KensingtonSwan
LAWYERS

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Ministry of Business, Innovation and Employment
PO Box 1473
Wellington 6140

Review of Corporate Insolvency Law

Submission to the Ministry of Business, Innovation and Employment by Kensington Swan on recommendations made in Report No. 2 of the Insolvency Working Group ('IWG') relating to voidable transactions, Ponzi schemes and other corporate insolvency matters

Introduction

Thank you for the opportunity to submit on the recommendations made in Report No.2 by the Insolvency Working Group dated 15 May 2017 ('**the Report**'). Our submission comments on the Report generally, before addressing the questions for submitters on the Report.

Kensington Swan is a premier New Zealand law firm with over 25 partners and more than 140 staff based at offices in Auckland and Wellington. The firm has an active insolvency and restructuring team that takes a keen interest in developments relating to insolvency law and practice. We act for both insolvency practitioners and creditors, so we see the issues from 'both sides of the fence'.

General Comments

The Report is a helpful review of the issues relating to voidable transactions, Ponzi schemes and other corporate insolvency matters. We thank members of the IWG for the time, effort and expertise they have invested in the Report.

We strongly support the reduction in the period of vulnerability for insolvent transactions from two years to six months. We consider that this amendment, in itself, will cure most of the present ills with the voidable transactions regime. The Supreme Court's decision in *Allied Concrete* is a clear indication that certainty for payment recipients is a primary policy objective. We are less certain about the benefit of repealing the 'gave value' limb of the s296(3) defence.

If the Government does decide to repeal the 'gave value' limb, then we agree with the IWG that this reform should not be implemented in isolation. Doing so would swing the pendulum too far in favour of the collective interests of creditors. Implementation of recommendations 1 and 2 must occur simultaneously, if recommendation 1 is to be effected at all.

We support amendment of the Property Law Act to aid the recovery of funds following the collapse of a Ponzi scheme. We consider that the establishment of a compensation scheme may not be warranted.

We support most of the other recommendations in the Report as they relate to other corporate insolvency issues.

Questions for Submitters on the Report

Voidable Transactions

Question 1(a): *Do you agree with the Insolvency Working Group's assessment of the impact of the Supreme Court's decision in* Allied Concrete v Meltzer *on New Zealand's voidable transactions regime? (paragraphs 32-34)*

In general, we agree with the IWG's assessment of the impact of the *Allied Concrete* decision. If the result of the judgment has been to "*...return the regime to one in which unremarkable transactions were immune*",[1] then it is no surprise that the decision has been embraced by the business community.

Question 1(b): *If not, what is your assessment of the impact of the decision?*

Not applicable.

Question 2(a): *Do you agree with the Insolvency Working Group's listed objectives of the voidable transactions regime? (paragraph 53)*

Yes.

Question 2(b): *Should other objectives also be considered?*

No.

Question 2(c): *What weighting should be given to the objectives, e.g. equally or differently?*

Ideally, the equal sharing objective should be given more weight than the other objectives. However, our perception (although we cannot point to any empirical data) is that proceeds of voidable transaction recoveries are not always shared equally among unsecured creditors, but are often absorbed by the fees and costs of liquidation. If that is the case, then we see fairness to individual creditors as having equal weight as a policy objective.

Question 3(a): *Do you agree with the Insolvency Working Group's views on the problems with the status quo? (paragraphs 56-69)*

We definitely agree that individual creditors who are not related to the debtor company are subject to excessive business uncertainty due to the two-year period of vulnerability for clawing back voidable transactions. An effects-based test and a two year period of vulnerability are incompatible. We agree with the IWG that the "*...risks to commercial confidence under the current law are significant*".[2] Further, we agree that it can be particularly harsh if what appears to be a normal, everyday commercial transaction is re-opened long after the event.[3]

We are less sure that the status quo insufficiently protects the collective interests of creditors. Under the status quo, liquidators can claw back payments made in a two year period prior to liquidation. Even if establishing value under the third limb of the s296(3) defence is easier following *Allied Concrete*, the first two limbs of the defence can be difficult to satisfy, given the resources available to creditors and the passage of time between transactions and litigation.

