Recommendation:

That the doctrine of relation back be removed, and the rules of voidable transactions be relied on to achieve the same purpose. To remove this doctrine, the bankruptcy should begin at the point of adjudication, not the time the act of bankruptcy was committed.

Recommendations

The Ministry recommends:

- The introduction of a financial audit, instigated by a Request for Solvency Assessment form ('RSA form'); and
- A 14-day stay of proceedings that begins when the RSA is filed with the Assignee.

The Ministry has no recommendations to make in terms of financial counselling. Comments on this issue are sought.

Recommendations

The Ministry recommends:

- Increasing the threshold of debt for a summary instalment order from $12,000 to $40,000;
- Providing for private administrators to administrator the Part XV proposals and the summary instalment orders, rather than the court; and
- Increasing the commission for private administrators to 10percent.

Recommendations:

The Ministry does not have a preferred solution on proceedings consequent on adjudication for estates with no assets for distribution. The Ministry would like comment on issues and options for reform of this area. The Ministry is interested in whether the current practice is the most appropriate one for dealing with estates without assets.

Recommendations

The Ministry recommends that:

- Repeat bankrupts, or fraudulent bankrupts, should not qualify for automatic discharge until after three years; and
- Bankrupts, who have not been involved in commercial misconduct should receive an automatic discharge :

  (a) After one year; or

  (b) After two years.

The Ministry seeks comment on which discharge period is preferred.

Recommendations

The Ministry recommends: the introduction of Income Payment Orders ('IPO's') that can be up to one year's duration after the bankrupt has been discharged.

Application made for bankruptcy

Yes

By creditor:
Petition filed in High Court for order to be made that debtor is bankrupt (section 23). Creditor owed min $200,and debtor committed 'act of bankruptcy' within 3 months (section 19)?

By debtor:
Petition filed in High Court (ssections21,22)

No

Court hearing – both creditor and debtor appear (court may appoint receiver before adjudication adjudged bankrupt?

Creditor seeks recovery of debt by agreement with debtor or through courts.

No

Debtor adjudged bankrupt. Property of debtor passes to Assignee. (Debtor now referred to as 'bankrupt')

Right of appeal against adjudication by any 'aggrieved person' (section8). Appeal successful?

Bankrupt
Restricted from dealing with property;
All property vests in the Assignee (section42);
Must aid in realisation of his/her property (section60);
Cannot enter into business, or be involved in management or control of business without consent of Assignee.

Assignee
Has power of sale over bankrupt's property (s72)

Creditors
Must prove their debt (section88); Proof to be examined by Assignee and admitted or rejected (issubject to right of appeal to Court).

Assignee advertises adjudication (section 31)

No

All proceedings to recover debt stayed (ssection32). Court has discretion to allow commenced proceedings to continue.

Assignee sends notice to bankrupt requiring statement of affairs and personal details (section33) – can require attendance at meeting (if meeting required, Assignee shall advertise details).

Assignee has discretion to call meeting of creditors within 14 days of compliance of section33 (section34). Assignee to pass on debtors information to creditors (section35)

Assignee may require bankrupt's attendance at all meetings if wish (section37). Meeting must be attended by Assignee and one creditor at least).

Bankrupt, creditor or other 'aggrieved person' may apply to court to reverse/ modify act/ decision of Assignee (section86).

Assignee can seek assistance of court in any aspect of carrying out of its duties (section85). Such advice exempts Assignee from future claims.

Assignee administers bankrupts affairs and realises bankrupt's assets. Assignee's general powers subject to exercise of legislative rights, including:
- Assignee or any creditor may call for public sitting in Court for examination of bankrupt (section69);
- Creditors may, by resolution, appoint expert or committee of persons to assist Assignee in administration of estate;
- Assignee or any creditor may apply to Court for order requiring bankrupt to contribute towards payment of debts.

Assignee distributes monies received from realisation of bankrupts property according to legislative order of priority (section104)

Discharge of bankrupt (section-108) – will be discharged 3 years from adjudication, unless:
- objection by Assignee or creditor;
- bankrupt is required to, and has not passed, public examination.

Recommendation:

Voidable transactions provisions in the Insolvency Act should, like those in the Companies Act, set aside transactions based on their effect, regardless of the intention, motive or knowledge of the debtor or the recipient of the transaction.

Recommendation:

The ordinary course of business exception should be removed and replaced with a simple rule that will achieve greater certainty. This should be coupled with a shorter time period so as to minimise the likelihood that any injustices will result from the application of a more rigid rule.

Recommendation:

Personal and corporate insolvency voidable transactions law should be harmonised into a single law based strictly on the effect of the transaction, regardless of the intention, motive or knowledge of the debtor or the recipient of the transaction.

Recommendation:

The Ministry considers there are strong policy arguments in favour of replacing the existing voidable transaction provisions with one provision that would cover all types of voidable transactions.
The Ministry seeks submissions on whether a single provision could be achieved, with careful definition of terms, to cover any depletion of the insolvent's assets, that enables another person to receive more than they would have in the liquidation. Could such a provision be effective regardless of whether the recipient is a creditor, the beneficiary of a gift, the grantee of a security, or a person acquiring an asset for less than the market value?

Recommendation:

The Ministry does not propose that any amendments be made to section 47 of the Matrimonial Property Act 1976 at this time.

Recommendation:

Section 60 Property Law Act should be retained.

Recommendation:

New Zealand should enact a provision that is in line with the United States 'net effect' provision. The provision should not, however, include the defence of 'ordinary course of business' exception or the requirement of insolvency contained in that provision. Further, the New Zealand provision should be phrased more widely than the American provision so that it encapsulates all types of depletion of assets rather than just payment of a pre-existing debt.

Recommendation:

There should be one period in which transactions may be set aside unless there is a strong justification for a different time period. The Ministry recommends that the period in which payments may be recovered be six months from the date of filing the application commencing formal insolvency procedures.

Recommendation:

The Masters should have jurisdiction over all matters relating to voidable transactions.

Recommendations:

The notice system contained in s 294 Companies Act and rules 700ZJ and 700ZK of the High Court Rules should be retained and used as the single process for challenging voidable transactions.

Voidable transaction matters should remain within the jurisdiction of the High Court The High Court has a general overview of the administration of insolvency. It is not considered appropriate that the High Court's overview should be piecemeal.

Recommendation:

Insiders should be treated more severely with regard to voidable transactions by extending the length of time within which insider transactions may be challenged to two years rather than the six months generally.

Recommendation:

The existing defence should remain available to recipients who, acting in good faith, have altered their position in reliance on the receipt of the transaction and would suffer such hardship as a result of having to repay it that it is inequitable to require repayment. The court would be given the power to order either partial or no return of the transaction in such a situation.

Recommendation:

The existing defence should remain available to recipients who, acting in good faith, have altered their position in reliance on the receipt of the transaction and would suffer such hardship as a result of having to repay it that it is inequitable to require repayment. The court would be given the power to order either partial or no return of the transaction in such a situation.

Recommendation:
Any amendment made to voidable transactions law will need to be aligned with the PPSA.

Recommendation: There are two options regarding the current preferential status of revenue-related claims:

(i) The current legislation should be amended so that:

- The priority status in corporate insolvency and personal bankruptcy of GST, customs duty, and levies under the Fisheries Acts and the Radiocommunications Act should be abolished.
- The priority status of NRWT and RWT in corporate insolvencies under the Companies Act 1993 should be retained and extended to personal bankruptcies under the Insolvency Act 1967.
- The priority afforded to PAYE should be retained, but in the modified form suggested by the Commission.

or

(ii) the same amendments should be made, except that:

- The existing preferential status of unpaid GST and PAYE deductions should continue in their present form.
-

INSOLVENCY LAW REVIEW: TIER ONE

DISCUSSION DOCUMENTS

January 2001

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PREFACE

In May 1999 the Ministry signalled its intention to commence a review of both personal and corporate insolvency law. The review is being progressed in two tiers.

The Tier One issues are: -

- Bankruptcy Administration;
- Voidable Transactions;
- Priority Debts in the Distribution of Insolvent Estates; and
- Phoenix companies.

The Tier Two issues are: -

- The role of the State and enforcement mechanisms in insolvency proceedings;
- Voluntary administration procedures;
- Director's duties in relation to financially distressed companies;
- Insolvent partnerships;
- Statutory management; and
- Whether personal and corporate insolvency law should be harmonised into a single statute.

The Tier One issues are discrete problem areas of a technical nature which are causing unnecessary costs or have recently been the subject of consideration by the Law Commission. The Tier Two issues generally deal with broader and more fundamental issues regarding the structure and objectives of insolvency law. They are being considered in parallel with the Tier One topics.

The discussion documents contained in this paper form part of Tier One. The Background and Framework Document sets out the principles and objectives of the review, and the specific topics and timeframe in which they are to be addressed. It is accompanied by four discussion papers. Two of the papers (Voidable Transactions and Priority Debts) are in furtherance of work previously undertaken by the Ministry and the Law Commission. They chronicle the work that has been undertaken to date, analyse the submissions received and go on to indicate the Ministry's preliminary policy approach to a number of key issues.

The papers on Bankruptcy Administration and Phoenix Companies are preliminary discussion documents, which identify the problems arising in these areas, and ask a series of wide-ranging questions about possible solutions.

The Ministry welcomes submissions on any of these papers. Comments and questions should be sent to the Insolvency Law Review, Ministry of Economic Development, PO Box 1473, Wellington (or email martin.fowke@med.govt.nz) by 6 April 2001. The papers are also available in electronic form on the Ministry's website at www.med.govt.nz.

CONTENTS

THE INSOLVENCY REVIEW: BACKGROUND AND FRAMEWORK

1. PURPOSE

This paper provides:

- Background on the current review of New Zealand insolvency law (headings 2 and 3);
- A general analytical framework for considering insolvency law issues (headings 4 and 5); and
- Information on how to make a submission on the issues papers that are a companion to this paper (heading 6).

2. BACKGROUND

In recent years there has been an increasing trend of bankruptcies and liquidations, with continuing low returns to unsecured creditors. This suggested it was timely to undertake a major review of insolvency law. In 1999 the Ministry of Commerce began a review of both personal and corporate insolvency laws. The successor ministry, the Ministry of Economic Development, and the New Zealand Law Commission, have been releasing papers for public consultation on a range of topics in the insolvency arena.

New Zealand's personal insolvency law (bankruptcy) was last reviewed in the 1960s, resulting in the enactment of the Insolvency Act 1967. Corporate insolvency law (liquidation) was amended to some extent with the enactment of the Companies Act 1993 and related legislation. However, major insolvency policy issues at the time, and that have arisen since were deferred in anticipation of a comprehensive and co-ordinated review of both personal and corporate insolvency.

The existing insolvency law framework is generally considered to be functioning adequately. However, there are a number of problem areas that need to be assessed and, where necessary, addressed by consistent, well reasoned reform. The review is being carried out in two stages. The Tier One issues are:

(a) Bankruptcy procedures;
(b) Voidable transactions;
(c) Priority debts;
(d) Phoenix companies; and
(e) Cross-border insolvency .

Discussion documents on items (a)-(d) have been released at the same time as this paper. Each of those documents outlines the Ministry's preferred positions on the relevant topics. The papers on Voidable Transactions and Priority Debts are based on earlier work in the form either of Law Commission reports or targeted consultation by the Ministry with specialists in insolvency law. For those two papers we wish to obtain comments on whether improvements on the Ministry's preferred options could be made and, if so, how.

The Ministry's thinking on Phoenix Companies (paper (d)) and Bankruptcy Administration (paper (a)) is at an earlier stage of development. We are seeking views on whether alternative options should be considered. If so, what options should be considered, and why? If not, how might our preferred options be improved?

The policy development is largely complete on item (e), with general agreement among interested parties that New Zealand law should be consistent with the United Nations Commission on International Trade Law (UNCITRAL) model law on cross-border insolvency[1].

The Tier Two issues are:

(f) Corporate rescue/voluntary administration;
(g) The role of the state;
(h) Insolvent partnerships; and
(i) Directors' duties.

Discussion documents are currently being prepared on the public policy issues relating to items (f) and (g) with a view to public release in March 2001. Items (h) and (i) are the least progressed issues. The Ministry is currently considering problem definition aspects. Once this work is completed we will make recommendations to the Associate Minister of Commerce on whether the issues are significant enough to justify the release of additional discussion documents on one or both topics.

Finally, a legal framework is being prepared, which will also be released in March 2001. The aim of this work is to provide a coherent framework for consolidating insolvency law into a single piece of legislation.

Arguably, items (a) and (f) are the most important of the review issues. The extent to which insolvency law seeks to rehabilitate insolvent persons or rescue businesses significantly shapes most other major features of the law. The overall objective is to make a full set of recommendations on insolvency law to the Government later in 2001.

3. INSOLVENCY LAW IN NEW ZEALAND

The legal framework for insolvency is administered in two parts: personal and corporate insolvency. The law dealing with personal insolvency is the Insolvency Act 1967, which refers to the procedure for administering individual insolvency as ‘bankruptcy’. Corporate insolvency is administered under the Companies Act 1993 and the related Corporations (Investigations and Management) Act 1989 and Receiverships Act 1993. These two forms of insolvency are discussed below.

3.1 Personal insolvency

Personal insolvency, and personal solvency, are terms that describe the financial state of a person. The term ‘bankrupt’ refers to the status of a natural person who, on filing a petition, or on one of their creditors’ filing a petition, is then adjudged bankrupt by the High Court under the Insolvency Act. The Act:

- Sets out the High Court’s jurisdiction and powers in bankruptcy;
- Provides procedures for creditors and debtors to seek a bankruptcy order;
- Provides for the office of the Official Assignee, the administration of bankrupt estates, and the control of the person and property of a bankrupt;
- Provides for the distribution of a bankrupt’s estate amongst creditors; and
- Provides for the discharge of a bankrupt from bankruptcy.

Bankruptcy is a procedure for administering the bankrupt’s estate for the distribution of the debtor’s assets to creditors and discharging the bankrupt from any outstanding debt after the completion of the procedure. It is designed to be the last available option for the debtor and creditors when insolvency occurs. Issues during the procedure generally arise because there are never enough assets to meet all the liabilities.

Debtors that become bankrupt are both consumers and sole traders, although there is an increasing trend for the majority of bankrupts to be consumers.

3.2 Corporate insolvency

Part XIV of the Companies Act 1993 aims to provide a straightforward and fair procedure for liquidating (ie winding up) a company. The liquidator’s principal roles are to:

- Collect and realise the company’s assets;
- Ascertain claims;
- After recovering the expense of the liquidation, distribute the net proceeds to creditors in the order laid down by the Act; and
- After investigations have been concluded and reports made, bring the company’s legal existence to an end through dissolution.

The Corporations (Investigation and Management) Act 1989 provides for government intervention in cases of major corporate collapse where conventional procedures would be ineffective. It allows the Registrar of Companies to obtain information from, and investigate the affairs of, a corporation to ascertain whether it is in danger of failing. If necessary, a statutory manager may be appointed to run the company.

The Receiverships Act 1993 codifies the common law in relation to receivers. It sets out the qualification requirements of receivers and the circumstances in which a receiver may be appointed. It also sets out receivers' powers, duties and liabilities and provides for the High Court to supervise receivers' activities.

4. A FRAMEWORK FOR CONSIDERING INSOLVENCY LAW

In this section of the paper, the focus moves from the liquidation/bankruptcy legal framework to a business/consumer insolvency public policy taxonomy. The reasons for this are that:

- Business insolvency, whether corporate or individual (as partnerships or sole traders) occur for similar underlying reasons; and

- The reasons for personal insolvency arising out of business failure and consumer-related indebtedness differ significantly.

Insolvency law is considered from three perspectives in the paragraphs below: the objectives of insolvency from a debtor and creditor perspective, the causes of insolvency, and the impacts that insolvency has. Each of these is considered in terms of business failure and consumer-related indebtedness.

4.1 Business insolvency

4.1.1 Debtor objectives in business insolvency

The individual debtor in financial difficulty will be seeking relief from outstanding debt and legal action by creditors, and a simple, quick procedure for administering the insolvency. Rehabilitation, in the sense of discharge from debt and in the sense of encouragement of sensible risk-taking, is an important aim for a debtor. Debtors will also want certainty concerning their legal position and information on the steps that must be taken to use the bankruptcy procedure.

Companies, partnerships and sole traders will want an insolvency procedure to achieve similar objectives. The directors and people involved in business insolvency will be focusing on rescue for the business initially and failing that, a simple and quick liquidation procedure. Other important factors will be avoiding stigma and the ability to return to normal business activity.

The debtors, whether businesses or individuals, will be interested in suspending creditors' rights and remedies in favour of one procedure. This is because the collective procedure prevents creditors pursuing individual remedies that are detrimental to any rescue of the company and will not maximise the pool of assets available for distribution to all creditors.

4.1.2 Creditor objectives in business insolvency

Creditors will focus on maximising returns to themselves. However, the individual and collective interests of creditors differ. If a debtor is or may be insolvent, each individual creditor has an incentive to look after their own interest at the expense of other creditors and the total pool of assets.

To avoid destructive fights between creditors and races among creditors to the courts, insolvency law provides all creditors with some measure of equality. In the case of corporate liquidation, a trustee acts on behalf of unsecured creditors to realise and distribute the company's net assets and distribute them in accordance with clearly defined rules. This pari passu principle is critical to the effective and efficient operation of insolvency law.

4.1.3 Societal objectives in business insolvency

Business failure, whether corporate or individual, can arise for four reasons. Before describing those reasons, it is important to point out that these categories are simply a framework for analysis. In a real sense, the categories are on a continuum with some blurring of distinctions between neighbouring categories. In stark terms, the reasons for business failure are set out in 4.1.3.1 - 4.1.3.4 below.

4.1.3.1 The unavoidable cost of rational risk-taking

This category recognises that all business decisions are made without full information, markets are unpredictable, and unforeseeable externally caused change occurs (eg new government regulation). Any of these characteristics can mean business decisions that were rational at the time they were made could subsequently lead to insolvency.

Rational risk-taking is at the heart of entrepreneurial activity. It is something that society wishes to promote and encourage. For this category of business failure, there are strong arguments for promoting societal attitudes and insolvency laws that avoid stigma and provide the opportunity for rehabilitation or corporate rescue with a view to resuming full business activity as quickly and efficiently as possible. At the same time, it is important to promote creditors' rights to recover debts.

4.1.3.2 Managerial mistakes

Managers and owners can have good business skills but may nevertheless make mistakes that lead to insolvency. These can be judged to have been mistakes at the time, not just with the benefit of hindsight. A general expectation is that such persons can be expected to learn from their mistakes and, given further opportunity, have good prospects of becoming successful entrepreneurs. The societal objectives are largely the same as for the previous category: avoidance of stigma, opportunities for rehabilitation and corporate rescue and creditors' rights to recover debts.

4.1.3.3 Lack of business skills

Some managers and owners may not have good business skills. Furthermore, they may not have the potential to ever learn the art of being successful entrepreneurs. In such cases, the aim is not to rehabilitate them back into business activity. However, there is still a rehabilitation aim in the sense that these individuals should be given opportunities to contribute to society in other ways. Insolvency law may have a role to play in encouraging people to move to areas where they are competent.

4.1.3.4 Dishonesty

Societal objectives are somewhat different in relation to this category of business failure. Some persons who commit insolvency-related crimes may be open to rehabilitation. However, there are some who appear before the courts time after time with no real intention of ever making a positive contribution to society. The objective is to make it as difficult as possible for such individuals to continue to exploit corporate governance and insolvency laws to make personal gains at the expense of society as a whole and the individuals that suffer financial hardship and personal anguish as a result of the offender's conduct.

To promote these objectives it is necessary to:

- Clearly define offences of dishonesty;
- Have a well resourced agency that actively enforces the law; and
- Provide for maximum penalties that give the courts ample scope to punish the offender with sufficient severity to deter further transgressions by the same person or by others.

4.2 Consumer-related insolvency

Personal insolvency arises when a person cannot pay their debts as they fall due. Consumer insolvency is a subset of personal insolvency. The purpose of it is to provide financial relief for honest individuals who find themselves in financial difficulty. This provides the opportunity for:

- the debtor to make a fresh start more easily; and
- creditors to obtain a quick distribution of assets in accordance with the pari passu principle.

Also, the law aims to protect society from dishonest and reckless conduct by debtors.

Since the last review of personal insolvency legislation in the 1960s, the number of consumer bankrupts has increased and now surpasses the number of business-related bankrupts. This appears to be linked to the increasing availability of credit.[2] However, credit availability is not the underlying cause of consumer-related insolvency. Rather, consumer over-indebtedness is caused by:

- Inability to meet repayments because of changing circumstances: eg job loss, separation or illness.

- Lack of awareness of the consequences of taking out consumer credit. Consumers may agree to act as a guarantor without understanding the full nature of the obligations incurred.

- Recklessness. Consumers can knowingly obtain credit when they know it is or may be beyond their means to meet all repayments as they fall due. In these circumstances, the debtor may risk serious asset loss.

- Dishonesty. The most common forms of criminal conduct by debtors include concealing or removing property, destroying or falsifying documents relating to their affairs, failure to keep proper records, absconding, and obtaining credit contrary to a court order. Although dishonest behaviour may not be the sole cause of an insolvency, it will almost certainly lead to bankruptcy, as creditors will be reluctant to participate in informal or formal arrangements with the debtor.

4.3 Uncertainty and compliance cost issues

Evaluating policy alternatives requires considering not only the merits of each alternative but also its implementation costs. These costs can fall on businesses, enforcers and regulators in the form of excessive uncertainty, enforcement costs and litigation costs.

Compliance costs can vary significantly depending on the insolvency law model adopted. Simple rules and efficient, predictable and quick processes can generally be expected to reduce compliance costs and should be used where they will lead to accurate outcomes (in terms of deterring undesirable conduct and promoting desirable conduct) nearly all of the time.

However, simple rules may lead to a significant number of arbitrary and indiscriminate outcomes. In this case it may be desirable to make the rules more complex in order to promote a greater level of desirable outcomes.

5. CONCLUSIONS

Bringing all of the above discussion together, the objectives for insolvency law are to:

- Create the right environment for business growth and entrepreneurship. The law needs to give confidence both to lenders to provide capital to business and to entrepreneurs to be innovative and take responsible business risks.

