between freedom of speech and the offence in s 4(1)(a) of the Summary Offences Act 1981 (the Act). That section is one of a series headed “offences against public order” and provides:

Every person is liable to a fine not exceeding \$1000, who, [i]n or within view of any public place, behaves in an offensive or disorderly manner.

In *Morse*, the Supreme Court was required to determine when flag burning as a means of expressive behaviour could properly be criminalised as “behaving in an offensive manner”. The five separate judgments were unanimous on three points: that the offence requires an objectively sufficient disruption of public order; that the trial miscarried; and that no retrial should be ordered. What remains unsettled is how a “sufficient disruption of public order” is to be determined.

### II THE ANZAC DAY PROTEST

The appellant ignited a New Zealand flag on the grounds of the Victoria University of Wellington Law School in view of the large crowd assembled at the Wellington cenotaph at the dawn service on Anzac Day 2007. The flag burning was an escalation in a long-standing series of Anzac Day protests by the appellant and a group of anti-war activists from Peace Action Wellington.

A nearby constable threw the burning flag to the ground and arrested the appellant for offensive behaviour under s 4(1)(a) of the Act. Convictions were entered against the appellant after a defended hearing in the District Court<sup>2</sup> and upheld in the High Court<sup>3</sup> and the Court of Appeal (Glazebrook J dissenting).<sup>4</sup>

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1 *Morse v Police* [2011] NZSC 45, (2011) 25 CRNZ 174 [*Morse* (SC)].

2 *Police v Morse* DC Wellington CRI-2007-085-2806, 23 November 2007.

3 *Morse v Police* HC Wellington CRI-2007-485-153, 29 May 2008.

4 *Morse v R* [2009] NZCA 623, [2010] 2 NZLR 625 [*Morse* (CA)].

### III THE ERROR IN THE COURTS BELOW

All three lower courts were guided by the Supreme Court's earlier decision in *Brooker v Police* on s 4(1)(a) of the Act.<sup>5</sup> The majority in *Brooker* held that behaviour would only become "disorderly" when it was disruptive of public order beyond what the reasonable citizen should be expected to bear.<sup>6</sup> Of particular importance was Blanchard J's obiter definition of "offensive behaviour".<sup>7</sup> His Honour stated that offensive behaviour would be made out when the behaviour could be said to be capable of causing "substantial offence" by virtue of its capability to wound feelings or "arous[e] real anger, resentment, disgust or outrage" in the mind of a reasonable person "of the kind actually subjected to it".<sup>8</sup> This test did not, however, make reference to any requirement for the behaviour to have a tendency to disturb or violate public order. It is unsurprising that the courts below and the majority in the Court of Appeal followed this approach. They were, however, in error and it is on that point that the appeal in *Morse* was determined. Blanchard J issued a *mea culpa* for creating this confusion and modified his earlier test to incorporate a requirement for disturbance of public order.<sup>9</sup>

As there had been no real evidence or argument focused explicitly on the essential need for a disruption to public order, the Supreme Court held that the trial had miscarried and that the conviction must be quashed. Given the period of time that had elapsed, no order was made for a retrial.

### IV THE MEANING OF "OFFENSIVE BEHAVIOUR" IN S 4(1)(A)

The majority (Blanchard, Tipping, McGrath and Anderson JJ) agreed that notions of offensiveness remained relevant to s 4(1)(a). Their general interpretation was that the level of offence to those affected, viewed objectively, should determine when behaviour is sufficiently disruptive of public order as to become "offensive behaviour" in terms of s 4(1)(a).

Beyond that general holding, the majority differed on how to determine the level of offence and on exactly what an "objective view" entails. Blanchard J saw the need for the behaviour to be offensive in the sense of being capable of "wounding feelings or arousing real anger, resentment, disgust or outrage" in the mind of a hypothetical reasonable person "of the kind actually affected".<sup>10</sup> Tipping J (with whom McGrath

5 *Brooker v Police* [2007] NZSC 30, [2007] 3 NZLR 91.

6 *Ibid*, at [90] per Tipping J.

7 *Morse* (CA), above n 4, at [21] per Arnold J.

8 *Brooker v Police*, above n 5, at [55].

9 *Morse* (SC), above n 1, at [61].

10 *Ibid*, at [67].

J agreed on this point) avoided defining “offensive” using synonyms but required that the level of offence caused must exceed what those affected should be expected to tolerate “on account of the rights and freedoms being exercised by those responsible for the behaviour”.<sup>11</sup>

The Chief Justice dissented on this point, drawing on her reasoning in *Brooker* that the text, purpose and context of s 4(1)(a) and its predecessors were concerned only with “the protection of the public from disorder calculated to interfere with the public’s normal activities”.<sup>12</sup> Her Honour’s preferred test for “behaving in an offensive manner” would exclude any balancing of interests and simply ask whether the behaviour interferes with the use of public space, “as through intimidation, bullying or the creation of alarm or unease at a level that inhibits recourse to the place”.<sup>13</sup>

## V THE OBJECTIVE VIEWPOINT

All five judges of the Supreme Court saw some need to assess objectively the level of disturbance and offence, but their Honours could not agree on the device that would best make that assessment. Anderson J expressed a preference for an unqualified objective view and the Chief Justice also accepted that ultimately some objective assessment was necessary.<sup>14</sup> The majority qualified their objective viewpoint with the need for the reasonable person to have some subjective element, but they differed on quite what that subjective element should be. Two judges (Blanchard and Tipping JJ) thought the reasonable person ought to be “*of the kind actually subjected to it* in the circumstances in which it occurs”.<sup>15</sup> According to Tipping J, that hypothetical person would be prepared to tolerate “some degree of offence on account of the rights and freedoms being exercised by those responsible for the behaviour”.<sup>16</sup> There is an attraction to using a standard that turns on the “expectations of society” rather than a viewpoint incorporating subjective elements because what amounts to “public order” will fit better with the “expectations of society” than it will with the expectations of any particular group. Moreover, McGrath J’s formulation accords with the international law understanding of “public order” as “the sum of rules which ensures the functioning of society or the set of fundamental principles on which a society is founded” including “respect for economic, social and cultural rights”.<sup>17</sup>

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11 Ibid, at [70] per Tipping J.