Most reputable liquidators apply a high degree of rigour when considering whether to make claims (or whether to continue them, once they have received an opposition from a creditor). The concern

[1] Paragraph [34] of the Report.
[2] Paragraph [69] of the Report.
[3] Paragraph [69] of the Report, referring to *Allied Concrete* at [1(b)].

expressed by Mike Whale that, following *Allied Concrete*, there will be far fewer insolvent transaction is not surprising.[4] There is little, if any, evidence that recoveries are being consistently shared with unsecured creditors – the very creditors who are meant to benefit from them under the equal sharing principle.

Question 3(b): *Are there other problems?*

We agree with the IWG that the main issue for the voidable transactions regime is balancing the three objectives identified in paragraph [53] of the Report.

Question 4(a): *What are your views on the package of changes recommended by the Insolvency Working Group in Chapter 1?* (recommendations 1 and 2 and paragraphs 72-77)

We are lukewarm about recommendation 1. While we acknowledge the rationale in repealing an aspect of the s296(3) defence that has become effectively redundant following *Allied Concrete*, we do not necessarily see that removing 'gave value' will improve overall outcomes. There will continue to be a disproportionate emphasis on creditor knowledge which is at odds with the rejection of the creditor-deterrence theory by the Companies Act. Repealing 'gave value' will not change that.

We strongly support recommendation 2. Reducing the period of vulnerability will significantly improve business confidence in the voidable transaction regime.

Question 4(b): *Do you agree with the Insolvency Working Group that recommendations 1 and 2 need to be implemented as a package? (paragraph 70) If possible, please provide information on the number of voidable transactions that you are aware of that fall within the* specified period *(but not the restricted period) and the dollar amount of such claims.*

We do not consider that recommendations 1 and 2 must be implemented as a package.

If the Government is intent on repealing 'gave value', then we consider that it is absolutely vital that recommendation 2 is implemented at the same time, otherwise completely excessive regard would be given in law to the collective interests of creditors.

We do not have any data on voidable transactions that fall within the specified period (but not the restricted period).

Question 5: *Are there other feasible options?*

One option would be to implement recommendation 2 and leave s296(3) as it currently stands.

Another would be to implement recommendation 2 and amend the language in s296(3) so that it is exactly the same as the equivalent Australian provision (s588FG(2)).

Other issues relating to voidable transactions and other recoveries

Question 6(a): *What are your views on the other changes to the voidable transaction regime and other recoveries recommended by the Insolvency Working Group in Chapter 2? (recommendations 3-11)*

- *Recommendation 3*: We consider that it is fair to retain the two year period of vulnerability for clawbacks for unrelated party transactions at undervalue.

[4] See paragraph [66] of the Report.

- *Recommendation 4*: We also consider it fair to standardise the period of vulnerability for all clawbacks under ss 292, 293, 297 and 298 at four years, where the debtor and preferred creditor are related parties.
- *Recommendation 5*: We agree that the definitions in s245A should also be used for the purposes of ss 298 and 299.
- *Recommendation 6*: We support the presumption of insolvency in the restricted period for claims.
- *Recommendation 7*: We support reducing the time limit for liquidators to file clawback claims from six years to three years, although a two year time limit would be equally acceptable.
- *Recommendation 8*: We would only support providing the Court with discretion to extend the filing period on the basis that the liquidators would need to prove that a creditor(s) had obstructed the liquidators from obtaining information.
- *Recommendation 9*: We support adding a defence for a creditor with a valid security interest who can demonstrate that there was no preference at the time they received payment.
- *Recommendation 10*: We support the simplification of the continuing business relationship rule by removing the subjective element relating to the parties' intentions.
- *Recommendation 11*: We support clarification of the starting point of a continuing business relationship.

Question 6(b): *Are the recommendations likely to have a material impact on the total amount of funds that liquidators would be able to recover under the voidable transaction for the benefit of creditors and, if so, how?*

Overall, we do not consider that the recommendations, if implemented, would have a material impact on the funds that liquidators would be able to recover *for the benefit of creditors*. Most of the recommendations bring consistency and fairness to the law.

Question 6(c): *Do you agree that the limitation period for voidable transaction clawback claims should be reduced from 6 to 3 years? (recommendation 7) How often are voidable transaction claims initiated 3 years after the commencement date of the liquidation?*

We agree with recommendation 7, but would be equally comfortable with the limitation period being reduced to two years.

Question 7: *Do you agree with the Insolvency Working Group's view that the recommendations contained in Chapter 2 can be made with or without making the changes recommended in Chapter 1?*

Yes.