- Provide a predictable and simple regime for financial failure that can be administered quickly and efficiently and imposes the minimum necessary compliance and regulatory costs on its users and balances uncertainty and inflexibility.

- Distribute the proceeds to creditors in accordance with their relative pre-insolvency entitlements, unless it can be shown that the public interest in providing greater protection to one or more creditors (statutory preferences) outweighs the economic and social costs of any such entitlements.

- Maximise the returns to creditors by providing flexible and effective methods of insolvency administration and enforcement which encourage early intervention when financial distress becomes apparent.

- Enable individuals in bankruptcy to again participate fully in the economic life of the community by discharging them from their remaining debts in appropriate circumstances.

These objectives are diverse, and there are tensions between some of them. For example, there are trade-offs between the interests of creditors and debtors. Rehabilitation from bankruptcy suggests that the debtor should be able to retain enough assets to make a fresh start to their financial life. However, the more the debtor may keep, the more creditor risk is increased.

Furthermore, it is not always easy to judge what approach is best in relation to specific cases of insolvency. For example, it can be difficult to distinguish between responsible and irresponsible decision-making. It may also be difficult to determine whether a first time criminal offender will be open to rehabilitation.

These uncertainties create challenges for the design of insolvency law.

6. SUBMISSIONS

The Ministry of Economic Development has prepared this and the accompanying set of papers. They do not represent Government policy. Written submissions on the issues raised by these discussion papers are invited from interested parties. The closing date for submissions is 6 April 2001. The Ministry will then further analyse the issues before preparing its final advice to Ministers later in 2001.

Submissions should be made out to:

The Insolvency Review
Competition and Enterprise Branch
Ministry of Economic Development
PO Box 1473
WELLINGTON

Phone: (64 4) 470 2313
Fax: (64 4) 471 2658
Email: martin.fowke@med.govt.nz

The contents of submissions provided to the Ministry in response to these discussion documents will be subject to the Official Information Act 1982 and the Privacy Act 1993. If the Ministry receives a request for information contained in a submission, we would be required to consider release of the submission, in whole or in part, in terms of the criteria set out in these Acts.

In providing your submission, please advise us if you have any objections to the release of any information contained in your submission and, if you do object, specify which parts of your submission you would wish to withhold and the grounds for withholding.

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Executive Summary

Bankruptcy is a procedure for administering the estate of the bankrupt for the distribution of the debtorÕs assets to creditors, and discharging the bankrupt from any outstanding debt after the completion of the procedure. It is designed to be the last available option for the debtor and the creditors when insolvency occurs. Issues during the procedure generally arise in relation to the lack of assets to meet all the liabilities.

The current administration procedure has not been reviewed since the 1960s, with several issues arising since then. For an effective personal insolvency regime, including alternatives to bankruptcy (formal and informal) as well as the bankruptcy procedure itself, the procedure must:

- Clarify the current confusion as to when the bankruptcy administration procedure begins. This is important as it impacts on what assets are available for distribution to creditors;
- Educate debtors and creditorÕs about the options available to them and the obligations of pursing those options. The current lack of knowledge and information lessens the effectiveness of the regime; and
- Tailor the regime to better match the nature of debtors, for example business related or consumer related, so that the procedure is as effective as it can be. The changing make-up of a "typical bankrupt" means that the regime is no longer providing an effective solution to majority of debtors and creditors. This is largely related to the increase in people who become bankrupt due to consumer credit related issues, as opposed to a higher number of 'sole-trader bankrupts' when the law was last reviewed in the 1960s.

The Ministry of Economic Development proposes to address these issues with solutions that will provide a regime that is as simple and accessible as is possible, while also retaining certainty for the parties involved. Any changes to the regime will also be mindful of the costs of administering and complying with the bankruptcy administration procedure.

Bankruptcy administration arose as a topic in the Insolvency review for a number of reasons. The market place and the make-up of a typical debtor has changed and the New Zealand Insolvency and Trustee Service, as part of the Business and Registries Branch of the Ministry of Economic Development, was concerned that the bankruptcy administration procedure did not reßect these changes. Two areas where review is needed in relation to bankruptcy are the administration procedure and the role of the state.

This paper concerns the bankruptcy administration procedure and solving the issues that have arisen with the procedure since it was last reviewed. The Ministry has made recommendations based on the issues but these recommendations are not deÞnitive. Comment is sought on any viable alternatives to the issues.

1. INTRODUCTION

In 1999 the Ministry of Economic Development ('the Ministry') began a review of both personal and corporate insolvency laws. This discussion document reviews concerns about the adequacy of the current bankruptcy administration procedure and recommends a framework for reform.

7. BACKGROUND TO BANKRUPTCY

This paper focuses on the role and administration of bankruptcy in New Zealand. It is part of a wider review, traversing legislation that applies to both corporate and individual insolvency. In New Zealand, the legal framework for insolvency is administered in two parts: personal and corporate insolvency. The law dealing with personal insolvency is the Insolvency Act 1967 and refers to the process of individual insolvency as 'bankruptcy'. The term 'bankrupt' refers to the status of a natural person (not a corporation) who, on filing a petition, or one of their creditors filing a petition, is then adjudged bankrupt by the High Court.

A 'natural person' is basically any individual, whether involved in trade or consumer. Traditionally, the typical debtor that was adjudicated bankrupt was a sole trader. The changing make-up of a typical bankrupt means the majority of bankrupts are now increasingly consumers.

Personal insolvency, or solvency, is a person's financial state, while bankruptcy is the legal status of a person that has been adjudicated bankrupt by the courts. While a bankruptcy adjudication may be obtained without proving the debtor's true insolvency, it is held generally that the debtor's insolvency is reasonably to be inferred under the circumstances. Regardless of the uncoordinated appearance of insolvency and bankruptcy, the underlying links between the two are important as they determine who can become bankrupt and at what point the bankruptcy procedure begins.

Bankruptcy is a procedure for distributing a bankrupt's estate to their creditors and discharging the bankrupt from any outstanding debt once the procedure has been completed. It is designed to be the last available option for the debtor and the creditors when insolvency occurs. During the procedure, issues generally arise in relation to the fact that there are never enough assets to meet all the liabilities.

Bankruptcy law in New Zealand is based on the British historical notions of bankruptcy. Before the enactment of legislation in 1861, there was no bankruptcy administration procedure at common law. Until legislation in 1705-06 the legal concept of discharge did not exist. After this legislation, discharge was possible for traders but there was no similar discharge provision for individuals, and no bankruptcy administration procedure at common law, until the enactment of further legislation in 1861. The modern system of Official Assignees to administer the bankruptcy procedure did not begin until the nineteenth century. Before this, the procedure was open to abuse.

Before the legal concept of discharge from debt, the history of bankruptcy law tilted the balance between debtors, creditors and public interests in favour of the creditors. With the introduction of the concept of discharge, and the focus on administration without corruption, the law gradually reflected the need for balance between debtors rehabilitation, the public interest in processing insolvencies, and maximising returns to creditors.

This balance was last reviewed in the 1960s with the introduction of the Insolvency Act 1967. This paper will provide a much-needed review of the bankruptcy administration procedure in light of the changes to the market place's make up and behaviour of the market-place since the last review.

8. GOALS FOR REFORMING THE BANKRUPTCY ADMINISTRATION PROCEDURE

The Government's key goal in reforming insolvency law is to provide an environment that furthers the public interest by maximising the business community's contribution to the New Zealand economy. This can be achieved by fostering an environment which encourages businesses to produce goods and services at least cost, directs scarce resources to areas where they can contribute the most to the economy and fosters innovative ways to meet consumer needs.

A bankruptcy administration regime should be predictable and as simple as possible. The cost of aiming for a simple system is lost flexibility. Having a system that manages financial failure as quickly and efficiently as possible will reduce the costs of failure for everyone involved. Given the nature of the New Zealand market-place, the system for administering financial failure should not stifle innovation, responsible risk taking and entrepreneurialism by excessively penalising business failure. However, bankruptcy should have a deterrent role by providing clear signals to individuals that commercial misconduct or dishonesty is unacceptable behaviour.

The system for administering financial failure must also seek to maximise creditors' returns by providing flexible and effective methods of insolvency administration and enforcement that encourage early intervention when financial distress becomes apparent. The costs of not seeking to maximise returns to creditors will be a decrease in certainty in the market.

For debtors, a procedure that enables them to be discharged of outstanding debt, in appropriate circumstances, will enable them again to participate fully in the economic life of the community.

9. THE IMPACTS OF BANKRUPTCY

The aim of bankruptcy administration is to provide a procedure for realising the debtor's assets and equitably distributing the debtor's property to creditors. An issue that arises constantly is the lack of assets available for distribution to creditors. Personal insolvency legislation is therefore a balancing act between the rights of the various groups of creditors and the debtor.

However, the impacts of insolvency extend further than the creditors and the debtor of any particular insolvency proceeding. They include insolvent debtors, solvent debtors, creditors involved in insolvency proceedings, creditors, the wider community and Government. The market's behaviour in response to the insolvency regime has significant impacts on these stakeholders.

4.1 Cost and availability of credit

Bankruptcy administration procedure affects the cost and availability of credit within the economy. If the bankruptcy process does not focus on returning the assets to creditors, the security of payment for creditors will be diminished. As the cost of credit increases, fewer business projects will secure finance. This will place at risk income and jobs. Further, fewer consumers will be able to either access credit or access credit at reasonable rates.

An administration procedure may also increase the cost of credit if it adds to uncertainty by, for example, making it unclear what a creditor's rights will be if a debtor becomes insolvent.

4.2 Harsh costs to debtors

It is important that the bankrupt be able to retain a certain level of assets and income over the period of the bankruptcy. Assets, such as tools of trade, may provide an opportunity for the bankrupt to resume earning an income sufficient, for example, to repay at least a portion of the outstanding debts. An income and other assets may also be necessary to ensure at least an adequate standard of living for the debtor.

4.3 Efficient use of resources

For an economy to maximise opportunities for growth, it is important that investment resources are used to best effect. Business failure wastes investment resources. A bankruptcy administration regime that penalises bankrupts who have acted imprudently is likely to encourage sound investment decisions, and reduce the incidence of bankruptcy. Similarly, a regime that allows bankrupts to again enter business allows for those bankrupts to again contribute in a positive way to the economy.

4.4 Administration costs

The administration costs of bankruptcy are the costs the Government incurs in developing, implementing, enforcing, monitoring and reviewing the regime. Ultimately the costs fall on taxpayers. The more significant the changes to the existing regime, for example, the higher the short-term administration costs are likely to be (although this may be more than balanced by long-term savings).

4.5 Transaction costs

The transaction costs to debtors and creditors when bankruptcy occurs are the costs they incur in transacting with non-Government entities and individuals. Changes to the bankruptcy regime that detract from certainty may, for example, lead to creditors incurring higher costs in screening potential debtors and subsequently monitoring debtor behaviour.

4.6 Compliance costs

Compliance costs are the costs debtors and creditors incur in interacting with Government to comply with the regime's requirements. The more cumbersome and complicated the bankruptcy regime, the greater the likely costs to creditors and debtors in complying with that regime.

5. THE BANKRUPTCY ADMINISTRATION PROCEDURE

The bankruptcy administration procedure is managed by the Official Assignee ('the Assignee'). The Assignee is a role established under the Insolvency Act 1967 ('the Act'). The Assignee, as an officer of the High Court, is required to implement the law impartially. The office of the Assignee is part of the New Zealand Insolvency and Trustee Service, under the Business and Registries Branch of the Ministry of Economic Development.

Bankruptcy is designed to be the 'last resort' in personal insolvency. Before this, the debtor has alternatives, both formal and informal. Under the Act, there are two formal alternatives available to the debtor.

5.1 Alternatives to bankruptcy

The existing pre-bankruptcy alternatives are summary instalment orders and proposals under Part XV of the Act.

Debtors may apply for a summary instalment order. This is an order made by a District Court Judge which allows a person whose total debts are less than $12,000 to pay back those debts in regular instalments, without the threat of further legal action in relation to those debts while the order is in force.

Part XV of the Act allows a debtor to make a proposal to their creditors. A proposal may include all or any of the following:

- An offer to assign all or any of their property to a trustee for the benefit of their creditors;
- An offer to pay their debts by instalments;
- An offer to compromise their debts at less than 100 cents in the dollar;
- An offer to pay their debts at some time in the future; and
- Any other offer for an arrangement for the satisfaction of their debts.

A proposal may include any other conditions for the benefit of the creditors and may be accompanied by a security or guarantee. The proposal must: be:

- Accompanied by a statement of affairs in the form prescribed, verified by affidavit showing particulars of the insolvent's assets, debts, and liabilities, the name, address, and occupation of every creditor of the insolvent, and the securities (if any) held by each creditor;
- Signed by the debtor and have the name of the person willing to act as trustee for the creditors endorsed on it; and
- Filed in the office of the court nearest to where the insolvent resides, and neither the proposal nor any security or guarantee tendered with it may, without the leave of the court, be withdrawn pending the decision of the creditors and the court.

The time a proposal is filed in the court constitutes the time for the determination of creditors' claims and for all other purposes of the Act.

After the proposal has been accepted, a meeting of creditors is convened. At this meeting the creditors decide whether to accept the proposal. If the proposal is accepted, the trustee must immediately apply to the court for its approval, and must, at least 10 days before the hearing date, send notice (of the hearing of the application, in the prescribed form) to the insolvent and to every known creditor. However, if the creditors at a meeting held under section 142 of the Act do not accept the proposal, then the chairman of the meeting will return the proposal to the court with the words 'not accepted by creditors' endorsed over his signature and the Registrar will cancel the proposal.

If the creditors accept the proposal and the court approves it, Part XV provides that, in respect of that debt and while the proposal remains in force, a creditor cannot:

- File or proceed with a creditor's petition against the insolvent (except with the leave of the court given on such terms as the court thinks fit); or
- Enforce any civil remedy against the insolvent's property; or
- Commence any legal proceeding in respect of the debt.

At any time after the court has approved the proposal the court may vary or cancel the proposal on application of a creditor or the trustee.

5.2.1 Debtor petitions

When a debtor files a petition, they immediately become bankrupt and there is no need for a court hearing. As the filing of a debtor's petition is equivalent to an order of adjudication, a debtor's petition cannot be withdrawn, so instead the debtor must move for an annulment of adjudication.

5.2.2 Creditor petitions

Creditors are entitled to file a petition in the High Court if they are $200 or more, the debtor has committed an act of bankruptcy within three months before the filing of the petition, and the debt is a liquidated sum payable either immediately or at some certain future time.[3] The creditor and debtor[4] appear at a court hearing which determines whether to adjudge the debtor bankrupt. If the court is satisfied as to the facts alleged in the petition and that the debtor has been duly served, the debtor may be adjudged bankrupt.

On adjudication, all the debtor's property is vested in the Assignee. The potential outcomes of the court hearing are:

- The debtor may be adjudged bankrupt;
- The petition may be dismissed;
- Proceedings may be stayed; or
- The Assignee may be appointed as receiver and manager of the debtor's property.
- If the debtor is not adjudged bankrupt creditors can seek recovery of debts by agreement with the debtor or through the courts.

5.2.3 Effects of adjudication

At the point where the debtor is adjudged bankrupt, the distinction between a debtor-filed petition and a creditor-filed petition is not relevant to the effects of bankruptcy on the bankrupt.

> Commencement of bankruptcy relates to the time of the act of bankruptcy on which the petition is founded or the time of the first of the acts of bankruptcy which the bankrupt is proved to have committed within the three months immediately before the petition was filed. Section 42(1) of the Act states that all the bankrupt's property and powers vest in the Official Assignee. Section

42(2) of the Act states that the property that vests in the Assignee is that belonging to or vested in the bankrupt at the commencement of the bankruptcy. The Official Assignee becomes entitled to all[5] real and personal property, vested in the bankrupt at the commencement of bankruptcy or acquired by him or her before discharge.

Once the debtor is adjudged bankrupt, the Assignee under section 33 of the Act, either sends the bankrupt certain forms relating their assets and liabilities and a list of questions relating to his or her affairs, or the bankrupt is requested to attend an interview at an office of the New Zealand Insolvency and Trustee Service to complete the same forms.

Once adjudged bankrupt, the bankrupt receives a notice that can be shown to their creditors as evidence of their bankruptcy. A notice advertising the bankruptcy is published in the regional newspapers where the bankrupt lives and has incurred the majority of their debts.

Immediately after adjudication, the bankrupt may select and retain, with the Assignee's agreement, tools of trade to the value of $500, furniture and personal effects not exceeding $2,000 in value and money to the value of $400. With this exception, the Official Assignee becomes entitled to all[6] real and personal property vested in the bankrupt at the commencement of bankruptcy or acquired by him or her before discharge.

The Assignee may call meetings of creditors and compel the bankrupt to attend them. The Assignee has discretion to call a meeting of creditors within 14 days of compliance with section 33 of the Act. The Assignee may from time to time summon a further meeting of creditors and must call one if required to do so by one-quarter (in value) of the creditors who have proved their debts. The Assignee and at least one creditor must attend meetings.

The Assignee can require the bankrupt to undergo a private examination in respect of their property either before or after their discharge. The usual purpose of a private examination is to discover whether the debtor has documents that have not been disclosed to date and, if so, to have the property or information delivered up to the Assignee. The private examination provides a mechanism for dealing with a bankrupt whose conduct is unsatisfactory or who is suspected of concealing his or her property.[7]

Public examinations can also be held, but these are rare due to the expense involved and sometimes serve more of a scandalous than a public interest. Public examinations usually take place immediately before the hearing of an application for discharge. Creditors may by resolution appoint an expert or a committee of persons to help the Assignee administer the estate.

During bankruptcy, the bankrupt is restricted from entering into business alone or in a partnership and from being a director of, or taking any part in the management of, a company without the Assignee's. The bankrupt is also prevented from obtaining credit for $100 or more without disclosing that he or she is an undischarged bankrupt and from leaving the country within three years of adjudication without the Assignee's.

4.4.4 Discharge

A bankrupt may apply for discharge at any time after the adjudication is made. This is determined in a court hearing, and the bankrupt has to show good cause for an early discharge. If an order of discharge is not granted, the bankrupt can make further applications from time to time unless the court in refusing the discharge, stipulates the earliest date on which he or she can apply again.[8]
At the hearing of an application for discharge, or any hearing where the automatic discharge of the bankrupt is opposed, the court may:

- Grant an immediate order of discharge; or
- Grant an order of discharge subject to such conditions (including consenting to any judgment or order for the payment of any sum of money) as it thinks fit, or suspend any order for discharge as it thinks fit; or
- Grant an order of discharge with or without such conditions as it thinks fit to take effect at a specified future date; or
- Refuse an order of discharge, in which case the court may specify the earliest date on which the bankrupt may apply again to the court for an order of discharge.
-

A bankrupt is normally discharged three years after adjudication unless this is objected to by a creditor with leave of the court, or the Assignee, or the bankrupt is required to pass a public examination and has not done so[9].

The court, before or while granting an order of discharge, may make an order prohibiting the bankrupt, following discharge, from engaging in business without leave of the court. The restriction period need not be limited, but the court may at any time cancel or vary the order.[10]

4.5 The typical attributes of a debtor

Bankruptcy administration is available only to individuals. This includes a wide variety of people, such as consumers, employees, sole traders and partnerships, and it is quite common for a bankrupt to be a mixture of these. The statistics available on bankruptcy are often incomplete, but the available statistics for the years 1997-2000 provide some information on bankrupts in New Zealand, in conjunction with anecdotal evidence from the New Zealand Insolvency and Trustee Service.

For the year ended June 2000,[11] where dividends were not paid in 79 percent of estates (2,235 out of 2,817). Some money was recovered but not paid in dividends to creditors 4.6 percent of estates (132 out of 2,817) and 0.9 percent of estates (28 out of 2,817) paid 50-99 cents in the dollar.

Statistics show a seven percent decrease in the number of bankruptcies for 1999. There were 3,003 people adjudicated bankrupt during 1999, as against 3,224 in 1998. For the year ended 31 December 1999, 59 percent of bankruptcies resulted from debtor's petitions.

Consumer bankrupts continue to represent the majority of bankrupts, contributing to 63 percent of all bankrupt estates for the year ended 31 December 1999. This is an increase from 1998 in which 55 percent of all bankrupts were consumer related.

For the period 1 July 1997 until 30 June 1998, the statistics available cover a wider range of topics but are still incomplete. They do, however, provide some insight into bankruptcy.

Table One: Sample of reponses received for the period 1 July 1997 until 30 June 1998

Filed by creditors	263	
	Male 81 %	Female 19%
Filed by debtors	805	
	Male 55%	Female 45%
Aged between 25 and 40 years	50% of total bankruptcies	
Aged between 41 and 55 years	28% of total bankruptcies	
Married / de facto	557	48% of total bankruptcies
In business during the two years before bankruptcy		20% of total bankruptcies
Employed	30% of total bankruptcies	
Receiving Income Support	50% of total bankruptcies	
Bankrupts owning credit cards	Males 30% of total bankruptcies	Females 31% of total bankruptcies
	Of this Þgure, 48% of males owned two or more credit cards	Of this Þgure, 62% of females owned two or more credit cards
Second time bankrupts	6% of total bankruptcies	

Based on the empirical evidence and anecdotal information provided by the New Zealand Insolvency and Trustee Service, the make-up of the 'typical' New Zealand bankrupt can be drawn out. Almost 80 percent of bankrupt estates do not return a dividend to creditors. The majority of bankruptcies began with a debtor-filed petition and the debtor is usually aged between 25 and 40 years. A large number of bankrupts are married or in a de facto relationship, and many own more than one credit card. Half the bankrupts are receiving income support, so have no income with which to pay creditors once they are bankrupt.

Since the last review of personal insolvency legislation in the 1960s, the number of consumer bankrupts has increased and has surpassed the number of business-related bankrupts.

4.6 Factors contributing to personal insolvency

Personal insolvency, and therefore bankruptcy, can arise for many reasons, including credit and overindebtedness, the unavoidable cost of sensible risk-taking, lack of business efficacy, and dishonesty or criminal conduct. The factors that contribute to insolvency are generally similar for debtors, whether they are consumers, sole traders or partnerships. Where they differ is in the impact that each factor has on the different types of debtors. For example, access to credit and overindebtedness is an issue for all debtors, but impacts greatly as a factor leading to personal insolvency for consumers.