12 Ibid, at [3] citing *Brooker v Police*, above n 5, at [32] and *R v Lohnes* [1992] 1 SCR 167 at 178–179.

13 *Morse* (SC), above n 1, at [2].

14 Ibid, at [13] per Elias CJ and [123] per Anderson J.

15 Ibid, at [64] per Blanchard J. See also *ibid*, at [70] per Tipping J.

16 Ibid, at [70].

17 *Siracusa Principles on the Limitation and Derogation Provisions in the International Covenant on Civil and Political Rights* E/CN.4/1985/4 (1984).

Blanchard J took the opportunity to respond directly to criticism by Glazebrook J in the Court of Appeal that the requirement for the “reasonable person” to be “of the kind affected” is inappropriate in extreme circumstances such as, for example, a case in which a civil rights activist angers a crowd of Ku Klux Klan members, because it involves an awkward assumption that the reasonable Ku Klux Klan member would be able to exercise reasonable tolerance and self control.<sup>18</sup> Blanchard J’s response was to emphasise that his hypothetical reasonable person has qualities of tolerance and appreciation for others’ rights.<sup>19</sup>

This brief rejoinder does not entirely remove the sting of Glazebrook J’s criticism. Conditioning the hypothetical reasonable person with the qualities of those affected *and* with the qualities of tolerance and respect for rights does not fully remove the risk that individuals will be convicted in circumstances where the “disorder” is more likely the fault of the audience than those exercising their freedom of expression.

## VI THE APPROACH TO THE BILL OF RIGHTS

The NZBORA played a relatively minor role in the interpretation of 4(1)(a) of the Act. The analytical template provided by the majority in *R v Hansen*<sup>20</sup> played even less of a role (being mentioned only by Tipping J).<sup>21</sup> Those judges who focused on the operative provisions of the NZBORA (Elias CJ, Tipping and McGrath JJ) saw the s 6 preference for a rights consistent meaning as the first port of call,<sup>22</sup> while Tipping and McGrath JJ adopted a s 5 balancing of the reasonableness of any limit as a tail-end proportionality check.<sup>23</sup> The Chief Justice saw no real role for any s 5 balancing methodology as she was of the view that the legislative history of “offensive behaviour” made clear that Parliament had already balanced the limit of the s 14 right by anchoring the limit to “public order” considerations.<sup>24</sup>

## VII CONCLUSION

In a recent High Court appeal against a conviction by a Community Magistrate under 4(1)(a), Williams J considered *Morse* and averted to the

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18 *Morse* (CA), above n 4, at [105].

19 *Morse* (SC), above n 1, at [65].

20 *R v Hansen* [2007] NZSC 7, [2007] 3 NZLR 1.

21 *Morse* (SC), above n 1, at [68].

22 *Ibid.*, at [17] per Elias CJ, [105] per McGrath J and [68] and [70]–[72] (implicitly) per Tipping J.

23 *Ibid.*, at [68], [70]–[72] (implicitly) per Tipping J and [106]–[107] per McGrath J.

24 *Ibid.*, at [14] and [16] per Elias CJ.

difficulty of determining when public order has been sufficiently disrupted.<sup>25</sup> After identifying three separate tests (those of Elias CJ, Blanchard and Tipping JJ), his Honour refrained from expressing any preference for one test, and simply suggested that the complexities suited re-hearing before a District Court judge rather than a Justice of the Peace. This application appears to indicate that the Supreme Court has not yet achieved the Chief Justice's laudable aim of ensuring that both rights and criminal offences under s 4(1)(a) be certain and ascertainable in advance.<sup>26</sup>

A significant consequence of the understandable error in approach by the courts below is that the Supreme Court has not applied any of the various definitions posited in the judgment to the actual facts of the case. The Court believed that the unsatisfactory state of the evidence prevented any definitive pronouncement on the appellant's behaviour.<sup>27</sup>

As a result, the bolstering of the right to freedom of expression in *Morse* does not extend to any kind of statement that the appellant's burning of the flag was in fact lawful. The point was left entirely open. Whether a repeat of the conduct will attract conviction for offensive behaviour under s 4(1)(a) will always turn on an analysis of the time, place and circumstance. The Supreme Court was silent on the correctness or otherwise of Glazebrook J's view that "the burning of the flag by itself on university grounds as a genuine exercise of the right to express political opinions could not be seen as offensive". McGrath J's acknowledgment of the rights of those commemorating Anzac Day to tranquil observance of the day's solemnity<sup>28</sup> should, however, serve as a warning to those contemplating a similar protest in the future.

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25 *Benvenuti v Police* HC Wellington CRI-2011-485-8, 21 July 2011 at [35].

26 *Ibid.*, at [35] and [37].

27 *Morse* (SC), above n 1, at [57] per Elias CJ, and [119] per McGrath J.

28 *Ibid.*, at [111].