Procedural issues

Question 8(a): *What are your views on the procedural changes proposed by the Insolvency Working Group in Chapter 3? (recommendations 12-15)*

We support recommendations 12 and 13 and consider them to be helpful. In particular, we support liquidators identifying what they see as the date and dollar value of all transactions forming part of the continuing business relationship.

We refer to paragraphs [130] and [131] of the Report. We consider that it would be useful for the Government to consider imposition of a materiality threshold for setting aside transactions. There may be merit in a materiality threshold of $10,000 being imposed. Any threshold below $10,000 would not be a sufficient restraint, for if less than $10,000 is recovered, it is likely to be all applied to liquidator fees and costs.

We refer to paragraphs [132] to [135] of the Report. Some of our creditor clients take a (somewhat understandably) cynical view of voidable transactions. Their perception is that the only parties who benefit from voidable recoveries are the liquidators and their lawyers.

The Report does not recommend the ring-fencing of the proceeds from voidable transactions and charges. The position appears to be based, in part, on the Australian courts permitting proceeds to be applied towards the liquidators' general costs. The Report states that the law in New Zealand is and should continue to be the same, without explaining why this should be the case.

This aspect of potential reform requires further consideration. Ring fencing proceeds may incentivise liquidators to only pursue cases of significant merit and quantum. We acknowledge that steps are being taken to improve the regulation of liquidators. We support these steps, which should assist with ensuring only meritorious voidable claims are pursued.

Question 8(b): *In regard to recommendation 13 (content of liquidator's notice to set aside transactions) what standard and basic (**additional**) information should a liquidator's notice to creditors under section 294 provide and why? How would the creditor receiving the notice benefit from receiving this additional information and what would be the costs to the liquidator in providing the information?*

We do not consider any additional further information is required.

Voidable transactions and recoveries generally

Question 9: *Are there any other issues with the voidable transaction and other recoveries regime that are not covered by Chapters 1 to 3 of the Insolvency Working Group's report?*

We consider that further procedural reforms could also be explored to make the voidable transactions regime more efficient:

- Require liquidators, within 20 working days (or similar period) of receiving an opposition from a creditor, to initiate an application in the High Court.
- Impose a materiality threshold of $10,000 (as discussed above).
- Require a certain percentage of gross recoveries to be shared with unsecured creditors.
- Prescribe a statutory early settlement discount (say 25% of the value claimed) if a creditor settles an alleged voidable transaction claim with a liquidator after receiving a set aside notice. For example, if a creditor received a notice from a liquidator seeking to set aside a payment worth $60,000 and chose to settle with the liquidator within the prescribed period, the creditor would receive an automatic discount of 25% and would have to pay the liquidator (at most) $45,000. Such a discount would encourage all parties to save costs and hopefully leave more funds available to be shared with the general body of unsecured creditors. The discount could be set as only applying to alleged voidable transactions of up to a certain value (e.g. $100,000). The drawback of such a discount is that it may encourage liquidators to make more voidable transaction claims. This downside risk would be offset by the reduction in the period of vulnerability for transactions, as well as the improved regulation of liquidators.

We are concerned that the knowledge and intentions of creditors should be as important as they are now, given the aim of the current regime was a strict effects-based test. In this respect, we refer to the concerns outlined in paragraphs [61] and [62] of the Report.

Ponzi schemes

Question 10: *What are your views on the possible changes to the Property Law Act 2007 outlined by the Insolvency Working Group to aid the recovery of funds (adding a Ponzi presumption and a good faith defence)? (recommendation 16(a))*

We agree with the IWG that the purpose of corporate insolvency law is not to prevent or address investment fraud.[5] That said, we agree with the IWG that the Government should consider making changes to the prejudicial dispositions regime of the Property Law Act to aid the recovery of funds.

Since the Report was released, the Supreme Court has issued its judgment in *McIntosh v Fisk*.[6] The judgment adds weight to the IWG's suggestion that making changes to the Property Law Act would make it easier to apply the Act to Ponzi schemes. As William Young J noted in his separate judgment, the insolvent transaction provisions of the Companies Act were "*awkward to apply*" in a Ponzi context.[7]

We are, at this stage, not convinced that New Zealand needs, or can afford, a compensation scheme for shortfalls in investor recoveries following fraud. As the IWG points out, given the small size of the New Zealand market, such a scheme would probably require government contribution or underwriting.[8] As Ponzi schemes are unusual in New Zealand, our view is that the establishment of a compensation scheme is a low priority.