The historical view of the causes of personal insolvency centre on the individuals' failure in terms of their conduct. The current view of the causes of personal insolvency is that, for individuals involved in trade, the cause is generally poor management. The most common factor that leads to 'consumer' insolvency is the increasing availability of credit and overindebtedness. This factor also affects sole traders and partnerships, but in those cases it is not the main cause.

1.1.1 Credit and overindebtedness[12]

Overindebtedness occurs when borrowers find themselves with a higher level of debt than they can service. There are indications that levels of consumer debt are increasing and that this is resulting in overindebtedness:

- Reserve Bank of New Zealand surveys have demonstrated trends toward rising personal indebtedness. For instance, from 1978 to 1987 household debt remained below 50 percent of personal disposable income but climbed steadily to exceed the 100 percent level by 1997[13]. The survey shows that most forms of consumer borrowing, particularly from the major trading banks, have significantly increased in that time.

- New Zealand's network of Budget Advisory Services reports that more people are requiring its services. In the 12 months to June 1999, it reported that the number of people applying for budgeting help rose from 70,500 to 91,700, and the total amount the services clients owed rose from $43.7 million to $56.4 million. (In part, however, this may be due to increased consumer awareness of the Budget Advisory Service.)

- In the first six months of 1999, the credit check agency Baycorp reported that 22.8 percent of a sample of people on its credit file had an 'adverse credit record'. The figure for the same survey for the first six months of 1998 was 19.7 percent.

- More consumers are filing for bankruptcy. In the year to the end of June 1998, consumer bankruptcies rose by 42 percent to 1,844. In the year ended June 1999, they rose again slightly, to 1,945. The number of consumer bankruptcies in comparable countries has also steadily increased. For example, in Australia, the consumer insolvency rate more than doubled between 1986/87 and 1996/97 and in Canada, it also rose considerably in the 1990s.

1.1.1 The nature of consumer debt

Individual overindebtedness has three causes namely where a consumer:

(a) Has received credit which they were always unlikely to be able to repay;

(b) May become unable to meet repayments because of changing circumstances - for example job loss, separation, or illness;

(c) Agrees to act as a guarantor[14] without understanding the full extent of the obligations incurred and later discover they are responsible for repaying the debt.

1.1.1 Credit which consumers cannot repay

For a variety of reasons such as desperate need, or not understanding the full extent of what they are committing themselves to [15] some consumers obtain credit when, objectively, there is no likelihood they can repay it.

This raises the question of whether lenders are making commercially responsible lending decisions. The argument is often made that lenders may 'overlend' if, in the event of default, they have sufficient security, or a guarantor, to cover the debt. Lenders dispute this: they say it is irrational to over lend, there are significant transaction costs in realising security, and (apart from loans secured against real property) the value of security is rarely enough to cover the debt and the lender's enforcement expenses.

1.1.2 Changing circumstances

Consumers can find themselves in circumstances, not anticipate when they obtained credit. This can occur, for example, through illness, job loss, or the breakdown of a relationship.

Circumstances such as job loss and illness can be insured against but even if insurance has been taken out, the terms of the policy may not sufficiently cover the debt. For example, the circumstances of a consumer's job loss may not meet the requirements of the policy, or an exclusion in the policy may mean a consumer's claim is rejected.

1.1.3 Guarantors

There is also the risk that a guarantor a consumer who guarantees repayment of the debt could end up suffering the consequences of overindebtedness. This will occur if the borrower defaults and the guarantor is called on to honour repayments. Some guarantors have no idea of the obligation that they have undertaken by agreeing to guarantee a loan, or never expect to have to fulfil the guarantee.[16]

1.1.4 The unavoidable cost of sensible risk-taking

The unavoidable cost of sensible risk-taking can lead to personal insolvency for both consumers and sole traders or partnerships.

This category recognises that decisions are made without full information, markets are unpredictable, and unforeseeable externally caused change occurs (e.g. new Government regulations). Any of these characteristics can mean business decisions that were sensible at the time they were made can subsequently lead to insolvency.

5.4.7 Lack of business efficacy

There are people who do not make sensible decisions in relation to risk-taking. This behaviour creates a substantial risk of serious loss of assets by the debtor. It can easily lead to personal insolvency, bankruptcy, and to repeat bankruptcies.

5.4.8 Dishonesty or criminal conduct

The most common forms of criminal conduct by a debtor, in terms of insolvency legislation, are concealing or removing property, destroying or falsifying documentation relating to their affairs, failing to keep proper business accounts, absconding and obtaining credit when a Court has ordered them not to.

Although the behaviour in itself may not be the sole cause of insolvency, it will certainly lead to the bankruptcy, as creditors will be unlikely to participate in informal or formal arrangements with a dishonest debtor.

2 PROBLEM DEFINITION

There are several issues that require consideration. These include the starting point for the bankruptcy administration procedure, sufficiency of incentives for early intervention and that the current regime attempts to provide one system to process all types of estates and bankrupts.

1.1 Defining bankruptcy

The point at which bankruptcy occurs, and the nature of bankruptcy, will affect the application of the bankruptcy procedure. Currently, the Act provides confusion and uncertainty.

There are two parts to this issue: the doctrine of relation back, and the current definition of the acts of bankruptcy in the Act. The two are linked, particularly in the case of creditor-filed petitions.

At present, bankruptcy begins for creditor-filed petitions when the debtor makes the act of bankruptcy (see 6.1.1), not at the point of adjudication. This is due to the doctrine of relation back. For debtors, bankruptcy begins at the time of filing or, if the bankrupt is proved to have committed an act of bankruptcy, at the time of the act.

6.1.1 What is an act of bankruptcy?

For the purposes of adjudication, section 19 of the Act defines bankruptcy as one of several acts set out in that section. A debtor commits an act of bankruptcy in each of the following cases:

(a) Where in New Zealand or elsewhere the debtor makes a disposition of all or substantially all of their property to a trustee for the benefit of all or any of his or her creditors.

(b) Where, in New Zealand or elsewhere, the debtor fraudulently, or with intent to give any creditor a preference over other creditors,
(i) Makes any disposition of his or her property or any part of it; or
(ii) Creates any charge on it or gives any security over it; or
(iii) Makes any payment; or
(iv) Incurs any obligation.

(c) Where, with intent to defeat or delay his creditors, the debtor leaves, attempts to leave or is about to leave New Zealand, or (being out of New Zealand) remains out of New Zealand, or leaves his or her home, or otherwise absents himself or herself, or keeps to any premises or to part of premises to avoid his creditors:

(d) Where a creditor has obtained a final judgment or final order against the debtor for any amount and execution of it has not been stayed, and the debtor has a bankruptcy notice under the Act served on him in New Zealand (or, by leave of the Court, elsewhere) and does not, within the required notice period, either comply with the requirements of the notice or satisfy the Court that he or she has a counterclaim, set-off, or cross demand which equals or exceeds the amount of the judgment debt or sum ordered to be paid, and which the debtor could not set up in the action in which the judgment or order was obtained or the proceedings in which the order was obtained.

(e) Where the creditor gives notice to any of his or her creditors that he has suspended, or is about to suspend payment of his or her debts.

(f) Where at any meeting of his or her creditors, the debtor admits insolvency and either
(i) A majority (in number and value) of the creditors present at the meeting by resolution at the meeting require the debtor to file a debtor's petition; or
(ii) He or she consents to file a debtor's petition and does not do so within 48 hours (excluding any holiday) from the time of his or her consent file the petition.

(g) Where possession has been taken under execution issued against the debtor or his or her property on any legal process and the judgment or order in respect of which the execution is issued is not satisfied within seven days after possession has been taken. (However, where an interpleader summons has been taken out in regard to the property seized, the time between when the summons is taken out and when the proceedings on the summons are finally disposed of, settled, or abandoned is not taken into account in calculating the seven-day period.)

(h) Where a writ of sale directed against any of the debtors land or any interest in it has been delivered to a Sheriff, and that land or interest has been advertised for sale under that process.

(However, if the judgment or order for which the writ of sale was issued is satisfied within seven days after the writ of sale has been delivered to the Sheriff and advertised, no act of bankruptcy is committed.)

(i) Where a return of nulla bona (insufficient goods found on which to levy) has been made to any execution issued against the debtor or his or her property on any legal process.

(j) Where, with intent to prejudice his or her creditors or to prefer one creditor above another, the debtor removes or conceals any of his or her property or attempts to do either.

(k) Where the debtor is required by law to keep a trust account any court has given judgment against him for non-payment of trust money and the judgment is unsatisfied for seven days.

Such a list of acts of bankruptcy is needed to provide guidance for creditors and debtors as to what an act of bankruptcy is and when the bankruptcy administration procedure can be initiated. The common theme that runs through most of the listed acts of bankruptcy is that of an outstanding debt which has not been paid even after a creditor has used their available remedies to pursue the debt.

The acts of bankruptcy become very important in creditor-filed petitions, and sometimes in debtor-filed petitions. The occurrence of the act of bankruptcy will determine when the bankruptcy begins for the purposes of asset realisation, a situation that is termed the doctrine of relation back. The doctrine means that although the bankruptcy procedure began at the point of adjudication, the scope of the bankruptcy can extend back to transactions before adjudication. How far back may depend on when the act of bankruptcy that the creditor's claim was initially tied to occurred. This doctrine overlaps with the role of voidable transactions, also a topic under Tier One of the insolvency review.

6.1.2 What assets are available to the collective pool of creditors?

Statistics show that most estates have few, if any, assets for distribution to creditors. Relation back allows the Assignee access to those assets held before adjudication, but after the point of insolvency, that the debtor may have distributed in favour of certain creditors. This doctrine is hardly used, as it is difficult to determine when insolvency begins. However, relation back should not be discounted due to its current lack of use.

Bankruptcy administration facilitates compulsory and collective realisation of a debtor's assets, which is regarded as more efficient in maximising the pool of assets available to all creditors than would be the case were creditors left to pursue their individual remedies. It also allows for distribution to creditor groups equally, thus upholding the pari passu principle. Relation back allows all assets that should be in the central pool to be used for equal distribution to the groups of creditors.

The other option available to the Assignee for realisation of assets that should be used for all creditors is voidable transactions. This is a separate topic under the insolvency review, looking at approaches to improving the application of these rules. Voidable preference law is designed to support this system of collective realisation and the underlying pari passu principle. By discouraging, or reversing the effect of one creditor's gain at the expense of creditors generally, provisions avoiding these types of transactions ensure that there is a 'level playing-field' for all creditors and that there is something left to play with.

The overlap between voidable transactions and the doctrine of relation back provides for two methods of achieving the same aim. The problem is that debtors and creditors need certainty as to when bankruptcy begins. It does not provide certainty to have two rules fulfilling the same purpose.

6.2 Insufficient incentives for early intervention

When considering the issues of insufficient incentives for early intervention, one option is to focus on incentives for debtors and creditors. Improving incentives for debtors would involve providing them with a benefit they would not otherwise receive if they did not seek early intervention. Incentives can include access to alternatives to bankruptcy, a shorter time period for bankruptcy, or support and advice financial management. Another option is providing a 'breathing space' for debtors that are insolvent and facing legal action by creditors. A mixture of these would increase the incentives for debtors to seek early intervention.

6.2.1 Debtor incentives

Encouraging debtors to seek help before bankruptcy would improve the opportunities to avoid the stigma of bankruptcy and the financial inevitability of a poor credit rating that continues after discharge. Increasing the availability of information will increase access to available options.

6.2.2 Creditor incentives

Early intervention could benefit creditors because the insolvency framework will focus on retaining assets within estates for repayment to creditors. As indicated in the statistics for the year ended June 2000, usually little or no money is currently repaid to creditors from a bankrupt's estate. This is because by the time the bankruptcy starts, most of the debtor's assets have been used to try to stave off the bankruptcy. Early intervention, without the costs of court action, could maximise creditors' returns.

6.2.3 Education and dissemination of information

Debtor education comprises three main roles: decision-making, resource management and community participation. Decision-making is influenced by the factors surrounding the debtor at the time of the decision. It is important information to provide a debtor with education and information on choices and responsibilities, especially in relation to credit. Financial planning, money management, prudent purchasing habits and sensible risk taking skills are all necessary tools for debtors. A sound working knowledge of business and Government processes will provide individuals and communities with the tools to make sensible decisions. Information on the procedures and options when financial difficulties occur is valuable as information. Information on the benefits of early intervention will provide awareness of incentives.

3.3 The existing regime is not appropriate in all cases

The problem may be stated as *the existing regime is not appropriate in all cases*. There are essentially two types of bankruptcies and different considerations apply to each, yet the existing regime does not take account of these differences. The two types are debtors with little or no assets and estates with assets.

The current regime attempts to provide one system to process all types of estates and bankrupts. The result is that it focuses on the bankruptcy administration procedure at the expense of alternatives to bankruptcy. As a consequence, estates that would be better suited to the alternatives end up in formal bankruptcy proceedings. When debtors become bankrupt, their ability to participate in the market-place, contributing to the economy as a whole, is removed. The Ministry wishes to develop a system which maximises returns to creditors, provides certain and predictable outcomes and, where appropriate, provides alternatives to bankruptcy. To fulfil this objective, the current system needs to be 're-balanced' to accommodate the dual functions of rehabilitation and deterrence and to address the distinct problems posed by debtors with assets, debtor without assets, and dishonest debtors.

6.3.1 Debtors with assets – appropriate alternatives

In certain circumstances, where a debtor has assets it is more appropriate for stakeholder interests to rely on alternatives to bankruptcy, leaving an increased proportion of assets for distribution to creditors. This results in the debtor avoiding the penalties of bankruptcy.

The current bankruptcy regime provides alternatives to bankruptcy for payment of creditors. These alternatives are effective in themselves but, placed within the context of bankruptcy as a whole, fail to achieve the desired effect. This is due to the strong focus on bankruptcy, but not the formal alternatives, and on the costs of court involvement and the lack of information or awareness about these options.

The problem with these procedures is, first that the regime requires High Court proceedings at certain stages and, secondly, that such court proceedings are costly and subject to time delays.

Alternatives are not widely used in New Zealand. The lack of information available on alternatives to bankruptcy means debtor's often do not know about them until after they are adjudged bankrupt.

The specific deficiencies surrounding summary instalment orders are due to a combination of reasons including the low ceiling permitted for the total amount of indebtedness, the lack of supervision and administrative support (i.e. trustees and supervisors), the unsuitability of debt repayment schemes, and the lack of punitive provisions for breach of agreements.

The specific problems with proposals under Part XV of the Act include the high levels of court involvement, with the ensuing time and cost prohibitions, and the difficulty of managing creditor expectations. These proposals require creditor approval but do not deliver adequate supervision, administrative support and punitive provisions for breach of agreements to ensure creditor agreement.

The current alternatives aim to provide formal arrangements for the debtor to repay debt. There are two alternatives under the Act, one of which is aimed at debtors with low total debt while the other is a general alternative. Currently, neither is meeting the aims of providing formal arrangements for debtors to repay, as debtors are not using them. However, the principles behind the alternatives are necessary for a balanced bankruptcy system.

6.3.2 Debtors without assets

Where debtors have little or no assets for distribution to creditors, the formal alternatives are not available to them. Where a debtor cannot pay their debts and does not have the requisite amount of enough remaining assets to use an alternative the only option available to them, is the bankruptcy administration procedure.

The procedure is designed at present to deal with all debtors, regardless of their financial position. The time frame for bankruptcy is set at three years, partly to provide sufficient time to process the estate and partly as a deterrence to other debtors.

Administration by the Assignee for estates without assets is usually fast-tracked and dealt with in six months.

A function of the duration of bankruptcy is deterring debtors from commercial misconduct and safeguarding the community from debtors that do become involved in commercial misconduct. It is difficult to balance the need for deterrence and the desire to encourage innovation and entrepreneurial activity. There is no empirical evidence that the current term does or does not achieve the correct balance. The current three-year time period was designed to fit a situation that existed before the enactment of the Companies Act 1993. Before the 1993 changes, one-person businesses couldn't be incorporated as a company, and most bankruptcies were a result of these small businesses failing. Currently, most estates without assets are consumer bankruptcies, i.e. where a person incurs debt and becomes insolvent as a consumer, as opposed to in a business context.

The role of safeguarding the community is important. However, the number of debtors who are involved in fraud or commercial misconduct is relatively low compared with the number of debtors who are 'honest' but poor at managing credit and commercial affairs. The Assignee has tools to restrict certain debtors from re-entering the community in a business capacity.

There is an increasing international trend to reduce the time frames for bankruptcy, with the United Kingdom suggesting a reduction to six months, Australia recommending a move from three years to two years and the United States at six months.

As part of this review, the Ministry seeks comment on ways to reduce the number of debtors who are left with no alternative but bankruptcy. Comment on this area should take into account the role of deterrence and protection of the community, bearing in mind the focus on sensible risk-taking and innovation by New Zealanders, and the changing nature of the 'typical debtor'.

The procedure could be designed for ease of processing of estates without assets. In doing so, it could fast-track the legislative administration period. The trade-off would mean less deterrence for debtors to avoid bankruptcy.

4 PROPOSED REFORM OF BANKRUPTCY ADMINISTRATION PROCEDURE

There are several areas where the existing procedure needs to be reformed to address the issues discussed above. These include defining bankruptcy, improving incentives for early intervention, and addressing the need to make the existing regime more appropriate for all cases.

1.1 Defining bankruptcy

Defining who is bankrupt and at which point they became bankrupt will affect the returns to creditors and the level of certainty in the market. The aim is to improve the current system, which is not used as it is too complex and involves defining when insolvency has occurred. One option is a 'simple' rule that states, for example, that bankruptcy begins at a certain defined point like adjudication or any point where an objective test can be applied. This would remove the relation back doctrine. Another option is a 'complex' rule that attempts to deal with the issues on a case-by-case basis. This provides substantial flexibility. Improving bankruptcy, in terms of simplicity, will involve trade-offs in terms of certainty and flexibility.

In the context of bankruptcy administration, providing a simpler rule will mean people can apply the rule before bankruptcy and know for certain whether they fall within the procedure. The use of simplified rules has the benefit of easily applied, simple tests. This will provide certainty, but will also decrease flexibility, as simple rules generally do not catch all the parties they are intended to catch and normally catch parties for whom the rule was never intended. The trade-off for a simple rule to determine when bankruptcy begins is a lack of flexibility.

Complex rules provide flexibility by allowing case by case application. Flexibility is an important fixture of a bankruptcy system because it means the rules can be applied to the parties they are intended for, minimising the chance of unintended consequences. However, the costs of the system could increase as parties may be forced to litigate to determine the position at law.

A simpler rule for determining when bankruptcy begins will mean individual cases will not be so easily dealt with on their merits. However, maintaining the courts role in this area will introduce flexibility in cases where the parties disagree as to whether the debtor should be adjudicated bankrupt. The majority of bankruptcies begin with debtor filed petitions, and a simpler rule as to when bankruptcy begins would give them certainty. In creditor-filed petitions, the court will be able to determine the matter should flexibility be required.

A simpler rule for determining when bankruptcy begins should provide certainty when combined with the flexibility of court procedures to resolve complex cases where disagreements about insolvency arise. The simple rule could be that bankruptcy begins at adjudication, when the debtors legal status.

1.2 Early intervention

Issues involved in solving the problem of lack of incentives for early intervention revolve around the trade-offs between the debtor and creditors. Possible solutions could be an increase in the amount of information available to the debtors and the creditors, or proactive intervention by the parties or the Assignee. In considering these alternatives, weighing the impacts on all the parties is important and should be considered in light of the need for certainty and simplicity without increasing the costs on either party.

Currently, an audit occurs when the debtor has been adjudicated bankrupt. By changing the timing of the audit so that it occurs before bankruptcy, it could be used as a tool to sort debtors into the most efficient procedure for distributing their assets to creditors. This would not necessarily affect the incentives for creditors, but would improve the debtor's access to alternatives

To take this further, and actually provide a tangible incentive, the audit could provide 'breathing space' for debtors by instituting a moratorium on creditors, claims while the Assignee determines the debtor's financial position and provides information on the options available. For example, once the audit begins, all claims by creditors could be placed on hold for 14 days. This would affect creditor rights by decreasing certainty of outcome. However, it would be worthwhile to trade off less certainty for increased returns to creditors, as debtors start to seek help at a stage when they have assets to pay creditors.

Debtors could complete a form that signals their intention to file a debtor's petition (Request for Solvency Assessment, or RSA) which would allow the Assignee to provide a financial audit before a debtor's petition is filed. Debtors would have to provide information on their financial position, including a list of creditors and amounts owing and their total pool of assets. Information could also be provided on alternatives to bankruptcy at this stage.

1.2.1 Financial counselling

Extending this option further could involve a commitment to provide complete financial counselling for the debtor at this point, regardless of the options they have available them in terms of bankruptcy or alternatives. This service could be provided by the Insolvency Service or by private counselling services, and counselling could be compulsory or voluntary. The focus would be on rehabilitation and providing debtors with appropriate financial skills.

The key to providing effective information to debtors is to provide it at all stages of the credit process. Education of consumers and lenders about their rights and responsibilities in relation to credit may help consumers in their financial decision-making. The aim would be to help consumers avoid over-committing themselves. Providing information during the credit process could involve using community agencies that educate debtors on good money management and assist them in financial distress. The next stage is information provided towards the end of the credit process, where the debtor will already be in severe financial difficulty. This information would be centred on bankruptcy and the formal alternatives available to the debtor under insolvency legislation. Finally, information should be provided on exit from the credit process. Education at this stage should aim to decrease the possibility of the debtor repeating similar mistakes.

The Ministry of Consumer Affairs is involved in a review of the consumer credit law, with a discussion document for public consultation released in August 2000. One of the topics of Part 4 of this review is overindebtedness. In terms of information and education, that review focuses on the early and middle stages of the credit process. This raises the need for information and education in the final stages.

The factors that need to be considered here are what benefits will be gained and at what cost. The benefits of counselling centre on rehabilitation. Providing basic information to debtors about budgeting, credit management and responsible risk taking will result in increased knowledge. The effectiveness of this cannot be quantified if it is provided at the end of a credit process, but that does not mean the information is ineffective. Debtor awareness of the risks and responsibilities associated with credit is important information.

The costs of providing financial counselling could be high, and the returns to capital invested would be difficult to measure. The Insolvency Service could not provide as high a level of service as community agencies which specialise in providing support.

1.2.2 Preferred options for providing incentives for early intervention

The Ministry favours the introduction of a financial audit, instigated by a Request for Solvency Assessment form ('RSA form'). This form could signal the debtor's intention to file a bankruptcy petition. The RSA's purpose would be to determine the debtor's financial position and list the options available given that information. Information could then be provided on the next step, whether it is using a formal alternative, or filing for bankruptcy. If a formal alternative was available contacts could be provided for private sector administrators. If bankruptcy was the only option available to the debtor, the Insolvency Service could advise on how to file a debtor's petition and the consequences of doing so. At that point, the debtor could be given time to consider options, or could instigate a solution then. The time taken to consider would be influenced by the moratorium placed on creditors. The content of the form could provide for a list of all assets and all liabilities.

The RSA form could be made available via the Insolvency Service website and distributed to firms and organisations eg the Budget Advisory Service. Debtors would be able to fill one in either before an appointment with their local Insolvency Service office, or fill one in at an appointment with a branch of the service. The RSA form could be similar to the Statement of Affairs form currently used once a debtor has been adjudicated bankrupt, listing the debtor's assets and liabilities.

The RSA form could include sections on demographic information for statistical purposes. This information will aid the Ministry in reviewing policy. The RSA form would affect creditor rights and would be legally binding on a debtor. Once the form had been processed, the debtor would be provided with 'breathing space' for 14 days, during which all creditors claims would be temporarily postponed. This will allow the debtor to seek early advice or intervention. Existing penalties for failing to disclose all information in the current proceedings will also apply to the proposed proceedings. A debtor should only be able to use one RSA form within any 12-month period.

The balance between incentives for debtors to seek early intervention and certainty for creditors in terms of protection of their rights, is important. The debtor's incentive to approach the Assignee regarding their options would be the 'breathing space' that a stay on proceedings would provide. For creditors, the stay could have two impacts on their position. If creditor-initiated proceedings had already commenced and the debtor filed an RSA form with the Assignee, the RSA form could mean the stay of proceedings took precedence over the creditor-initiated proceeding until the stay expired, for example after 14 days. During this time, alternatives could be pursued with creditors. If no proceedings had been initiated, and the debtor filed an RSA form with the Assignee, the effect would be to stay any proceedings that individual creditors may wish to make for the following 14 days, for example.

Providing a debtor with incentive to seek early intervention will increase the number of debtors using alternatives or debtor petitions, thereby limiting the cases where individual creditors expend the resources to pursue the debtor via the court. This would provide certainty for creditors that no one creditor was asserting their rights over and above any other creditor. The Ministry does not have a preferred option in terms of financial counselling. Comments are sought on this issue.

While the information set out in this section on a possible solution is specific, it is by no means a predetermined solution. The Ministry seeks comment and welcomes suggestions on alternative options.

1.3 Tailoring the regime to suit the debtor's financial position

An aim of this review is to reduce the number of estates with assets that proceed to bankruptcy by encouraging early intervention so that the alternatives to bankruptcy are valid options for debtors and creditors. These alternatives will be strengthened and debtor access to them will be improved. For those estates with assets that do end up in bankruptcy, the aim is to find the best method for dealing with those estates. This aim is countered by the knowledge that the bankruptcy regime must also cater for debtors that are not honest.

1.3.1 Formal alternatives to bankruptcy

Improving the formal alternatives to bankruptcy should increase debtors and creditors' access to and use of them. This should decrease the number of debtors in bankruptcy that could have explored other options. The formal alternatives would be improved by either improving the existing alternatives or creating new alternative procedures.

1.3.1.1 Improving the current alternatives

Removing the prohibitive time and cost of court involvement from the alternatives will increase the viability of summary instalment orders and proposals under Part XV of the Act as alternatives to bankruptcy. Providing for the Assignee or private administrators to manage the alternatives would significantly reduce the time and cost of the alternatives while increasing debtor awareness of them at an earlier stage.

7.3.1.2 Summary instalment orders

Already some private administrators are administering summary instalment orders and Part XV proposals. With summary instalment orders, the private administrators are responsible to the court.

The option could be made available to more debtors by increasing the threshold of debt for a summary instalment order from $12,000 to $40,000 and improving debtor access to information at an earlier stage.

Increasing the commission available could make the administration economically viable for private administrators. The commission for private administrators could be increased to 10percent, with changes to commission fees made by Order in Council. This would provide increased incentives to administrators to work in this area. The private administrator would have the right to waive the fee. Trust accounts and the ensuing obligations would apply to private administrators.

7.3.1.3 Part XV proposals

Providing for private administrators to administer Part XV proposals, rather than the court, would allow administration decreased costs due to less court involvement. Debtor awareness of the alternatives, at a stage where they are viable options, will be provided through early intervention at the audit and options stage.

As proposed with regard to summary instalment orders, the commission for private administrators could be increased to 10 percent.

7.3.1.4 The role of the court and the Assignee

The court's role could be partially carried out by the Assignee in the particular situation of alternatives. The Assignee could monitor or supervise debt repayment schemes for suitability, make cosmetic changes, or recommend significant changes that will require creditor approval before the Assignee will approve the scheme. High Court procedures would be available in complex situations, and the right of appeal would remain.

Where there are breaches of agreements, creditor access to the punitive provisions of bankruptcy would be improved, as the Assignee would be directly involved in administering the failed scheme and the consequential bankruptcy procedure. If an alternative became onerous on the debtor, they could apply to the Assignee to alter its terms. Creditors would have to be informed of reasons behind changes and would be able to apply to court to have the debtor comply with the original proposal or order, or to have them adjudged bankrupt.

This issue is being considered in Tier Two of the insolvency review, under the role of the state. Comment on this issue should take into account the further work that is taking place and the context in which that work will occur. Issues to consider concern how much involvement the state should have in bankruptcy, whether the involvement is currently acceptable, and what role is appropriate for private administrators.

Using alternatives to bankruptcy will maximise returns to creditors. Part payment will, probably continue, but the sooner the debtor becomes involved in the active repayment of the debt, the higher the level of assets available for distribution to creditors. Compliance costs are expected to decrease, as alternatives to bankruptcy impose less onerous structures on creditors than bankruptcy. Where the returns to creditors will be maximised, the costs of credit will decrease as certainty of return increases.

The Ministry would like comment on options for creating new alternative procedures and for improving the existing alternatives.

7.3.2. Asset distribution where there are few, or no, assets

The options to improve bankruptcy administration when the debtor has few, or no, assets centre on decreasing time costs and administration costs, while maintaining quality administration of estates.

7.3.2.1 Proceedings consequent on adjudication

Where it is determined that the bankrupt has no assets, a bankruptcy administration procedure that focuses on distribution of assets will not provide the best outcome at the lowest cost. Without assets to distribute to creditors, the meeting of creditors and the process undertaken by the Assignee's is costly and time consuming and unlikely to increase returns to creditors. In particular, the procedural could be lessened, while the working relationship between the Assignee and creditors could be more suitably catered for.

Currently, the Assignee uses its back office to administer all non-complex estates (making up 70percent of all estates).

Section 34A of the Act allows the meeting of creditors to be dispensed with, and such meetings are very rarely held. In its first notice to creditors, issuing within 25 working days of adjudication, the Assignee notifies creditors whether a meeting will be held.

There would be lower compliance costs for stakeholders if the bankruptcy administration procedure were able to decrease the costs of administration where the returns to creditors will be minimal.

7.3.2.2 Discharge

Currently, in approximately 90 percent of cases where an estate has no assets, the administration is completed within six months. Discharge could be automatic at any stage after the Assignee has processed the estate, for example after six months, one year or 18 months. The factors to consider in determining the length include deterrence and rehabilitation. Where the estates have little or no assets to realise, the underlying reasoning behind long periods for bankruptcy relate to deterring future debtors from less than sensible risk-taking and keeping bankrupts out of the community where they can cause financial harm to themselves or others.

The underlying reason behind allowing for discharge at all is summed up in the third overarching objective of the bankruptcy administration review:

> *Enabling individuals in bankruptcy again to participate fully in the economic life of the community by discharging them from their remaining debts in appropriate circumstances.*

Automatic discharge allows bankrupts who have not been involved in commercial misconduct to receive a discharge without the expense of a court application. The dishonest bankrupt can be prevented from obtaining an automatic discharge.

The automatic discharge that applies after three years could be altered to apply after one year. The early discharge would provide the debtor with incentives to disclose all information to the Assignee and to consider ways in which of paying a greater portion of their claims.

It would be possible for the Assignee, or creditors, to apply to the Court to suspend the operation of the discharge.

There is a strong argument for ensuring that society is given some protection from any future repetition of commercial misconduct. As bankruptcy statistics show, the number of repeat bankrupts is very low. However, some individuals are simply dishonest or have shown little or no regard for the interests of their creditors.

Repeat bankrupts, or fraudulent bankrupts, should not qualify for automatic discharge at the same time as other debtors. Instead, the discharge would become automatic after three years. The Ministry notes that the court has an existing discretion to provide restrictions on such individuals once they have been discharged.

3.3.3.3 After discharge

It is possible to increase the total pool of assets available for redistribution so that money owed by the bankrupt is paid. This would increase the certainty of payment function of bankruptcy, which would aid the objective of goods and services being produced at least cost. This would be achieved through Income Payment Orders ('IPOs'). It could be used for debtors who experience a significant increase in assets or income after discharge from bankruptcy.

The Assignee would be able to grant an automatic IPO, and a creditor would be able to request an IPO from the Assignee, but where the Assignee declined a creditor's request for one, the Assignee would have to state the reason for doing so. If the creditor was unsatisfied with that reason, they could apply to the court to consider the matter.

For one year after the bankruptcy, the debtor would have to provide the Assignee with information on their financial position and either a signed declaration once every 3 months stating that the debtor's position has not altered or a signed declaration stating the alteration to the debtor's position within 14 working days of the alteration. During that one year, an IPO could be made, which could run for up to one year. The debtor would have to disclose all information regarding their financial position during that one year after bankruptcy. If they did not disclose all information, the IPO could be made, at the Assignee's discretion after the six-month period, when the failure to disclose was brought to the Assignee's attention.

Conclusion

This review is concerned principally with the application of the bankruptcy administration regime to individual debtors. Its purpose is to consider the impact of bankruptcy administration on the stakeholders, and propose ways to minimise that impact. The review takes into account the changing attributes of a typical debtor in proposing a simple regime that aims to maximises returns to creditors and enable individuals in bankruptcy to again participate fully in the economic life of the community.

The Ministry of Economic Development invites comments on the recommendations in this paper. Appendix One

New Zealand Bankruptcy Procedure: Insolvency Act 1967

1)

2)

3)

Administration by Assignee

VOIDABLE TRANSACTIONS

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1. EXECUTIVE SUMMARY

The main purpose of bankruptcy and liquidation systems is to provide for an orderly, compulsory and collective realisation of a debtor's assets. It has long been accepted that to avoid destructive fights between creditors and races among creditors to the courts, insolvency law provides all creditors with some measure of equality.

Individuals and corporations are generally insolvent in a technical sense for some time before formal insolvency. Voidable transactions law reverses some transactions that occurred before formal insolvency. In doing this, these provisions support the system of collective realisation and thereby the underlying pari passu principle.

The Ministry commissioned a paper on voidable transactions law in New Zealand by David Brown, a Senior Lecturer in Law at Victoria University. That paper was circulated with a series of consultation questions written by the Ministry in a round of targeted consultation. Both Mr Brown's paper and the submissions received on it indicated that there are significant problems associated with the current personal and corporate voidable transactions laws in New Zealand. In summary, those problems are that the provisions are resulting in:

- Inconsistency in processes and evidential requirements – this results in different outcomes depending on the provision used and means the provisions are not consistently enhancing the pari passu principle;
- Uncertainty regarding the interpretation of key tests – this results in unnecessary or drawn out litigation and creates difficulties for businesses in determining whether to undertake particular transactions; and
- Unnecessary costs of pursuing and defending potentially voidable transactions – this is due in part to uncertainty of tests and complexity of processes.

The Ministry's proposals are:

- Consideration should be given to whether it is feasible to replace all the current voidable transaction provisions with one provision that would apply regardless of:
  - the nature of the transaction;
  - the intention, knowledge or motive of the debtor or recipient of the transaction; or
  - whether the debtor is an individual or a company.
- As with the current Companies Act provisions, the provision would seek to set aside transactions based on the transaction's effect on creditors in general.
- The 'ordinary course of business' exception in section 292 of the Companies Act would be replaced with a test that considers the net effect of a series of transactions, based on the United States 'net effect' rule.
- The existing defence in section 296(3) of the Companies Act would be retained.
- Transactions occurring within six months of the application to liquidate/bankrupt could be challenged, except where the recipient is an insider, in which case transactions occurring within two years of the application to liquidate/bankrupt could be challenged.
- The existing procedure in section 294, which enables transactions to be set aside by notice, will be retained as the procedure for seeking to set aside transactions under the new provision.

2. INTRODUCTION

As part of its wider review of insolvency law, the Ministry of Economic Development commissioned a paper by David Brown, a Senior Lecturer in Law at Victoria University on voidable transactions provisions in New Zealand.[17] That paper was circulated with a series of consultation questions written by the Ministry in a round of targeted consultation.

Both Mr Brown's paper and the submissions received on it indicated that there are significant problems with the current personal and corporate voidable transactions laws in New Zealand. This paper details these problems and states the Ministry's preferred option for amending the existing law to address the problems.

3. OBJECTIVES

3.1 Objective of bankruptcy/insolvency law generally[18] and avoidance provisions specifically

The main purpose of bankruptcy and liquidation systems is to provide for an orderly, compulsory and collective realisation of a debtor's assets. This is regarded as more efficient in maximising the pool of assets available to all creditors than would be the case were creditors left to pursue their individual remedies.

It has long been accepted that this collective realisation process must be a fair one, in which all like creditors are treated alike. Consequently, the 'pari passu' principle[19] has existed as a fundamental principle of insolvency law since the sixteenth century. It is also generally accepted that companies and bankrupts are almost invariably technically insolvent for some time before the commencement of formal insolvency procedures.

The general objective of avoidance provisions is to achieve some degree of equality between creditors and to ensure there is something left to distribute at the point of formal insolvency. The collective realisation and the pari passu principle are undermined if particular creditors are preferentially paid in the period immediately before formal insolvency, and/or if there are no assets remaining at formal insolvency. To prevent this occurring, voidable transactions law grants to the liquidator or the Assignee the power to set aside certain pre-liquidation transactions.

The existing avoidance provisions can be divided into at least two categories of provisions, which each have slightly different objectives.

First, 'voidable preference' provisions[20] are aimed at achieving equality[21] amongst creditors. These provisions do this by overturning transactions between the debtor and any creditor when the company was technically insolvent. In doing this, the provisions effectively move the time at which the pari passu principle 'bites' back from the date of formal insolvency to the date of technical insolvency. There is not necessarily anything 'wrong', or any misconduct associated with, these transactions. However, they are set aside because it is considered inequitable for a debtor to pay one creditor in full on the eve of liquidation at the expense of the general body of creditors.

The second category of provision is designed to set aside those transactions that diminish the value of the debtor's net assets in a certain period before formal insolvency. While these provisions may incidentally achieve equality amongst creditors where the party to the transaction is a creditor, the emphasis is instead on the effect of the transaction on the debtor's assets and the provisions' application is not limited to transactions with creditors. Transactions that fall within this category include voidable gifts,[22] improving another's property,[23] and transactions at an undervalue.[24] These provisions are therefore designed to ensure the assets of the debtor are not disposed of on the eve of formal insolvency.

Special provisions also exist, which could be considered a third category, relating to securities and charges given by insolvent debtors before formal insolvency. In the case of individuals, that stems from the fact that the term 'gift' does not include the granting of a security. In the case of companies, these provisions exist because it is arguable that granting a security does not diminish the company's assets as such, but places an important encumbrance over them.

Finally, transactions with 'insiders' are scrutinised more closely. The Companies Act specially provides for avoidance of transactions with those who have a close connection with the debtor company because they are deemed to have special knowledge of, and/or responsibility for, the company's situation.[25] Transactions between husband and wife receive special attention in bankruptcy under the Matrimonial Property Act 1976 for similar reasons.[26]

3.2 Defences

In the context of voidable transactions law, a defence is an argument the recipient of an otherwise voidable transaction can use to avoid having the transaction set aside.

If the objective of voidable transactions law is to support the collective realisation of assets and thereby the pari passu principle, defences, by allowing a party to an otherwise voidable transaction to retain the benefit of that transaction, necessarily undermine that objective.

However, these defences exist notwithstanding that. Their objective is twofold. First, they are designed to ensure effective challenges cover only the type of transactions which the law is concerned to discourage or reverse. Secondly, they are designed to temper the pursuit of collective justice for creditors as a whole with individual justice for a particular party in the circumstances of each case. There is a risk that, if the law fails to do so, it might impair the free flow of trade by undoing transactions a reasonable New Zealander, aware of the facts known to the trader, would consider normal.

4. COMMON ISSUES WITH CURRENT VOIDABLE TRANSACTIONS PROVISIONS

The issues discussed below have been identified for the most part from Mr Brown's paper and from responses to that paper by various stakeholders. Because the voidable transactions provisions in the Insolvency Act 1967 and the Companies Act 1993 are worded and interpreted quite differently from each other, some of the issues which relate to personal and corporate voidable transactions are also quite different. Nevertheless, it is possible to identify some common issues.

4.1 Inconsistency

Both the Companies Act and the Insolvency Act, as well as other statutes such as the Property Law Act and the Matrimonial Property Act, contain voidable transaction provisions that have differing time periods and requirements of proof. An example of this is that some of the Companies Act provisions have a presumption of insolvency. As well as differing requirements of proof, procedures vary depending on which section is used. For example, section 294 of the Companies Act establishes a procedure whereby liquidators can set aside transactions by lodging a notice with the court. This procedure does not apply to all the voidable transaction provisions under the Companies Act, and this variation in procedure can produce different results depending on which voidable transaction law is used. [27]

These inconsistencies are for the most part historical and should not be retained unless there is a sound policy justification for the difference.

4.2 Uncertainty

There is real uncertainty surrounding the actual meaning of certain key tests in the existing avoidance provisions. The best example is the 'ordinary course of business' test in section 292 of the Companies Act. If a transaction is in the 'ordinary course of business' then it is not considered to be a voidable preference. There have been a significant number of cases concerning the meaning of the test in the six years since its enactment, including a decision of the Privy Council.[28]

It is clear that in each case the definition of 'ordinary course of business' will depend on the particular circumstances of that case.[29] Judicial precedent has given some guidance on how the circumstances of each case will be interpreted. However, the subjective nature of the test means that there still remains significant uncertainty regarding whether a particular transaction is within the 'ordinary course of business' in the context of section 292.[30]

4.3 Cost

Both creditors and liquidators/assignees agree that the cost of pursuing or defending a voidable transaction is high. This cost is attributed in large part to the inconsistencies and uncertainty addressed above.

While these costs are commonly seen as a negative factor, it may also have a self-regulating effect on the amount which liquidators/Assignees consider worth pursuing. This is because a liquidator is unlikely to pursue a transaction where the amount that will be recovered is less than the cost of pursuing it, even if there is a high chance of success.

However, a system that imposes significant or excessive costs is likely to prevent worthwhile actions being taken where there are insufficient funds remaining for the liquidator to proceed with the action. The costs of pursuing a transaction will also reduce the net recovery for creditors.

4.4 Insider preferences

The Companies Act currently provides two sections aimed specifically at transactions with directors and other insiders: sections 298 and 299. Section 298, for example, is aimed at transactions where the recipient is a director or other person closely related to the debtor company and inadequate or excessive consideration has changed hands. That section allows transactions to be challenged within three years of insolvency, and there is no defence to a claim under section 298. Similar provisions exist in personal insolvency law also. For example, under the Matrimonial Property Act,[31] transactions between husband and wife are scrutinised more closely than transactions with non-related parties. Where that occurs, a creditor who is required to return a voidable transaction will not receive a pro rata dividend. It is difficult to justify the voidable transaction regime where there is not an equal distribution of available assets to all unsecured creditors.

4.5 Priority debts[32]

As discussed above, the general understanding of the purpose of voidable transactions provisions is to put all creditors in an equal position in insolvency. Creditors who are asked to disgorge payments would tend to be more accepting of the rationale behind the law if a liquidator or Assignee could assure them that the payment they are returning will be shared equally with all creditors on a pro rata basis. Unfortunately, the existence of preferential creditors often results in there being little or no remaining assets for distribution to unsecured creditors. If that occurs, the recipient of a voidable transaction is asked to return a payment which is ostensibly for the benefit of all creditors but in fact goes to one or a small number of preferential creditors.

4.6 Knowledge

The existence and effect of voidable transaction provisions is not well known. It is likely that most small businesses are unaware of the voidable transaction regime and its rationale. Indeed, even some large businesses have no knowledge of this area of the law. Generally, the first awareness of the voidable transaction regime arises when a business is asked to return a voidable payment to a liquidator. While deterrence is not one of the objectives of voidable transactions law, it might be hoped that the existence of the provisions has some impact on people's behaviour. However, some people who do not know about the provision will behave differently than if they did know.

5. THE MINISTRY'S PROPOSAL

5.1 An effects-based test

5.1.1 Proof of intention to prefer under the Insolvency Act

While the 1993 amendments to company law introduced effects-based tests for determining whether a transaction can be set aside, some provisions in the Insolvency Act still focus on the debtor's intention. For example, section 56 of that Act, which provides for the setting aside of voidable preferences, requires proof that the debtor made the payment "with a view to giving that creditor…a preference over other creditors."

There are two key problems with using proof of a debtor's intention as the determining factor for whether a transaction should be set aside. First, proving a subjective element such as intention can be difficult. More significantly, such a test is inconsistent with the general objective of avoidance provisions. Each of these difficulties is addressed in more detail below.

Case law interpreting section 56 Insolvency Act has held that the intention to prefer must be the debtor's *dominant* intention.[33] It is not enough that *one* of the debtor's intentions was to prefer that creditor. In practice, proving that a particular intention was the dominant intention is very difficult. It is relatively easy for a creditor to point to some other intention. For example, the courts have held that if the debtor intends to benefit himself or his family, or his dominant motive was to defeat other creditors rather than to benefit a particular one, the intention element is not met.[34] The small number of cases taken under section 56 reflects the difficulty created by the interpretation of 'intention' in this section.

More significantly, however, *any* test that uses the debtor's intention to prefer one creditor as the basis for setting aside transactions is at odds with the primary object of voidable preference law, which is to achieve equality between creditors. This is because under such a test a transaction that has the effect of preferring one creditor may be allowed to stand, depending on what can be proved to be the debtor's intention in entering into that transaction.

The 1993 amendments to company law moved to an effects-based avoidance regime. This was intended to remove the evidential difficulties associated with proving the state of mind of any party to the transaction and, more importantly, ensure that transactions are set aside on a basis that is consistent with the pari passu principle.

2.2.2 The 'ordinary course of business' exception under section 292 of the Companies Act

The voidable preferences provision in the Companies Act is section 292. Changes made to section 292's predecessor in 1993 were intended to shift the focus away from the parties' knowledge or intentions, and focus instead on the transaction's effect.[35] However, section 292 provides that an otherwise voidable preference will not be set aside if it is 'in the ordinary course of business'. The knowledge of the other party to the transaction is still a factor in establishing whether a payment was made in the ordinary course of business.[36] This has re-introduced the evidential difficulties and cost associated with proving such an element.

As was discussed above, given the objective of voidable preferences law, the parties' knowledge or intention should not be the determining factor for whether should be avoided. Focusing strictly on the effect of the transaction will provide a more principled and consistent basis for determining which transactions should be set aside.

In the context of section 292, a number of interested parties have criticised the uncertainty surrounding the ordinary course of business exception. While it could be argued that judicial interpretation may in time clarify the exception, the significant number of cases in the six years since it was enacted, including decisions of the Court of Appeal and the Privy Council, have not done so to date.

There is always a trade-off to be made between simple rules and principles. Simple rules provide more certainty, but may not cover every situation that arises, with the result that wrong decisions may be reached in some cases. In contrast, using general principles allows the flexibility to adapt to any situation. However, that flexibility may be achieved at the expense of excessive uncertainty, enforcement and litigation costs.

The advantages of flexibility offered by the 'ordinary course of business' exception are considered to be considerably outweighed by the disadvantages associated with it, particularly the unnecessary costs caused by the uncertainty surrounding what that phrase means in any given situation.

5.2 Harmonisation of corporate and personal avoidance provisions

Section 56 of the Insolvency Act[37] in its current form is almost identical to the voidable preferences section in the Companies Act 1955 (section 309). That section was repealed in the Companies Act 1993 so that an intention to prefer is no longer a crucial element in liquidations. However, section 56 was not amended at the same time. There is no justification for differentiating between transactions on the basis that the debtor is an individual or a company. The increasing number of sole traders incorporating since the enactment of the Companies Act 1993 shows that any distinction based on the form of the debtor is arbitrary and does not necessarily reflect any actual difference in the nature of the debtor.

5.3 A single provision

Both the Insolvency Act and the Companies Act provisions distinguish between, and provide different rules and procedures for, different types of transactions. For example, some of the Companies Act provisions enable the liquidator to challenge transactions by filing a notice with the High Court, while other provisions require the liquidator to commence proceedings in the normal way.

Another anomaly caused by the existence of different provisions for different type of transactions is seen in the application of section 57 of the Insolvency Act. That section provides that where a charge is granted against the bankrupt's property within 12 months of bankruptcy it is voidable unless it was granted in return for adequate contemporaneous consideration. The provision therefore enables a security granted shortly before bankruptcy to an existing creditor to secure a pre-existing debt, can be set aside. Such a security is analogous to a voidable preference, in that it puts the particular creditor in a better position on the insolvency of the debtor.

The difficulty arises where such a security is acted on shortly before bankruptcy, for example, by the grantee of the security seizing and selling the property pursuant to the powers granted under the security. In this situation, the Assignee cannot set the security aside because it no longer exists.[38] Legally this is the logical conclusion, based on the wording of the section. However, the results produced are inconsistent. If the security still exists, the law provides that the grantee should not enjoy its protection and the security is set aside. If, however, the grantee uses the powers under the security, and sells the property, the grantee is able to enjoy the proceeds of the sale. From a policy perspective, therefore, the provision is not consistently supporting the objective of achieving equality between creditors.

A section that focused instead on whether the ultimate effect of a transaction is to diminish the value of the debtor's assets would avoid anomalies resulting from sections targeting specific types of transactions. Arguably, the effect on creditors of granting a voidable security is no different to the effect of a voidable gift or a voidable preference. The Ministry therefore considers that there appear to be strong policy justifications for applying the same rules and procedures regardless of the nature of the transaction.

5.3.1 Section 47 of the Matrimonial Property Act 1976

Section 47 of the Matrimonial Property Act provides that the Assignee may challenge any transaction between spouses which is intended to defeat, or has the effect of defeating, creditors. So any transaction which gives one spouse more than the protected matrimonial property they would otherwise have been able to retain on their partner's bankruptcy will be voidable. This potentially creates an exception to the general rule in section 20 of the Matrimonial Property Act that the Act does not affect creditors' rights to a debtor spouse's property.

A Court of Appeal decision[39] has made it clear that, where section 47 Matrimonial Property Act applies, the provisions of the Insolvency Act and the Property Law Act are subordinate. *Fisher on Matrimonial Property* states, at page 46: 'Section 47 may therefore be better described as replacing the relevant sections of the Insolvency Act, rather than merely 'supplementing them'.

Clearly, given that the Ministry's preferred option is to move to a single transaction with a single process, there are strong arguments in favour of repealing section 47 to ensure consistency of rules and process. However, the Matrimonial Property Act was created to protect spouses' interest in matrimonial property. It is beyond the scope of this review to address the continued validity of that protection.

5.3.2 Section 60 of the Property Law Act 1952

This provision provides that every alienation of property with intent to defraud creditors is voidable. It has a different historical origin to the provisions in the Insolvency Act and applies outside of bankruptcy to any attempt to put property beyond creditors' reach.[40] While it is not necessary to show fraud, it is necessary to show the debtor's intention to put assets beyond creditors' reach, and thus dishonesty in relation to creditors.[41]

This provision has no time restriction on when a transaction must have occurred to be voidable and so can be used in cases of transactions outside the normal period provided in the Insolvency Act (although it is subject to time restrictions under the Limitation Act 1950). However, because this provision requires proof of the debtor's intention to defraud creditors, it is easier to proceed under the Insolvency Act if a transaction is within a relevant time period and so does not require proof of intention under that Act.

Even under an effects-based regime, there may still be instances where the section may be used to challenge transactions that occur outside the period of the insolvency legislation. This inconsistency could be argued to justify the repeal of this provision. However, the section originated outside the scope of insolvency law and applies more widely than just where a debtor is bankrupt. As a result, while again the goal of consistency would suggest that this section should be removed, the ramifications of that removal would be wider than the scope of this review.

5.4 Form of the provision

There are two effects-based voidable transaction regimes to which reference is commonly made. These are found in Australia and the United States. Each is explained in more detail below.

5.4.1 The Australian 'running account' principle

The running account principle existed at common law under Australia's voidable preference provision before1993 when its company law was reformed.[42] It is based on an explicit or implicit mutual assumption by the parties that payments would be made from time to time to ensure a continuing supply of goods or services, rather than merely to close an account in respect of a pre-existing debt.[43] Where there was a running account, the ultimate effect of a series of dealings was considered, rather than looking at an isolated transaction. This meant that even though the amount of a transaction exactly matched a pre-existing debt, if it were paid to ensure the continued supply of goods, then the transaction is viewed as part of a series of dealings. Sometimes, the debtor company may have been better off in that it received more value than the amount by which its assets were depleted, and so the transactions, viewed as a whole, would have been allowed to stand.

Australia has expressly recognised its 'running account' principle in section 588FA of the Corporations Law. That provision defines an 'unfair preference' as a transaction that results in a creditor receiving more from the company than they would have received if the transaction were set aside and the creditor were to prove for the debt in a liquidation at that time (a fictitious liquidation). The 'running account' principle is included as an example of a 'continuous business relationship' which, if proved, enables a series of transactions to be treated as a single transaction. The combined effect of those transactions is then considered to determine whether there was an unfair preference.

The key difficulty with the Australian running account principle is that it still requires proof that the parties considered the transaction to be part of a continuing business relationship. That approach focuses on the parties' state of mind with all the evidential difficulties associated with proving motive or knowledge.

5.4.2 The United States 'net effect' principle

The United States has an effects-based preference test in section 547 of the Bankruptcy Code and an ordinary course of business exception. However, the Code also contains a provision that states that the trustee cannot avoid an otherwise preferential transaction to the extent that after such transfer the creditor gave new value to, or for the benefit of, the debtor which value was unsecured and for which the debtor made no other unavoidable transfer. The effect of this is to codify a 'net result' rule which means that in the usual 90-day period before bankruptcy during which voidable preferences may occur, the trustee 'nets out' the payments made by the debtor against new value given by the creditor.

5.4.3 Conclusion

Both the United States and Australian regimes have problems associated with them that have resulted in an undesirable amount of litigation. However, in both countries the problems appear to relate more to the defences, such as the ordinary course of business exception in the United States, and their interaction with the voidable transaction provisions than to the provisions themselves.

Though the United States provision has less cumbersome wording than Australia's, the purpose is the same, and the provision is not limited to showing a running account or a continuing business relationship. This avoids factual examination of how far the creditor expected to be supplying future services and the details of the trading relationship between the parties. Given that the time period in the United States is only 90 days, there is less risk of unfairness or arbitrariness.

5.5 Time periods

Many of the provisions in the Companies Act contain different time periods. For example, section 292, which deals with voidable preferences granted by a company, contains two different time periods. Transactions occurring within two years of formal insolvency can be challenged, but unless the transaction is in the ordinary course of business, the liquidator must prove that the transaction:

(a) Took place within two years of liquidation;

(b) At a time when the company was unable to pay its debts; and

(c) Enabled the recipient to receive more than they would have received on liquidation.

However, if the transaction took place within six months of formal insolvency, there is a presumption that it took place when the company was technically insolvent (or unable to pay its debts) and that it was not in the ordinary course of business.[44] The other party may attempt to rebut the presumption by leading evidence to the contrary. Therefore the presumption's main effect is to shift the onus of proof from the liquidator to the recipient if the transaction took place within six months of formal insolvency.

The six-month and two-year periods are sometimes criticised as being arbitrary and lengthy. It is said that the two-year period in particular inhibits creditors from encouraging a company to trade out of its difficulty. Others argue that in some situations it would be preferable if creditors did 'pull the plug' earlier because, by allowing or encouraging a company to continue to trade, the dire financial situation is exacerbated and the indebtedness to creditors is increased.

Invariably any time-frame is likely to be somewhat arbitrary. The alternative, however, is to use the actual date of technical insolvency in each case for determining the relevant time period. The benefits of establishing an arbitrary timeline is that it increases certainty and reduces the costs involved in proving the date of technical insolvency in every case. The potential disadvantage is that an arbitrary rule will result in some transactions being set aside where the company was not in fact insolvent. However, the adoption of a shorter time period should minimise the likelihood of any such injustice occurring.

While there is no statistical evidence, it is also generally accepted that debtors are almost invariably insolvent for some time before formal insolvency. A shorter time period, such as six months, is more likely to coincide with that period of technical insolvency than a longer period, such as the current two-year period under the Companies Act. The six-month period also has the advantage that it matches the current 'restricted period' during which presumptions as to solvency apply in many of the Companies Act provisions. The existence of those presumptions mean that the bulk of the transactions currently challenged occur within 6 months of formal insolvency.

5.6 Procedure

Different procedures apply to different provisions within the Companies Act. For example, section 297 of the Companies Act is aimed at transactions that effect a net diminution in the value of the debtor company's assets because either inadequate consideration has been paid to the company or the company has paid excessive consideration. However, unlike section 292, no presumptions apply, and the liquidator cannot take advantage of the notice procedure under section 294 to challenge a transaction, but instead must commence proceedings in the normal way. The liquidator must prove the debtor company was insolvent when it entered the transaction, or became insolvent as a result of the transaction, or incurred obligations for which it had inadequate assets. The liquidator must also prove the other party to the transaction knew of the company's state of insolvency and show there was a disparity in consideration.

This large burden of proof for the liquidator has meant few transactions have been set aside on this ground. Thus, it is only in cases of clear disparity between consideration given and benefits received that a liquidator would be inclined to bring a case. A liquidator will generally pursue the transactions under section 292 if it is also a preference or under section 293 if it is a voidable security.

The procedural difficulties associated with pursuing voidable transactions have largely been addressed by the changes made this year to the High Court Rules,[45] which stipulate the procedure for issuing a notice setting aside a transaction (rules 700ZJ and 700ZK).

Masters have jurisdiction over sections 290, 291, 294 to 296 and 299 of the Companies Act 1993.[46] However, they do not have jurisdiction in relation to section 292 (voidable preferences), section 293 (voidable securities), or section 298 (transactions with directors or other insiders), or over the voidable transaction provisions in the Insolvency Act. The issues to be considered under these provisions are no more complex than those the Masters currently deal with. The Masters have considerable experience in voidable transactions law and it would seem appropriate that they be given jurisdiction over all matters relating to voidable transactions.

The Ministry has recommended that there be one provision that covers all types of voidable transactions. This naturally leads to the conclusion that there should be only one procedure for all types of recovery.

5.7 Voidable transactions with directors and other insiders

Currently the Companies Act provides additional provisions relating to transactions with insiders. Under section 298, transactions between the company and certain insiders for inadequate or excessive consideration may be challenged. The liquidator may make recoveries from insiders for property, services, or businesses acquired, or disposed of by, the company during a 3-year period immediately before the liquidation. There is no defence to a section 298 claim and the liquidator is not required to prove that the company was insolvent at the time. Nevertheless, the onus is on the liquidator to establish the claim for inadequate consideration.

Under section 299, every charge or security between a company and an insider is open to challenge, whether at a time of solvency or insolvency, with only the court, rather than any statutory requirements or defences, as the filter for deciding which ones should or should not be reversed (or creditors otherwise compensated). There is no time period before liquidation during which the transaction must be shown to have occurred.

Insiders are generally considered to be in a position to observe a company's or a person's financial precariousness at a far earlier time than independent creditors. Insiders therefore have far more time and scope to protect their position or remove assets than other people. The pari passu rule is based on the proposition that all creditors in a like position should be treated equally, but clearly there will be occasions where insiders will not be in the same position as other unsecured creditors. The Ministry therefore considers that insiders' intimate knowledge of the financial position of the company or person is sufficient justification in terms of the pari passu principle to justify a different rule.

5.8 Defences to voidable transactions

5.8.1 Defences under the Companies Act

Section 296(3) of the Companies Act provides a general defence to recovery by the liquidator if:

- The person from whom recovery is sought received the property in good faith and has altered their position in the reasonably held belief that the transfer to that person was validly made and would not be set aside; and
- In the Court's opinion, it is inequitable to order recovery or recovery in full.

This section is almost exactly the same as section 311A(7) of the Companies Act 1955. The problem is that section 309 of the 1955 Act, for example, was based on the debtor company's intent, whereas s 292 of the current Companies Act is effects-based. The predecessor to section 296(3) was therefore created as a defence to an intention-based voidable transactions law. It has been argued that the relief section made more sense when it related to a provision based on an intention to prefer.

It is somewhat difficult to reconcile the defence in section 296(3) with the ordinary course of business exception in the section 292 voidable preferences provision, because it is usual to consider knowledge of the debtor's insolvency when deciding whether a payment is in the ordinary course of business. If a court has already found that a creditor knew of the insolvency in the context of 'ordinary course of business' relief is unlikely to be able to be granted under the defence in section 296(3). If the creditor is held not to have the requisite knowledge under the ordinary course of business exception, the transaction will not be set aside and no defence is necessary.

If the ordinary course of business exemption were replaced with either a 'running account' or similar principle (as discussed in 5.31 to 5.3.3), the defence in section 296(3) would again be relevant.

The wider issue of whether there ought to be any defences to, or relief from, the voidable transaction regime at all must also be considered. One could argue that there should be no defences to the voidable transactions regime, as any defence would inherently undermine an effects-based test designed to enhance the pari passu principle. The counter-argument is that a move to a strictly effects-based test removes any protection afforded by the ordinary course of business to recipients of transactions in situations where it might be unjust to require repayment. If that is correct, some form of defence provision is necessary to prevent those injustices occurring in the individual situations.[47]

5.8.2 Conclusion

The Ministry is recommending that both the corporate and personal voidable transactions provisions be replaced with one effects-based voidable transaction provision. It considers that the adoption of a simple rule, and a short time period will increase clarity and certainty regarding voidable transactions law. However, it is possible that a simple rule will not produce the correct result in every case and that a strictly effects based-test removes any protection afforded currently to recipients of transactions in situations where it might be inequitable to require repayment.

The concepts of good faith and alteration of position in the existing Companies Act defence are now well established and the retention of that defence should not reintroduce too much uncertainty into the new voidable transactions provision.

6. THE PERSONAL PROPERTY SECURITIES ACT 1999

At present, many unregistered charges over personal property, such as a chattel mortgage, are void against the Assignee on the bankruptcy of the owner of the property.[48] So, on the owner's bankruptcy, the person holding that security will lose it and will instead rank as an unsecured creditor.

However, this situation will change when the Personal Property Securities Act 1999 ('PPSA') comes into force. Under the PPSA, an unperfected security interest (which includes unregistered security interests[49]) will not be void as against the Assignee. This change is likely to result in the Assignee challenging more securities over personal property under section 57 of the Insolvency Act.

The PPSA will also change the language used in statutes to refer to many security interests. If section 57 were to be retained in its current form, or left substantially unamended, the wording will need to be brought into line with that used in the PPSA. The same considerations will apply in relation to voidable charges under the equivalent section in the Companies Act, section 293.

PRIORITY DEBTS IN THE DISTRIBUTION OF
INSOLVENT ESTATES

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1. EXECUTIVE SUMMARY

One of the fundamental features of insolvency law is that it makes choices as to the order in which creditors should be entitled to receive any distribution from the debtor's assets. The discussion paper examines:

- The criteria that ought to be applied in determining whether any particular debt should be afforded preferential status; and
- Whether the existing priorities as set out in section 104 of the Insolvency Act 1967 (for personal insolvency) and the Seventh Schedule to the Companies Act 1993 (for corporate insolvency) can be justified when tested against these criteria.

2. BACKGROUND

In August 1998 the Ministry invited the Law Commission ('the Commission') to provide advice on whether existing classes of preferred creditors should continue to enjoy advantages over unsecured creditors in the event of bankruptcy or liquidation. The Commission sought and received submissions on the review from interested organisations and individuals.

In October 1999, the Commission released a study paper 'Priority Debts in the Distribution of Insolvent Estates'. The Ministry of Economic Development received a number of submissions on that paper. This discussion document reviews the Commission's study paper, the submissions received and the results of further research and analysis undertaken by the Ministry.

3. INTRODUCTION

Under New Zealand's insolvency laws, after the expenses of the liquidator/receiver/ official assignee, secured (fixed charge) creditors are the first to be paid in a bankruptcy, followed by preferential creditors, then secured (floating charge) and finally unsecured creditors. If a surplus remains, it is used to pay deferred creditors and interest to creditors. If a surplus remains after all creditors have been satisfied, it is returned to the debtor.

In accordance with, principally, the Insolvency Act 1967, the following debts have priority over unsecured creditors in a personal bankruptcy:

- The fees and expenses incurred by the Official Assignee (section 104(1)(a));
- Costs and expenses incurred by the creditor in obtaining the bankruptcy adjudication (section 104(1)(b));
- Arrears of wages or salary of any employee of the bankrupt, to a maximum of $6000 per employee (section 104(1)(d)(i));
- Any money which a court orders to be paid to an apprentice of the bankrupt under section 23 of the Apprenticeship Act 1983, to a maximum of $6,000 per apprentice (section 104(1)(d)(ii));
- Holders of liens over books of the bankrupt as against the Official Assignee, to a maximum of $100 (section 104(1)(d)(iii);

- The Commissioner of Inland Revenue in respect of debts money under section 163(1) of the Child Support Act 1991 to a maximum of $6,000 (section 104(1)(d)(iv));
- Claims under section 6 of the Volunteers Employment Protection Act 1973, by operation of section 15(1) of that Act;
- The Commissioner of Inland Revenue in respect of tax deductions held by the bankrupt (section 104(1)(e)(i));
- The Commissioner of Inland Revenue in respect of student loan repayment deductions held by the bankrupt (section 104(1)(e)(iii));
- The Accident Rehabilitation and Compensation Insurance Corporation in respect of earner premiums deducted from employees by the bankrupt (section 104(1)(e)(iv);
- Duty as defined by section 2(1) of the Customs and Excise Act 1996 (section 104(1)(e)(iv));
- The Commissioner of Inland Revenue in respect of unpaid GST (section 42(2)(a))Goods and Services Tax Act 1985,;
- Debts owing under the Radiocommunications Act 1989, by operation of section 183(4) of that Act;
- Levies payable to the Ministry of Agriculture and Fisheries under the Fisheries Act 1983, by operation of section 107K(3) of that Act; and
- Debts owed by the bankrupt to a layby purchaser (section 11 of the Layby Sales Act 1971).

In accordance with the Seventh Schedule to the Companies Act 1993, the following creditors have priority over unsecured creditors of an insolvent company in liquidation or receivership:

- The fees, expenses and remuneration of the liquidator;
- The reasonable costs of the creditor in obtaining the liquidation order;
- Actual expenses necessarily incurred by the liquidation committee;
- Wages or salary owed to employees for work done in the four months before liquidation, to a maximum of $6,000 per employee;
- Holiday pay payable to employees, to a maximum of $6,000 per employee;
- Any deductions from an employee's wages or salary made to satisfy an obligation of the employee, to a maximum of $6,000 per employee;
- The Commissioner of Inland Revenue in respect of debts money under section 163(1) of the Child Support Act, to a maximum of $6,000;
- Holders of liens over books of the company as against the liquidator, to a maximum of $500, by operation of section 263 of the Companies Act 1993;
- Any money which the Employment Tribunal orders to be paid to an apprentice of the company under section 23 of the Apprenticeship Act 1983;
- Where the liquidated company is a licensee company under the Motor Vehicle Dealers Act 1975, any sum which the Motor Vehicle Dealers Institute Incorporated is entitled to recover from the company under section 42 of that Act;
- Claims under section 6 of the Volunteers Employment Protection Act 1973, by operation of section 15(1)(a) of that Act, to a maximum of $200 per claimant;
- Debts owed by the company to a layby purchaser or seller under section 9 or 11 of the Layby Sales Act 1971;
- The costs incurred in organising and conducting a meeting of creditors under section 234 of the Companies Act 1993;
- GST owed by the company under Part III of the Goods and Services Tax Act 1985;
- The Commissioner of Inland Revenue in respect of tax deductions made by the company under the PAYE rules of the Income Tax Act 1994, non-resident withholding tax ('NRWT') under the NRWT rules of that Act, and resident withholding tax ('RWT') under the RWT rules of that Act;
- Levies payable to the Ministry of Agriculture and Fisheries under the Fisheries Act 1983, by operation of section 107K(3) of that Act; and
- Duty as defined by section 2(1) of the Customs and Excise Act 1996.

3.1 Purpose of priority debts

The purposes of the current priorities are, principally, to:

- Ensure funds are available to undertake the necessary insolvency proceedings;
- Protect the public interest in relation to the government's income; and
- Promote specific public interests, including those of employees and layby purchasers.
-

4. REFORM FRAMEWORK

As outlined in the insolvency framework document that accompanies this paper, the government's key goal in reforming insolvency law is to promote the public interest by maximising the business community's contribution to the New Zealand economy through increasing job opportunities and incomes. This can be achieved by fostering an environment which encourages businesses to produce goods and services at least cost, directs resources to those areas that contribute the most to the economy, and fosters innovative ways to meet consumer needs.

In essence, giving preferential status to a particular debt should occur only if there are compelling public interest reasons for doing so. That is, priority should be provided only where it can be justified by reference to principles of fairness: ie it will result in greater benefit to that group of creditors than the costs it imposes on other stakeholders.

When considering the costs and benefits arising from granting a priority the following key stakeholder groups, (who in many cases will have divergent interests) need to be considered:

- Insolvent debtors;
- Solvent debtors;
- Creditors;
- The Government; and
- The wider community.

In assessing whether a priority should be granted, it will be necessary to consider the possible costs and benefits outlined in sections 4.1 to 4.7 below.

4.1 The relative and absolute cost of capital and barriers to its supply

The cost of equity and credit (including trade credit) is determined by, among other things, the perceived risk of business performance, including the possibility of insolvency and the loss of value to creditors in insolvency. The cost of capital can be reduced by minimising uncertainty, for example, reducing the extent to which pre-insolvency rights are defeated by the debtors' actions during the insolvency process.

Creditors need to be able to assess, with some certainty, the relative strength of their claims in the event of insolvency, before investing or risking their resources with the company. This is necessary to minimise transaction costs and the cost of capital. It also helps to determine the relative cost of capital from different sources.

4.2 Company failure (as a result of ineffective incentives for debtors to manage credit efficiently).

The extent to which creditors perceive that their security in a business will be compromised by insolvency is likely to influence the extent to which they monitor the debtor company' actions. A company can be expected to lose favour with creditors if it behaves recklessly and will be discouraged from doing so if there is effective creditor monitoring of its actions. In turn, this is likely to affect the frequency of business failure.

Further, close monitoring of a debtor means it is more likely that creditors will take timely action, and well before the debtor's assets have been completely eroded.

4.3 Administration/fiscal costs

These are the costs the government incurs in developing, implementing, enforcing and monitoring/reviewing the regime. For example, complicated regimes generally result in high administration costs. These costs fall ultimately on taxpayers.

4.4 Transaction costs

For the purposes of this paper, these are the costs that businesses incur in transacting with non-government entities and with individuals. A regime that promotes greater creditor monitoring of debtors, for example, will add to transaction costs.

4.5 Compliance costs

These are the costs that businesses incur in interacting with government to comply with the requirements of the regime. A regime that gives the government a greater role in the enforcement of its provisions, or that imposes a greater level of complexity on the stakeholders it affects, for example, increase compliance costs.

4.6 Horizontal and vertical equity (not equality) between creditors and debtors and between creditor classes

As a rule, those in like situations should be treated the same. Different treatment should be justified only by direct reference to the characteristics that justify that different treatment and the likely impacts of that different treatment. For example, secured creditors tend to have long-term funds tied up in a debtor company compared with unsecured creditors, perhaps warranting a higher priority (to avoid higher financing costs for the firm).

4.7 Compliance with international treaties

New Zealand is signatory to several international treaties which require adherence to many standards. It may be that in the future priorities will need to be provided for as a consequence of treaties. Each case will need to be considered on its own merits, and in the context of the overall benefits to New Zealand of being a signatory to each treaty.

5. PROBLEM IDENTIFICATION

Some problems with the current priority debts regime are set out in sections 5.1 and 5.2 below.

1.1 Crown's use of its position as dominant creditor

Most priorities favour the Crown, and in particular the Inland Revenue Department. As the dominant beneficiary from the distribution of assets from an insolvent estate, the way the Crown exercises its rights can have a significant impact on the interests of the debtor, other creditors, and even wider economic interests.

The Crown does have a conflict of interest in establishing priorities. Unlike other creditors, it has been able to determine the situations in which it will take priority over the interests of others in insolvency. It was also argued in submissions that the Crown's position as a dominant creditor has some negative impacts. These include:

- A reduction in the amount of funds available to other creditors, the cost of credit and the risk of 'spill-over' business failure is increased.
- It encourages the Crown to be complacent and, as a consequence, it does not monitor debtors closely. This can mean that timely action is not taken to either prevent insolvency, or bring about insolvency while there are still assets available to distribute to creditors. It has been argued in submissions that, in the absence of the Crown's priority, other creditors would have greater incentive to monitor the debtor's actions.
- The Crown is contributing to uncertainty for creditors and accentuating the problems identified above by continuing to approve an ever-increasing list of priorities, often in a piecemeal way, and without assessing the possible implications

for wider policy objectives.

There is an argument that priorities favouring the Crown benefit the general community. While this may be at the expense of the individual, the argument is that individuals have the ability to choose who they deal with, which the Inland Revenue Department does not. Further, any change in the Crown's position as a dominant creditor will lead to a loss of Government revenue.

1.2 Those in like position not treated the same

Arguments were made in submissions to the effect that certain groups of creditors had different rights afforded to their security even though there were no compelling public reasons warranting it. For example, it was argued that the priority given to employees and consumers (in certain circumstances) was at the expense of small trade creditors who would benefit by at least as much from being granted a priority.

The problems identified above will be assessed in more detail below against the Ministry's proposed solutions.

6. PROPOSED REFORM

6.1 Process for new priorities

Preferences are provided for in numerous pieces of legislation. It has been charged that new priorities may be created without proper consideration being given to the wider insolvency law implications. For example, there appears to be some uncertainty around what debts will take priority in any given situation.

As a solution to this problem, the Commission suggested that the Insolvency Act 1967 and the Companies Act 1993 should be amended to provide that on the introduction of any Bill into the House of Representatives, the House must be notified of any provision which would affect the order of priorities set out in either section 104 of the Insolvency Act or the Seventh Schedule to the Companies Act.

Some submissions argued that legislative amendment was unnecessary. Instead, it was suggested that amendment to the Cabinet Office Manual would be a less intrusive and less costly means of achieving the same objective. Further, the Ministry notes that amendment to the Cabinet Office Manual could ensure officials consider the wider insolvency issues at the time of policy development rather than after the key decisions have been made.

Recommendation:

The Ministry proposes amendments to the Cabinet Office Manual to provide that officials must consult with the Ministry of Economic Development before recommending to Ministers a provision that could affect the order of priorities. The Ministry also recommends that any amendment to legislation that introduces a new priority should simultaneously amend the Companies Act and the Insolvency Act so that all priorities and their rankings are clearly set out. This would provide an additional mechanism for ensuring that the wider objectives of insolvency law are not compromised and aid transparency and compliance with the provisions.

6.2 Administration costs

The Commission concluded that administration costs (the fees and expenses of the liquidator/assignee) should receive priority for the following reasons:

- Administration costs are not pre-existing debts of the insolvent entity; they are costs incurred on behalf of the general body of creditors which should be borne by the creditors.
- It would be difficult, if not impossible, to get qualified people to act as insolvency administrators if their costs were not met as a first charge on the estate.

The Ministry agrees with this assessment.

Recommendation:

Administration costs are necessary to ensure the proper co-ordination and management of the bankruptcy or liquidation process. The Ministry recommends that administration costs should be afforded priority.

The Commission also proposed that a petitioning creditor should be entitled to preferential status for the reasonable solicitor-client costs and disbursements incurred when procuring an order of adjudication or liquidation (including those cases where a creditor is subsequently given leave to withdraw after receiving payment). The amount should be determined by the liquidator or Official Assignee, as appropriate, with a right of appeal for any party in the event of disagreement over costs awarded. The Ministry supports this recommendation.

Recommendation:

A petitioning creditor should be entitled to priority for the reasonable solicitor-client costs incurred when procuring an order of adjudication or liquidation.

The Commission also proposed that the actual expenses incurred by the Liquidation Committee should receive priority. Such expenses include remuneration where a majority in number and 75 percent of creditors by value have resolved to pay remuneration. Any creditors should have the right to appeal that decision to the courts, but a decision on remuneration should be overturned only if the Court is satisfied that there has been an abuse of process (ie. the resolution is not bona fide or has been made for an ulterior purpose). Currently, these costs must be borne by those creditors with the resources and expertise to contribute personnel to the creditors' committee. The proposal was argued to be particularly beneficial in large or complex liquidations, especially where expert assistance is needed to realise assets.

Similarly, the Commission also proposed that the Insolvency Act should be amended to ensure consistency with the above proposal (i.e. in relation to the granting of remuneration to those assisting the Official Assignee or liquidator in an official capacity).

The Ministry considers that these proposals have merit and are consistent with the broad objectives of the review in terms of promoting a clear and consistent legal framework that provides incentives for collective involvement in insolvency proceedings. However, the Ministry also acknowledges that these recommendations generated significant interest from submitters. Some suggested that payment could result in abuse, with over-participation in the administration of the insolvent estate, perhaps to the point of interference. It was argued that independent expert advice could be sought and paid for adequately under existing provisions. Finally, it was suggested that the process (in particular, requiring 75 percent majority support) as proposed by the Commission was cumbersome and could cause unnecessary delay. The Ministry therefore welcomes further submissions on this.

Recommendation:

The Ministry's provisional recommendation is that priority should be afforded to the actual expenses incurred by the Liquidation Committee. Further submissions are invited.

7. EMPLOYEE–RELATED CLAIMS

1.1 The right to priority

Currently, employees are entitled to priority on any arrears of salary and wages and related earnings (excluding redundancy payments) accrued over the previous four months, up to a maximum of $6,000.

The Commission supported the retention of this priority on the grounds that:

- The government has demonstrated in other areas a clear intention to protect employees;
- New Zealand is a member of the International Labour Organisation that has produced a convention that provides for workers' claims to be protected either by a privilege or by a guaranteed institution such as a wage earner protection fund;
- An employee is at arm's length from the employer, and is, consequently, not in a good position to evaluate an employer's financial position.
- There is a community expectation that employees should be protected to a degree on the insolvency of their employer.

The Commission also proposed that the priority should be expressed as being limited to employees who have the right to bring a personal grievance under the Employment Contracts Act 1991. The Commission's paper was written before the introduction of the Employment Relations Act 2000 ("ERA") and, while the Ministry considers that this recommendation is consistent with the objectives and principles underpinning the ERA, it invites further submissions on this point.

The market failure identified by the Commission (which the priority seeks to address) is the information asymmetry between employees and the company. It is argued that the asymmetry is greater for employees than for other creditors. This is because creditors such as banks are better placed to impose conditions on the debtor and withdraw their security if the company is considered to be getting into financial difficulty. However, one of the key objectives of this paper is to promote a robust debate regarding the retention of this priority. This is because, from an economic perspective, the employee preference creates potential risks and market distortions. For example:

- Many other creditors (such as contractors, trade creditors and customers) are in no better position, and perhaps in an even worse position, than employees to judge company performance.
- The preference may reduce availability, or increase the cost, of credit to certain firms, particularly in labour-intensive organisations. This may reduce the growth of some companies and also reduce job opportunities. In this case, the cost would be borne, principally, by the unemployed.
- As a group, employees are not necessarily more disadvantaged than other creditor groups, such as trade creditors. In fact, it can be argued that by increasing the cost on trade creditors in preference to employees, there is an increased risk that, to the extent trade creditors fail as a result, employment opportunities will be reduced, at least in the short term.
- Employees have the opportunity to take out income protection insurance to cover the risk of redundancy. The priority could therefore create inequality between those employees who have taken out income protection insurance and those who have not.
- It is not an efficient means of targeting need. For example in some insolvencies few if any assets will be available.
- Social Welfare is there to address instances of financial hardship.

These factors obviously need to be weighed against the benefit to creditors of retaining the priority. The submissions that were received in response to the Commission's paper tended to focus on the extent (i.e. the amount) of the priority and not whether there were legitimate policy grounds for retaining it. For this reason, the Ministry welcomes further submissions on this issue.

Recommendation:

The Ministry's provisional recommendation is that the employee preference should be retained. However, further submissions on the merits of the respective public policy arguments are invited.

1.2 The extent of priority

7.2.1 Directors as employees

The Commission recommended that directors, as defined by section 126 of the Companies Act, should be excluded from the employee preference. This definition includes employees acting in a management role.

Currently, directors of a company can enter into employment contracts with their companies to ensure that, in the event of insolvency, they are elevated from being a shareholder (who is paid only after all creditors have been paid) to a preferred creditor. This is in spite of their being privy to information about the company's financial status not available to other parties (and thereby in a better position to control their risk) and participating in decision-making that affects the company's future prospects. This reduces, if only marginally, the incentive directors have to ensure the company retains solvency and is inconsistent with the purpose behind the employment priority of protecting an otherwise vulnerable group.

Recommendation:

The Ministry proposes that directors, as defined by section 126 of the Companies Act 1993, should be excluded from the employee priority.

7.2.2 Contractors

The Commission considered and rejected the proposition that independent contractors should be entitled to the same preference as employees (as mentioned in section 7.1 above, this recommendation needs to take account of the new definition of 'independent contractor' contained in the ERA).

It could be argued that independent contractors, and sole traders who are completely dependent on an insolvent company, have no better information than employees and will suffer at least as much as employees. However, to treat some contractors (i.e. those with similar exposure to employees) but not others in this way would be extremely difficult in practice.

Recommendation:

The Ministry proposes that independent employee's should not be entitled to the same priority as employees.

7.2.3 Redundancy payments

The priority of redundancy payments in insolvency has become a topical issue, arising, for example, in:

- A Private Members Bill (arising from the collapse of Weddel freezing works) which provided for redundancy payments to be added to the list of employee benefits entitled to preferential treatment on insolvency. Consideration of the Bill was deferred pending consideration of the issue in the insolvency review.
- More recently, the New Zealand Stevedoring Limited insolvency in 1998 which renewed calls for greater protection of employee entitlements. In this case employees, as unsecured creditors, lost redundancy, holiday and long service entitlements to the approximate value of $14 million. At the time, it was widely argued that the insolvency of New Zealand Stevedoring Limited and the resultant continuation of a number of its businesses was a cynical attempt to defeat the legitimate interests of creditors (mainly employees) though a phoenix arrangement.

The Ministry acknowledges that without a priority for redundancy payments some employees will, in certain circumstances, be worse off than with such a priority. However, this benefit needs to be weighed carefully against the costs it could impose on other creditors and the likely impact on the cost and availability of credit, particularly for small companies.

In many liquidations, there is no secured creditor. A priority for redundancy payments could significantly reduce money available to trade and other unsecured creditors. This in turn could lead to a further round of company failures, and loss of employment opportunities. Further, such a priority could lead to trade credit being withheld or its cost increased in certain circumstances, thereby reducing opportunities for some companies to expand and decreasing income and employment opportunities.

Recommendation:

On the balance of expected risks and benefits, the Ministry's provisional view is that redundancy payments should not be afforded priority. However, it welcomes further submissions on this line.

7.2.4 Wage earner protection funds

The Commission suggested that the problems associated with redundancy entitlements could be overcome through the establishment of a wage earner protection fund, with the costs to be met by a levy on employers. The Ministry does *not* support the establishment of such a fund, on the grounds that:

- It would penalise, and hamper the performance of successful firms;
- It would create a moral hazard;
- Only some employees would benefit; and
- Collection costs would be excessive.

Further, the Ministry notes that firms (as part of their remuneration policy) and employees are free to insure against the risk of redundancy, should they so chose. In this way, the cost and the resulting benefits of the 'redundancy provision' are borne explicitly by the beneficiary (the employee). This is more likely than a priority or a dedicated fund to meet employee preferences regarding the value of the trade-off between the risk of redundancy (from whatever source) and the cost of that protection. it is also likely to provide more certainty in the event of company failure than a priority or a dedicated fund would achieve.

Recommendation:

A wage earner protection fund should not be established.

7.2.5 Phoenix companies

In commenting on the problems raised by the New Zealand Stevedoring case, the Commission has suggested that employee liabilities should be transferred to the purchaser on a sale of a business as a going concern. This proposal is based on the European Union Acquired Rights Directive under which an employee's contract of employment is automatically transferred (on existing terms and conditions) to the purchaser.

Initial research has revealed that the Acquired Rights Directive has been the subject of extensive litigation in each of the European Union's member states. There is also little evidence to suggest that it safeguards employment opportunities. For instance, in the United Kingdom the Transfer of Undertakings (Protection of Employment) Regulations (which enacted the Directive) are the subject of regular litigation as parties grapple with technical legal issues regarding the date of the transfer, whether the transfer constitutes the transfer of an economic entity, and whether the new purchasers can make out a 'economic, technical or organisational' ground that will enable them to renegotiate the transferred employees' contracts of the transferred employees. The Directive also allows member states to exclude collective insolvency proceedings such as liquidation from its ambit (although it does apply to receiverships).

The Ministry welcomes submissions on whether the Acquired Rights Directive may provide an effective solution to the complex issues that surround sales of going concerns. In particular, will such an approach encourage such sales and thereby stimulate the development of a corporate rescue culture?

The Ministry also notes that the Minister of Labour has established an advisory group to review minimum employment standards. The advisory group will examine the adequacy of existing arrangements for protecting wages and conditions of work when a business is sold or transferred or work is contracted out. It will also consider international practice in this area and consider options for change. The Ministry will have to revisit this issue once the advisory group's recommendations are known.

7.2.6 Award for lost wages

Section 123 of the Employment Relations Act 2000 provides that where the Employment Authority or the Employment Court finds that an employee has a personal grievance, it may settle the grievance through any of a range of remedies including:

- Reimbursing to the employee the whole or any part of the amount of wages or other money he or she lost as a result of the grievance; and
- The employee's employer paying compensation for, among other things, (a) humiliation, loss of dignity and injury to feelings of the employee and (b) loss of any benefit, whether or not of a monetary kind, which the employee might reasonably have been expected to obtain if the personal grievance had not arisen.

Section 128 also expressly provides provision for reimbursement of lost remuneration as a result of a personal grievance.

The Commission's provisional view when dealing with the priority for lost wages was that this liability was no different in nature to the current employee priority and should be treated the same. In relation to awards relating to, for example, humiliation and loss of dignity, the Commission concluded that a case had not been made for giving them priority. It also noted that no other forms of distress damages are given priority. The Ministry is inclined to support the Commission's recommendations, but it welcomes further submissions on this in view of the recent introduction of the ERA.

Recommendation:

The Ministry supports the Commission's recommendation that, as a general rule, awards made by the Tribunal or Court should not be given priority status if they would not have priority had the court not intervened.

7.2.7 Apprentices

Apprentices are given priority under:

- Clause 2(g) of the Seventh Schedule to the Companies Act 1993, which provides that any amount under section 23 of the Apprenticeship Act 1983 (which section 16 of the Industry Training Act 1992 deems part of an apprenticeship contract) that the Employment Court orders to be paid to an apprentice by the Employment Tribunal is a preferential debt; and
- Section 104(1)(d)(ii) of the Insolvency Act 1967,which provides that sums the Court orders to be paid to an apprentice under section 83 of the Insolvency Act 1967 are preferential debts.

In its report the Commission charts the historical origins of both provisions. It concludes that 'as the reasons for the apprentice provisions are now largely spent, it is unnecessary to retain the preference'. The Ministry of Economic Development and the Department of Labour support this conclusion.

Recommendation:

The preferential status afforded to apprentices under the Companies Act 1993 and the Insolvency Act 1967 should be abolished. The Department of Labour also recommends that apprentices should be afforded the same priority as is presently afforded to employees. The Ministry welcomes further submissions on this issue.

7.2.8 Volunteers Employment Protection Act 1973

Section 15 of the Volunteers Employment Protection Act ('VEPA') 1973 provides that any sum ordered or adjudged to be paid as compensation under section 6 VEPA shall be a preferential debt both in bankruptcy and liquidations. The priority is limited to $200.

Section 6 VEPA provides that every employer commits an offence if an employee's employment is terminated because the employee volunteered for, or underwent, any protected voluntary service or training. Where an employer contravenes section 6, the Court may order the employer to pay the worker a maximum amount equivalent to 16 weeks pay. The compensation under section 6 therefore relates to dismissal. Other awards made for compensation for dismissal do not have priority. The priority afforded to VEPA claims is an anomaly and the Commission identified objections which justified its abolition:

- Assessment being on a different basis to that which applies to other employees;
- The link between the employer's criminal behaviour and the preferential status of wages. The link is not a basis for priority in respect of other employees.

The Ministry endorses the Commission's views. However, it also notes that a private member's Bill proposing amendments to VEPA is currently before Select Committee. One of the proposed changes is to increase the list of currently protected issues. This matter will therefore have to be revisited once the Select Committee's report is available.

Recommendation:

The preferential status afforded to persons whose employment is terminated because of involvement in protected voluntary training under the VEPA should be abolished.

8. REVENUE-RELATED CLAIMS

As indicated above, section 104 of the Insolvency Act 1967 and the Seventh Schedule to the Companies Act 1993 set out lists of creditors who receive preferential status in personal bankruptcies and corporate insolvencies respectively.

The lists of priority debts include a number of debts to the Crown such as:

- The Commissioner of Inland Revenue in respect of unpaid GST (section 42(2)(a) of the Goods and Services Tax Act 1985 in respect of personal bankruptcies and Part III of the Goods and Services Tax Act 1985 in respect of corporate insolvencies);
- Duty as defined by section 2(1) of the Customs and Excise Act 1996 (section104(1)(e)(iv) of the Insolvency Act 1967 in respect of personal bankruptcies and the Seventh Schedule to the Companies Act 1993 in respect of corporate insolvencies);

- Debts owing under the Radiocommunications Act 1989, by operation of section183(4) of that Act;
- Levies payable to the Ministry of Agriculture and Fisheries under the Fisheries Acts and
- In respect of corporate insolvencies only, non-resident withholding tax and resident withholding tax deductions made under the NRWT and RWT rules under the Income Tax Act 1994.

In its the report, the Commission considered:

- The criteria which ought to be applied in determining whether any particular debt should be afforded preferential status; and
- Whether the existing preferences under section 104 of the Insolvency Act 1967 and the Seventh Schedule to the Companies Act 1993 can be justified on the criteria recommended;
- The Commission made the following general observations: Section 6A of the Tax Administration Act 1994 requires the Commissioner of Inland Revenue to collect the highest net revenue over time *that is practicable within the law* having regard to the resources available, the importance of promoting compliance and the compliance costs incurred by taxpayers;
- A preference is not necessary to protect the tax base. This is because Crown agencies have powers to collect tax, duties and levies and to impose penalties and interest or seek security for payment. Protection of the revenue base would be better achieved through exercising these powers in a timely fashion;
- The Crown is not an involuntary creditor. The Legislature has decided that the tax, duties and levies should be collected on its behalf. In addition, even if the Crown were an involuntary creditor, many other involuntary creditors do not receive preferential status.

In relation to the Crown debts, the Commission concluded that the preferential entitlements to GST, customs duty and levies under the Fisheries Acts and the Radiocommunications Act should be abolished. The Commission's reasoning was as follows:

- GST is not a debt analogous to a trustee's obligation to account to a beneficiary, because taxpayers who collect GST do not have to keep it separate from other monies. The obligation to pay GST is analogous to the obligation to pay income tax. There is no preference in relation to income tax so, in order to be consistent, there should not be one in respect of GST;
- The priority afforded to customs duties should be abolished because no anomalies will result from removing it; there is no evidence to suggest that preferential recovery by a creditor provides an incentive for the debtor to pay the duties promptly; and there are ample alternative remedies available to the New Zealand Customs Service to protect itself should the preference be abolished.
- The preference in relation to fisheries duties should be abolished because the only argument advanced for its retention was that arrears of levies arise from an illegal activity (ie fishing above quota) and the claim represents the recovery of stolen money. The Commission noted that no other claims for loss against thieves receive preferential treatment and, consequently, this argument was unsustainable. Furthermore, a preference in such a case could only be justified if the person who stole the money stood in a fiduciary position to the Crown.
- The preference in relation to debts owing under the Radiocommunications Act 1989 should be abolished because the Commission saw nothing to differentiate a levy under this Act from any general tax. The Ministry also notes that no arguments were advanced during previous consultation to support retaining this preference.

The Commission recommended that the preferential status of NRWT and RWT in corporate insolvencies under the Companies Act 1993 should be retained and extended to personal bankruptcies under the Insolvency Act 1967 because:

- The payments are made on behalf of a third party. Removing the preference would cause injustice to taxpayers who order their affairs on the assumption that payments have been made.

- It would be unjust to allow the assets of an insolvent to be swollen through the use of money which the debtor ought to have paid to the Commissioner on behalf of a third party.

- The Commission could see no reason why the preference should not be applied consistently in both bankruptcy and liquidation.

The Commission also recommended that the priority afforded to PAYE deductions made by a company under the Income Tax Act 1994 should be abolished and replaced by a gross priority for wages of $6,000 plus the PAYE component. This was because if an employee's wages are to be given priority, the tax component of those wages should also have priority. Further, it would be unfair to an employee who has acted in good faith on the assumption that their employer has paid tax to be put at risk of being personally pursued for the debt.

However, the Ministry notes that these proposals may have a significant effect on Crown revenue and on the behaviour of Crown agencies, businesses and consumers. Unpaid tax undermines the integrity of the revenue base and is a loss to all members of society.

A change in the status of revenue-related claims may lead to a change in the public perception of the revenues involved, which, in turn could affect future collections.

The Ministry will seek detailed comments from all affected Departments before finalising its recommendations. Public submissions are also welcomed.

The Commission also made recommendations in relation to child support deductions (cf The section of the 163 Child Support Act 1991), student loan deductions (cf the Student Loan Scheme Act 1992) and accident compensation levies. The Commission concluded that the priority afforded to all three payments could be justified on the grounds that:

- They are deductions from wages of third parties who are likely to have ordered their affairs on the basis that the payments have been met; and

- The money has not been applied for the purpose of paying the third party's debt so it would be unjust to allow these monies to be used to swell the assets available to the general body of creditors when it would be commercially impracticable to impress funds with a trust.

Notwithstanding this, the Commission recommended abolishing specific priorities and replacing them with a general provision in terms of the current clause 2(d) of the Seventh Schedule to the Companies Act 1993. The Commission believes that such a provision would give creditors a greater incentive to regularly monitor payment of the debt on a regular basis and take timely action to cover arrears. This incentive would flow from the fact that the Commissioner of Inland Revenue's priority would be restricted to the maximum amount of PAYE payable on the net wage priority of $6,000 and to deductions from wages (for child support etc) that have not been paid in accordance with the authority given to the employer. Furthermore, it would simplify the current preferential regime by enabling the priority to be stated in a succinct manner and to apply across the board to all relevant deductions authorised by the employee.

The Ministry supports this recommendation to the extent that it seeks to clarify and consolidate the law into a single provision. If adopted, the priorities afforded to child support deductions, student loan deductions and compensation levies because of their unique status as statutory trust monies, would continue. The Ministry suggests, however, that these priorities be consolidated into a single provision, as recommended by the Law Commission. It should be noted that previous submissions did not tackle this proposal in any detail, and further submissions are welcomed.

9. MISCELLANEOUS PRIORITIES

9.1 Motor Vehicle Dealers Institute

Section 42 of the Motor Vehicle Dealers Act 1975 ('MVDA') provides that where the Institute pays money out of the Motor Vehicle Dealers Fidelity Guarantee Fund to settle a claim against a motor vehicle dealer, the Institute is subrogated to all the rights and remedies of the claimant, as against the motor vehicle dealer claimed against. Section 42(2) MVDA provides that a District Court Judge may declare that a person is personally responsible for repayment of the amount paid from the fund in settlement of the claim.

The Commission received a submission from the Motor Vehicle Dealers Institute supporting the retention of the preference because among other things:

- The pari passu principle should not apply in all instances because some creditors lend money and give credit knowing that the entity is in a perilous state.

- Unlike a commercial insurer, the Motor Vehicle Dealers Fidelity Guarantee Fund has no control over the risk that it undertakes. Licences are issued by the Motor Vehicle Dealers Licensing Board rather than the Fund.

The Commission rejected these arguments because they did not reveal any compelling reasons to depart from the pari passu principle. It also noted that there has never been a similar preference in relation to fidelity funds operated by organisations such as the Institute of Chartered Accountants of New Zealand and the New Zealand Law Society.

Recommendation:

The Ministry endorses the Commission's approach. It notes the Institute's concern that the current Motor Vehicle Dealers Bill may abolish the Fund and will reduce consumer protection, as all claims arising will need to be lodged before a given date. The Bill is currently before the Commerce Select Committee and is due to be reported back on 15 December 2000. The Ministry will re-examine the Institute's concern once that Select Committee's report becomes available.

9.2 Layby sales

In its report, the Commission recommended preserving the priority afforded by the Layby Sales Act 1971. The Commission considered that, notwithstanding the significant changes in consumer behaviour (particularly the increased use of credit cards), prudent purchasers continue to use the layby system and should not be disadvantaged. Further, it considered that those using the layby system will generally have modest means and `can least afford to lose the money'. The amounts at issue in relation to preferential claims based on layby sales will generally be modest and unlikely to impact unduly on other creditors' dividends.

The Ministry agrees with these comments and also notes that if layby sales encourage consumers to have greater budgetary responsibility (and thereby reduce levels of consumer indebtedness), they should be encouraged. The Ministry also notes that, as of 15 November 2000 the Layby Sales Act applies to transactions of up to $7,500.

Recommendation:

The preference for layby sales should be retained.

9.3 Costs of compromise

The costs incurred in organising and conducting a meeting of creditors for the purpose of voting on a proposed compromise under Part XIV of the Companies Act 1993 are given priority (if the costs are incurred by a person other than the company, a receiver or liquidator). The Commission's report states that this provision provides an incentive for a company to face its creditors at the earliest possible time and, if possible, to restructure its affairs without the need for liquidation. The Ministry endorses the Commission's recommendation. The Commission also suggests that there is room to further extend the scope of this priority, particularly if New Zealand adopts a voluntary administration procedure akin to that used in Australia or the United Kingdom. Voluntary administration is one of the Ministry's Tier Two review topics and a paper on this issue will be released for public consultation in 2001. The proposal to extend this priority will therefore be addressed in this context.

Recommendation:

The priority afforded to the costs incurred in organising and conducting a creditor's meeting should be retained.

9.4 Liens over book debts and papers of a bankrupt or a company

A priority is currently given to holders of liens over books and papers of a bankrupt or a company in liquidation. The right to seek preferential payment of a debt to a maximum of $500 operates in lieu of the exercising the right of lien. The Commission's paper explains that the rationale for this preference is that lien holders could disrupt the orderly administration of a bankruptcy or liquidation by refusing to provide the records without, in effect, being given preferential treatment for the whole of the debt to discharge the lien.

The key issue is whether the priority should remain or whether lien holders should have to prove (on an unsecured basis) for the whole of their debt. The Commission's paper contrasts lien holder's position with that of a supplier of essential services which is prohibited from requiring outstanding charges to be paid as condition of supply or from requiring that the liquidator personally guarantee charges which would be incurred for supplying the service. The point of the distinction between the supplier of essential services (which has no preferential claim) and the lien holder (who does) is that the lien holder has a lawful possessory lien which is not allowed to prevail because it would create inefficiencies in the administration of an insolvent estate. In contrast the essential service supplier relies on its 'commercial muscle' to achieve a de facto priority.

The Commission also makes the point that someone who has done very little work may recover the whole of the debt back in priority to other creditors because of the limit on the preference. In contrast, someone who has undertaken a significant amount of work is only entitled to a priority to the extent of $500.

Recommendation:

The Ministry agrees that the current provisions have the potential to produce arbitrary results. It endorses the Commission's suggestion that the preferential claim should be made 10 percent of the amount of the total debt up to a maximum of $2,000, as this is likely to result in greater vertical equity as between different classes of creditor.

10. ADDITIONAL PRIORITIES AND OTHER ISSUES

10.1 Incentives to finance proceedings

The Commission's paper extensively reviews the relevant provisions of Australian corporations law and bankruptcy legislation. These provisions effectively invest the Court with power to confer an advantage on certain creditors who have helped the liquidator to recover or preserve the company's assets by providing an indemnity to the liquidator against the costs of litigation. As a consequence, creditors are encouraged to support a liquidator in taking legal proceedings for the recovery of property or to prevent further dissipation of the estate.

The Ministry believes such a priority could help further the broad objectives of the insolvency review with its emphasis on collective rather than individual processes for maximising the assets of the insolvent estate. The Ministry also notes that this proposal received support from insolvency professionals.

Recommendation:

The Ministry supports the introduction of a priority that will provide incentives to creditors to help liquidators in preserving the assets of an insolvent estate.

10.2 Reorganisation Costs

The Commission also considered whether there was any merit in including as a preferential debt the costs incurred in trying to put together a compromise for creditors when the compromise is ultimately unsuccessful. The Ministry shares the Commission's reluctance to make a definitive recommendation regarding this proposal until its full economic impact is assessed. This task is still ongoing.

Recommendation:

The Ministry should continue to assess the fiscal impact of the proposal to introduce a new priority for costs associated with unsuccessful compromise.

3.3 Construction subcontractors

The Commission's paper made a number of observations regarding the repeal of the Wages Protection Contractors Liens Act 1939 and the impact this has had on the position of subcontractors in the event of a head contractor's insolvency. The Ministry asked the Commission to provide further advice on this issue, and this resulted in the publication of Study Paper 3 *Protecting Construction Contractors* in November 1999.

The paper recommended that, rather than introducing a new priority debt, the introduction of legislation similar to the New South Wales Building and Construction Industry Security of Payment Act 1999 was the most effective mechanism for resolving some of the problems afflicting the construction industry. The New South Wales Act outlawed 'pay if paid' clauses and introduced a fast-track adjudication system for payment disputes.

This issue has continued to gain in significance with the high-profile collapse of a number of construction companies. Earlier this year the Hon Laila Harré (Associate Minister of Commerce) established a Ministerial Working Group comprising representatives of key stakeholders within the construction industry to assist the Ministry in its policy development. The Working Group supported the Commission's recommendation that New Zealand should adopt legislation similar to the New South Wales Act. Legislation is due to be introduced in 2001.

10.4 Subrogation rights

There is currently no statutory provision that clarifies which debts can be subrogated. The Commission recommends that subrogation rights should be expressed clearly in both the Insolvency Act 1967 and the Companies Act 1993. The Ministry supports this recommendation.

5.5 Environmental damage

The Commission's paper noted that the cost of remedying environmental damage has been given preferential status in some jurisdictions and questioned whether a similar priority should be introduce in New Zealand. The Commission did not receive any submissions on this issue and subsequently recommended that there was no compelling need for such a priority.

Recommendation:

A new priority should not be established for the costs of remedying environmental damage unless further submissions reveal a case for such a priority.

10.6 Gift vouchers

The potential problems that can arise from the use of gift vouchers came to public attention following the receiverships of Levene & Co Limited and Palmers Garden Centres Limited. The Ministry asked the Commission to review this issue to determine whether a new priority was necessary to protect the gift voucher holders. The Commission concluded that, as there are no ascertained goods at the time a gift voucher is purchased, no proprietary remedy can exist in favour of a person who has received the voucher as a gift. Only one submission was received on this issue, and it supported the introduction of such a priority. The submission comprehensively outlined the impact that corporate insolvency had on consumers, but it did not advance any public policy arguments supporting the introduction of such a priority.

Recommendation:

Priority should not be afforded to holders of gift vouchers.

10.7 Secured creditors

The Commission has advised that it can see no legitimate basis to question the priority given to secured creditors. The Ministry agrees with this assessment. However the Commission recommends that the definitions of 'secured creditor' in the Insolvency Act 1967 and the Companies Act 1993 should be harmonised. Further, only persons with perfected security interests under the Personal Property Securities Act 1999 and those with registered mortgages over land should be considered as secured creditors for insolvency law purposes. The Ministry welcomes submissions on this latter proposal.

11. FURTHER SUBMISSIONS

The Ministry welcomes submissions on all aspects of this discussion document. However, comments are particularly sought on the issues discussed in section 11.1 to 11.5 below:

11.1 Administration costs

Should the Insolvency Act 1967 be amended so the priority is extended to include remuneration granted to those helping the Official Assignee or liquidator in an official capacity?

11.2 Employee-related claims

(a) Should the priority afforded to employees in respect of any arrears of salary and wages and related earnings be retained?

(b) Will a solution based on the European Union Acquired Rights directive resolve the problems associated with the sale of a going concern?

(c) Should priority be extended to redundancy payments?

11.3 Apprentices

Should apprentices be afforded the same priority as that presently offered to employees?

11.4 Revenue- Related Claims

(a) Should the priority of Goods and Services Tax, customs duty, and levies under the Fisheries Acts and the Radiocommunications Act (in corporate insolvency and personal bankruptcy) be abolished? If so, why? If not, why not?

(b) Should the preferential status of NRWT and RWT (in corporate insolvencies under the Companies Act 1993) be retained and extended to personal bankruptcies under the Insolvency Act 1967? If so, why? If not, why not?

(c) If the response to questions 4(a) and (b) is affirmative, what impact will this have on the behaviour of Crown agencies, businesses and consumers?

(d) Is it feasible to abolish specific priorities and replace them with a single provision based on clause 2(d) of the Seventh Schedule of the Companies Act 1993?

11.5 Reorganisation costs

(a) Should the Insolvency Act be amended to provide that the actual expenses incurred by those assisting the Official Assignee or liquidator (in an official capacity) be afforded priority?

(b) One of the key themes of the Ministry's Tier Two review papers is the development of a corporate rescue culture. In this context, should a new priority be introduced for costs associated with unsuccessful companies?

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9. Recommendations

10. Legislative options

1. INTRODUCTION

The purpose of this paper is to seek comment from interested parties on the risks phoenix companies pose to the interests of creditors and other stakeholders of companies in the insolvency process, and on possible options for dealing with that risk.

2. EXECUTIVE SUMMARY

A phoenix company is a business that has been sold as a going concern to another company or to its managers/directors soon after (and in some cases before) its failure. Provided the business is sold at market value, the phoenix arrangement will be in the interests of creditors. However, where the sale price is less than could have been realised outside the phoenix arrangement, the legitimate interests of creditors will be compromised.

The Ministry considers the problem is most likely to arise before liquidation, when the company is still in the hands of its directors. In liquidation, the company and any asset sales are the responsibility of the liquidator/receiver, who is required to act in the interests of creditors by securing as high a price as possible for the company's assets.

The interest in phoenix companies was heightened by the insolvency of New Zealand Stevedoring Ltd. The Ministry's preliminary conclusion, however, is that the problems that arose in the New Zealand Stevedoring case relate less to the action of directors/owners in using phoenix arrangements and more to public perception around their use and to the order of employees' priority as creditors in the company. It is more appropriate to deal with the order in which creditors' claims are met during insolvency as part of the Ministry's review of priorities. This will allow redundancy payments to be considered against the strength of competing priorities and in the context of promoting the wider public interest.

There remain, however, possible policy issues relating to phoenix companies that may require government action. There is anecdotal evidence available that phoenix companies are, in certain circumstances, being used to defeat creditors' legitimate interests. The Ministry's preliminary assessment is that this problem stems from ineffective enforcement of the existing provisions of the Companies Act. Ineffective enforcement in turn appears to stem from:

- The high cost of accessing the judicial system;
- The free rider problem and high transaction costs;
- The creditors' perceived probability of successfully challenging the phoenix arrangement; and
- The low (civil) penalties in the event of a successful court case.

However the nature and magnitude of the problem outlined above remains somewhat uncertain. The evidence is mainly anecdotal as statistics are not collected on the prevalence of phoenix companies and the types of phoenix company that arise. For this reason, the Ministry is seeking comment on our preliminary assessment that the problem is mainly one of insufficient enforcement rather than inappropriate legislation. Similarly, as well as seeking comment on the options identified in the paper, the Ministry is also seeking comment on whether there are other options that will more effectively deal with the problems arising from phoenix companies than those outlined.

The Ministry recommends that:

(a) Lawyers be able to operate on a contingency fee basis when enforcing insolvency provisions; and

(b) Criminal penalties be available to the courts where directors are shown to have acted in bad faith to defeat creditors' legitimate interests.

3. BACKGROUND

3.1 Origin of the phoenix company review

In 1998, New Zealand Stevedoring Limited was placed in receivership. The businesses of the company and a number of its subsidiaries were transferred to associated companies.

As a consequence of the receivership, over 300 staff were made redundant. Outstanding claims in excess of $14 million (redundancy, long service and holiday pay) were not settled.

The Stevedoring case generated a large amount of public interest. In particular, concerns were heightened over the ability of directors and managers of a failed company to defeat creditors' legitimate interests in pursuit of their own interests. In response, the then government expressed concern at the circumstances surrounding the case and undertook to ensure the issue of phoenix companies would be dealt with in the current insolvency review.

4. POLICY FRAMEWORK

Insolvency law provides a statutory process for winding up insolvent companies and distributing remaining assets to creditors. It also provides penalties and sanctions for inappropriate commercial behaviour (for example, directors acting in bad faith) in the run up to and following insolvency.

The government's key goal in reforming insolvency law is to promote the public interest by maximising the business community's contribution to the New Zealand economy through increasing job opportunities and incomes. An insolvency regime, with respect to phoenix companies, will promote the Government's key goal if it:

- Provides a predictable and simple regime for financial failure that can be administered quickly and efficiently, imposes the minimum necessary compliance and regulatory costs on its users, and does not stifle innovation, responsible risk taking and entrepreneurialism by excessively penalising business failure;
- Distributes the proceeds to creditors in accordance with their relative pre-insolvency entitlements, unless it can be shown that the public interest in providing greater protection to one or more creditors (statutory preferences) outweighs the economic and social costs of any such preferences;
- Maximises the returns to creditors by providing flexible and effective methods of insolvency administration and enforcement which encourage early intervention when financial distress becomes apparent; and
- Provides enforcement resources commensurate with the expected benefits from that enforcement effort.

5. PROBLEM IDENTIFICATION

5.1 Definition of phoenix companies

A phoenix company is a company that has been 'reborn' soon after (and in some cases before) its failure. The new company takes on the failed company's business, often using a similar name, the same managers and directors, and the same assets. The use of phoenix arrangements to sell the business as a going concern is an alternative to breaking-up and selling the business assets individually.

5.2 Where phoenix companies serve the public interest

It is clear that the use of phoenix arrangements is counter to stakeholders' interests in only a subset of cases. Many phoenix situations will, in fact, promote the interests of creditors (including employees) through lower transaction costs and a higher sale price than would occur without phoenix companies. The business fetches a higher price through it being sold as a going concern than if its assets were broken up and sold individually. A higher price will be received, for example, where the existing managers and directors increase the company's sale value, or where sale to the managers will realise the highest price, for example. The value of phoenix arrangements is particularly pronounced where the business generates a large income stream yet has relatively few assets, for example, a computer consultancy business.

Phoenix arrangements may also result in companies avoiding insolvency and its associated costs. For example, rather than liquidating an insolvent company, creditors may prefer to have their security interests transferred across to the new company at a discounted value, but without first imposing formal insolvency proceedings.

In essence, provided the vendor is receiving true market for the sale of the company's assets (the highest price purchasers would be willing to pay for those assets), the Ministry considers that the use of phoenix companies is an effective way to meet creditors and debtors' collective interests. Employees, in particular, may benefit from the continuing employment opportunities provided by the continuation of the profitable business of an otherwise insolvent company. Similarly, through the entity continuing intact, trade creditors are more likely to benefit by retaining their supplier relationship with that entity.

5.3 Where phoenix companies are counter to the public interest

The owners/directors of a failing company may seek to sell that company (or part of that company) as a going concern, but leave it owned and/or managed by the same people in a deliberate effort to frustrate creditors' legitimate interests. This would occur where the business is transferred at less than market value before insolvency, thereby reducing the funds available to creditors. To do this, directors would need to obtain valuations made on a basis that suits the directors' interests rather than reflecting the market value of the business.

Besides disadvantaging creditors, use of phoenix companies in this way would allow directors who mismanaged the original company to retain control of the business to their benefit but to the detriment of the new company and other businesses that deal with that company.

Depending on the prevalence of the problem, the inappropriate use of phoenix companies could lead to less confidence in the value of creditor security, and the use of measures to counter risk to that security (for example, insurance such as income protection for employees, and increased monitoring of debtor behaviour). This in turn could lead to higher transaction costs and an increased cost and reduced availability of credit. There are also redistribution consequences, that is, assets being transferred from creditors to the owners/managers/directors of the failed company.

The Ministry considers the problem is most likely to arise before liquidation, when the company is still in the hands of its directors. In liquidation, the company and any asset sales are the responsibility of the liquidator/receiver, who is required to act in the interests of creditors by securing as high a price as possible for the company's assets in the circumstances.

The Ministry does not consider the interests of secured and unsecured creditors to diverge sufficiently in liquidation to make it likely that secured creditors would operate a phoenix arrangement to the disadvantage of unsecured creditors. In fact, the opposite (a preference for realising the assets individually) appears likely to be the case.

Even where company assets are expected to realise a higher price as a going concern, secured creditors can be expected to prefer breaking up and selling the company assets if the prices received meet, or nearly meet, the secured creditors' debts. This is because secured creditors will not wish to continue to operate the business as a going concern (in readiness for sale) in these circumstances (even though it would be in the unsecured creditors' interests). To do so would risk further deterioration of the value of the company's assets, threatening secured creditor security. Some favour voluntary administration as a mechanism for overcoming this problem, and it will be addressed in that part of the Ministry's review considering voluntary administration.

5.4 Phoenix companies: an issue of perception

The use of phoenix arrangements during company insolvency tends to generate 'bad press'. Creditors, in particular, may consider it unjust that the directors and managers who presided over the failed company, the insolvency of which cost them the value of their interests in that company, retain their positions, apparently unaffected by the insolvency. This 'bad feeling' towards the managers and directors may occur even where the phoenix arrangement is beneficial to creditors' collective interests.

Further, especially where the creditors who lose out are employees or small unsecured creditors, there may be a perception that secured creditors have benefited at their expense in any phoenix company arrangement. Again, this may be the case even where the phoenix arrangement increased, or at least did not reduce, the payout to those creditors.

Although creditor perceptions are important and should be acknowledged, ultimately the collective interests of the many stakeholders in the insolvency regime need to take precedence in the development of government policy in this area.

5.5 Legislative provisions to prevent the abuse of phoenix companies

Several legislative provisions in the Companies Act 1993 militate against directors and mangers using phoenix companies to defeat creditors' legitimate interests of creditors. The main provisions, with a very brief description, are identified below.

5.5.1 Voidable transactions

5.5.1.1 Section 297: Transactions at undervalue

Section 297 provides, among other things, that a liquidator may recover from any other party to the transaction any amount by which the value of the consideration or benefit the company provided exceeded the value of the consideration it received.

5.5.1.2 Section 298: Transactions for inadequate or excessive consideration with directors and certain other persons

Section 298 provides for the liquidator to recover from the person, relative, company or related company any amount by which the value of the business (including goodwill) exceeded the value of any consideration the company received.

5.5.2 Directors' duties

Section 131: Duty of directors to act in good faith and in best interests of company
Section 133: Powers to be exercised for proper purpose
Section 134: Directors to comply with Act and constitution
Section 135: Reckless trading

These sections require that a director of a company, when exercising powers or performing duties, must act:

- In good faith and in what the director believes to be in the best interests of the company;
- For proper purpose;
- In compliance with the Companies Act and the constitution of the company; and
- In a manner that is unlikely to create risk of serious loss to the company's creditors.

5.5.3 Repayment of money or property

Section 301: Power of court to require persons to repay money or return property

Section 301 allows the court to order a person (including past or present directors or managers) to restore money or property, or contribute compensation where that person has been guilty of breach of duty or trust in relation to the company.

5.5.4 Director prohibitions

Section 385: Registrar may prohibit persons from managing companies

Section 385 allows the Registrar to prohibit, for up to five years, a person from being a director or promoter, or participating in the management, of a company. The Registrar can do this where that person was wholly or partly responsible for a company being put into liquidation.

5.5.5 Pooling of assets

Section 271: Pooling of assets of related companies

Section 271 allows a court to order that a company that is or has been related to a company in liquidation must pay to the liquidator the whole or part of any or all claims made in the liquidation.

5.5.6 Offences

Section 380: Carrying on business fraudulently

Section 380 (b)(ii) provides that an offence is committed when a director, with intent to defraud creditors, causes property to be given or transferred to any person.

Principally, the Companies Act requires that the 'rebirth' of a company's business into another entity must be undertaken at market value. That is, creditors in the insolvent entity must not be disadvantaged, through a lower price received for the business, as a consequence of that business being sold as a going concern.

5.5.7 *Other legislation*

In addition to the Companies Act, section 234 of the Employment Relations Act 2000 provides a mechanism whereby officers, directors or agents of an insolvent company can be held personally liable for unpaid minimum wages and holiday pay if they have directed or authorised the default in payment of these monies to the employees.

6. ASSESSMENT OF NEW ZEALAND STEVEDORING LIMITED

During the liquidation of New Zealand Stevedoring Limited, three companies were transferred/sold as going concerns to a related company, with the proceeds used to meet creditor demands. The money ran out before employee claims could be paid in full. Although the employee priority for wages and holiday pay was satisfied, the company's redundancy commitments were not met. The remaining companies continued to trade, having reached an agreement with their employees on the terms and conditions of their employment contracts.

The Registrar of Companies investigated and found no evidence that the directors or owners of New Zealand Stevedoring had sought to defeat creditors' legitimate interests. The Registrar concluded that market value had been received for the company assets, with the proceeds used to repay creditors.

It is unlikely the public interest would have been served by prohibiting the use of phoenix companies in circumstances similar to those surrounding the insolvency of New Zealand Stevedoring Limited. Such a prohibition would be likely to result in a loss of value to creditors as a whole. This could in turn impact on certainty, the cost of credit and business viability and competitiveness.

The New Zealand Stevedoring case relates less to the problems associated with phoenix companies (market value was paid for the assets, and the interests of creditors were not frustrated by the phoenix arrangement) and more to the priority afforded employee creditors (in particular, redundancy monies).

Altering priorities in insolvency would, among other things, alter the relative cost of credit from those sources and effect the incentives of parties involved in liquidation (for example, creditors monitoring debtors) and the efficiency with which liquidations are conducted. These issues need to be considered carefully. It is important that any arguments in favour of a priority for redundancy payments be:

- Weighed against the possible costs;
- Considered against the strength of arguments in favour of other creditor groups receiving priority; and
- Assessed against other options that might better achieve the priority's objective.

For these reasons the redundancy payments priority is assessed in the Ministry's discussion document "Priority Debts in the Distribution of Insolvent Estates'. The discussion document also considers options for addressing the redundancy payments in insolvency, including:

- Giving redundancy payments a higher priority in insolvency;
- Providing for a fund (based on a levy on industry) to meet redundancy payments not satisfied as a consequence of insolvency;
- Attaching employee liabilities to assets transferred as a going concern to another company; and
- Relying on the social welfare system to meet the needs of redundant employees facing hardship.

7. PROBLEM DEFINITION

7.1 Origin of the phoenix problem

There are two ways the phoenix problem may arise.

7.1.1 Legislative

The first is if the legislation does not adequately protect creditors' interests or creditors from the abuse of phoenix companies. The benefits of reforming the law to better protect creditors would obviously need to outweigh the expected costs. Benefits might include a reduction in uncertainty and transaction costs (in turn resulting in cheaper credit to debtors), while costs could include administration costs (developing policy, enforcement and review), compliance costs and possibly wider regulatory costs.

Anecdotal evidence from the Business and Registries Branch of the Ministry of Economic Development and comments by the Law Commission in their discussion document, 'Priority Debts in the Distribution of Insolvent Estates', suggest gaps in the companies legislation are not the primary contributor to the phoenix company problem. The Law Commission, in addressing recent recommendations in Victoria on phoenix companies, comments that:

> 'New Zealand law is generally adequate in this area, with disqualification provisions having improved significantly with the passing of the Companies Act 1993. In addition, the laws in New Zealand relating to directors' duties provide adequate remedies against directors when phoenix companies are used in bad faith to defeat the claims of creditors.'

In fact, it is notable that Victoria identified some provisions in New Zealand legislation as offering potential solutions to the phoenix problem, for example, the Corporations (Investigations and Management) Act 1989.

7.1.2 Enforcement

The second way phoenix companies may frustrate insolvency objectives is where laws do protect the interests of creditors, but it is not practical to effectively enforce those laws.

Currently, effective enforcement relies on the private actions of creditors and civil remedies. It may be the case that effective enforcement is frustrated by:

- The free rider problem: that is, creditors may have insufficient incentive, by themselves, to take court action against the debtor even though collectively it may be in their interests to do so. Excessive transaction costs may prohibit co-ordinating collective action, together with the perception that court action will not be successful. In particular, the latter can be problematic due to the difficulty for creditors and liquidators in establishing the market value of the business sold. There is no observable market value outside the actual transaction.

- The high cost of accessing the court system and the cost of the subsequent investigation. Again, any decision to pursue court action must be weighed against the cost of taking that action, the probability that the action will be successful, and the expected return to creditors if it is. The higher the cost of accessing legal remedies, the less likely it is creditors will undertake enforcement action.

- Insufficient penalties to deter inappropriate debtor action. For example, the unwinding of voidable transactions does not include a provision for a penalty above the difference between the transfer price and fair value. This is likely to provide minimal, if any, deterrence effect.

The obstacles identified above are compounded where the amounts outstanding to creditors are small (expected benefits are small) or where the company structure is complicated and there are a large number of creditors (the free rider problem, and the high cost of co-ordinating court action).

The Ministry considers the principle contributor to the phoenix problem is a lack of effective enforcement.

8. OPTIONS

8.1 Enforcement

Options to enhance the effectiveness of enforcing the current provisions include, at a broad level, making it easier to take court action and increasing penalties on directors for abusing the phoenix company approach.

8.2 Increase access to courts

Some options to reduce the cost of taking court action are outlined below:

8.2.1 Placing onus of proof on receivers of assets

Sections 297 and 298 of the Companies Act, which specify as voidable the transactions most likely to arise in phoenix company situations, could be amended to make it easier for liquidators to take action under those sections.

The amendment could provide for the same procedure as in section 294, which applies to applications made under sections 292 and 293 of the Act. Those provisions enable the liquidator, on application to the court, to set aside all transactions within a specified period. This would put the onus of proof on the receiver of the assets to demonstrate that the assets were not acquired at undervalue.

There are risks associated with this approach. For instance, it may be difficult for directors/managers and affected creditors to counter-prove, resulting in successful court challenges when the challenges should not be successful and increased costs incurred in defending those challenges (perhaps often by innocent parties). These costs are likely to be far more pronounced than arise in respect of the transactions captured by sections 292 and 293, that are relatively straightforward. Sections 297 and 298, in comparison, would entail the problematic task of determining the correct valuation, and the circumstances that led up to the transfer. It may also make third parties more reluctant to purchase the assets of a failing company (to avoid costly defences of court action), thereby compromising creditors' interests.

The Ministry does *not* support this option.

8.2.2 Extend enforcement action to prior to insolvency

In insolvencies, most enforcement action is undertaken by liquidators/receivers and during the insolvency. Another option is to allow creditors to also take certain enforcement action, and before the insolvency. Provision could be made, for example, for creditors to apply to the court before insolvency to challenge the consequences of a company transferring business or assets.

These measures would increase the burden on the court system. Perhaps more importantly, however, giving creditors wide powers to challenge company decisions (before insolvency) may unnecessarily delay prudent business decisions, adversely impacting on business confidence and heightening international concern and perception of the risk of investing in New Zealand.

The Ministry does *not* support this option.

8.2.3 Litigation funding arrangements

Allowing lawyers to operate on contingency fees where payment is conditional on court action being successful could further enhance the effectiveness of this approach. This would shift the risk of court action from creditors to lawyers, who may be better placed to judge the probability of court action being successful, and therefore the value of further enforcement effort. However, it is important to note that there is ongoing debate regarding the introduction litigation funding arrangements and this proposal cannot be considered in isolation. The Ministry welcomes submissions on this proposal.

8.3 Strengthen penalties

A liquidator can reverse transactions involving business assets transferred from a company at undervalue before or after insolvency. However, it is questionable the courts can otherwise impose penalties on the parties to those transactions. This means directors seeking to defeat creditors' legitimate interests, in the event of the offending transaction being detected, would in most cases be no worse off than if they had not undertaken the transaction.

A penalty, for example, exemplary damages for directors who act in bad faith to defeat the legitimate interests of creditors, could be imposed to deter possible breaches in the legislation. However, a weakness with this approach, is that it does not get around the difficulty creditors have in accessing the court system, especially where the creditors have only a small interest in the company and are numerous. In these circumstances, the deterrence effect is likely to be minimal as there will be limited if any enforcement effort.

One option to reduce this problem is to provide for criminal rather than the current civil penalties. This would do two things. First, it would increase deterrence by making directors significantly worse off in the event they have initiated a transaction in a deliberate effort to defeat creditor's legitimate interests.

Secondly, it would mean the government, through the Registrar of Companies, would take primary responsibility for enforcement effort. This compares with the current situation which relies on private action. This would get around the free rider problem and the high transaction costs associated with numerous small creditors co-ordinating their actions.

However, a possible disadvantage with this approach, is that the Registrar may not have the best incentive or capability to undertake the appropriate amount of enforcement (up to the point where the extra benefit from enforcement equals the extra cost). This is due to, for example, budget constraints faced by the Registrar. This compares with the current situation where the creditors, by both incurring the cost and receiving the benefit of enforcement, have the best incentive to trade off enforcement effort against expected benefits.

Further, increasing penalties runs the risk of discouraging directors from taking sensible business risks, perhaps to the point where it disadvantages the company and its creditors. It is noted that creditors are currently encouraged to look after their own interests. A key judgement to make here is whether the legislative regime could be made 'too tough' on directors leading to too conservative an approach to business risk and under-performing businesses, or not tough enough, contributing to too high a number of insolvencies. The Ministry is undertaking further work in this area and a further discussion document on directors' duties will be released next year.

On balance, the Ministry recommends that criminal penalties be available to the courts where directors are shown to have acted in bad faith to defeat creditors' legitimate interests. So that directors would not be discouraged from taking legitimate business risks, the court would need to be satisfied beyond reasonable doubt that the directors acted with intent to defraud. The higher burden of proof that must be satisfied before imposing criminal penalties compared with civil penalties means that only the more serious offenders would be at risk and harsher penalties would be available.

9. RECOMMENDATIONS

The Ministry recommends that:

(a) Lawyers be able to operate on a contingency fee basis when enforcing insolvency provisions; and

(b) Criminal penalties be available to the courts where directors are shown to have acted in bad faith to defeat creditors' legitimate interests.

10. LEGISLATIVE OPTIONS

The Ministry's assessment of the phoenix company problem, and its conclusions regarding the most appropriate options for addressing that problem, are preliminary only and should not be seen as implying the Ministry is closed to alternative views. To this end, the following briefly identifies possible legislative options to protect creditors' rights including:

- Strengthening voidable transactions provisions, for example, to counter efforts to transfer assets from an ailing company to a related company;
- Restricting owners'/directors' involvement in companies following insolvency; and
- Restricting the use of company names following insolvency.

Although comment is welcome on these options, or any other legislative solutions, the Ministry favours in the first instance addressing barriers to more effective enforcement before addressing the legislative issues. Legislative solutions, without first addressing enforcement, run the risk of imposing unnecessary economic costs on the market. For example, restricting the use of phoenix companies could reduce the value of assets in liquidation to the detriment of creditors as a whole, thereby degrading creditors' securities and increasing the cost, and reducing the availability, of credit.

Once measures to enhance enforcement have been introduced and allowed to operate for a reasonable period, the changes could be reassessed and legislative options considered.

(Footnotes)

1 "UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment", adopted by General Assembly resolution 52/158 of 15 December 1997.

2 This factor is also a secondary element in sole trader and partnership insolvencies.

3 Section 19 of the Act.

4 The debtor has the option to appear but can choose not to do so.

5 Ibid.

6 There are limited exceptions to the property that vests in the Assignee. These exist under common law and include such things as monies from ACC that have been held separately from the bankrupt's assets.

7 See section 68 (1)(c) for further detail SSon what the Assignee can request

8 Detailed in Butterworths *Commercial Law in New Zealand* (2nd Ed) at p.909.

9 Section 69(7) states that 'The bankrupt shall not be deemed to have passed his public examination until the Court, by order, declares that his affairs have been sufficiently investigated and that his examination is finished'.

10 Section 111.

11 Statistics provided by the Insolvency Service, Business and Registries Branch, Ministry of Economic Development.

[12] The Ministry of Consumer Affairs provided the information used for the production of this section.

13 C Thorp and B Ung 'Trends in household assets and liabilities since 1978' Reserve Bank of New Zealand: Bulletin Vol 63 No 2, p 17.

14 Includes a co-signatory.

15 This applies particularly to contingencies such as default.

16 The Credit Contracts Amendment Act 1998 aims to alleviate some of these problems by requiring lenders to disclose the cost of credit to guarantors. This may influence some consumers in their deciding whether or guarantee a loan.

[17] 'Voidable Transactions – A Report For The Ministry of Commerce' October 1999. Certain parts of this paper rely on and/or are borrowed from Mr Brown's paper. However, this is a Ministry paper, which does not in any way represent Mr Brown's views, and any errors are the Ministry's.

[18] A fuller discussion of the Government's objectives for bankruptcy and liquidation systems is provided in the general framework paper that precedes these four discussion documents. These paragraphs are provided only as background and introduction to the discussion of voidable transactions law and should be read subject to the general framework paper.

[19] This principle provides that where there are insufficient assets to cover all liabilities, creditors should receive an equal portion of their total claim on a rateable basis.

[20] Section 56 of the Insolvency Act 1967; section 292 of the Companies Act 1993: see at 5.1.

[21] That is, those in like situations should be treated alike (horizontal equity), and 'equal' and 'equality' in this paper are used in that sense.

[22] Section 54 of the Insolvency Act.

[23] Section 55 of the Insolvency Act.

[24] Section 54(3) of the Insolvency Act; section 297 of the Companies Act.

[25] Sections 298 and 299 of the Companies Act. See discussion at 5.6.

[26] Section 47 of the Matrimonial Property Act. See discussion at 5.2.1.

[27] This procedure is only available to set aside transactions that prefer a particular creditor under section 292 or charges voidable under section 293 of the Companies Act.

[28] *Countrywide Banking Corporation Ltd v Dean* (1998) 8 NZCLC 261,509; [1998] 1 NZLR 385 (PC).

[29] Ibid.

[30] In fact, *Morrison on Company Law* states at para 63.6 that the Privy Council decision in *Countrywide v Dean* can be summarised as holding that 'it is inadvisable for a Court to make any comprehensive statement, suitable for all cases…'.

[31] Section 47. See discussion at 5.2.1.

[32] This issue is raised to highlight the potential impact of statutory preferences on voidable transactions law. This paper will not, however, address the matter further. A separate discussion document dealing specifically with priority debts in the distribution of insolvent estates has been included in this suite of discussion documents, and any issues relating to preferences, or proposals to amend the existing preferences regime, are best dealt with in that paper.

[33] *Tyree Power Construction Ltd v PS Edmonds Electrical Ltd (in liquidation)* [1994] 2 NZLR 268 (CA).

[34] *Ebbett v Official Assignee* (1992) 4 NZBLC 102,516.

[35] *Countrywide v Dean*: Note 30 above.

[36] Section 292(4) of the Companies Act states that the debtor's intention is irrelevant 'unless that other person knew that that was the intent of the company.'

[37] See discussion at 5.1.1.

[38] *Re McCandlish* (1897) 15 NZLR 407; *Williams & Kettle v Official Assignee* (1908) 27 NZLR 871.

[39] *Official Assignee v Williams* (Court of Appeal, CA295/98, 19 July 1999).

[40] Mr Brown's paper, page 24 (refer note 19 above).

[41] *Re Hale (A Bankrupt) (Note)* [1989] 2 NZLR 503 (judgment 1975).

[42] *Air Services Australia v Ferrier* (1996) 185 CLR 483.

[43] Ibid.

[44] Section 292(3).

[45] The High Court Amendment Rules 2000 (SR 2000/109), which came into force on 1 August 2000.

[46] Under section 26I Judicature Act 1908.

[47] For further discussion, see 3.2.1 on defences.

[48] This includes charges covered by the Chattels Transfer Act 1924, but not, for example, charges against motor vehicles under the Motor Vehicle Securities Act 1989.

[49] Note that there are other ways to perfect a security interest under the PPSA, so an unperfected security interest cannot simply be equated with an unregistered security interest.