Other corporate insolvency issues

Question 11(a): *What are your views on the other corporate insolvency law changes proposed by the Insolvency Working Group in Chapter 5? (recommendations 17-30)*

- *Recommendation 17*: We agree with the proposed amendment of the definition of secured creditor.
- *Recommendation 18*: We agree that recoveries from reckless trading claims should be for unsecured creditors only.[9]
- *Recommendation 19:* We agree that all administrators' reports should be filed with the Registrar of Companies.
- *Recommendation 20:* We cautiously support the recommendation providing powers to liquidators to obtain certain information from third parties without having to apply to the courts. We agree with the IWG that such a procedure should only allow the liquidator to obtain information that would ordinarily have been available to the liquidator if proper records had been kept by the company in liquidation. There should be no access to information that is otherwise confidential to the third party, such as bank records and internal correspondence between the third party and other parties. Further, the third party should be reimbursed for its reasonable costs in providing information to liquidators. Otherwise, the burden of providing

[5] Paragraph [140] of the Report.
[6] [2017] NZSC 78.
[7] [2017] NZSC 78 at [208].
[8] Paragraph [164] of the Report.
[9] See Michael Arthur "Reckless trading damages" [2013] NZLJ 51.

information would fall heavily on some large creditors, such as the trading banks, who would be likely to receive frequent information requests.

- *Recommendation 21:* We support the recommendation that the definition of 'telecommunications service' in the Companies and Receivership Acts be replaced with the definition of 'telecommunications service' in the Telecommunications Act 2001.
- *Recommendation 22:* We agree that fines and penalties should be provable claims, but that unsecured creditors should be paid ahead of fines and penalties.
- *Recommendation 23:* We support electronic communication with creditors.
- *Recommendation 24:* As below, we support this recommendation.
- *Recommendation 25:* As below, we support this recommendation.
- *Recommendation 26:* As below, we support this recommendation.
- *Recommendation 27:* We agree that no super-priority should be afforded to PAYE provable in a liquidation beyond that provided by Schedule 7 of the Companies Act.
- *Recommendation 28:* We support the Receiverships Act being amended to clarify that administrators continue to have a priority for their fees and expenses when a company has both receivers and liquidators appointed. In our experience, this has been a thorny issue in the past which has caused disputes between administrators and receivers.
- *Recommendation 29:* We support the removal of any circularity of priority in the Receiverships Act.
- *Recommendation 30:* As below, we support this recommendation.

Question 11(b): *What are your views on allowing liquidators to obtain, by right, certain information from third parties without having to go to the High Court? (recommendation 20 and page 48) What are the costs involved in seeking an order from the High Court? Does the High Court routinely approve such requests?*

As above, we cautiously support the recommendation providing power to liquidators to obtain certain information from third parties without having to apply to the courts. There should be no access to information that is otherwise confidential to the third party, such as bank records and internal correspondence between the third party and other parties.

We are not in a position to comment on the costs involved with seeking an order from the High Court or whether the Court regularly approves requests.

Question 11(c): *Do you agree that it is not clear whether long service leave forms part of Schedule 7 of the Companies Act? (recommendation 24 and page 51) How often does the possible recognition of long service leave as a preferential claim arise?*

We acknowledge the scope for ambiguity about the status of long service leave. We support the proposed reform (recommendation 24).

Question 11(d): *What are your views on establishing a new preferential claim for gift cards and vouchers? (recommendation 25 and pages 51-52)*

We support this proposed reform which protects the interests of vulnerable consumers. We have seen it as an issue in both the Icon and Dick Smith administrations.

Question 11(e): *What are your views on the recommendation to limit the preference claims of the Commissioner of Inland Revenue and the Collector of Customs to six months prior to the date of the commencement of the liquidation? (recommendation 26 and pages 52-53)*

We support this recommendation. The IRD, in particular, is in a better position than most creditors to identify when a company has become insolvent and to initiate steps for the appointment of liquidators. There is a sense that the IRD takes too long to take action against insolvent companies, but is one of the first creditors to benefit from any realisations.[10]

Question 11(f): *What aggregate information, if any, would be useful for the Registrar of Companies to publish and why would it be useful? (recommendation 30 and page 56)*

We agree with the suggestions made in the Report about the collation and publication of information.[11] There is little empirical data about recoveries made by liquidators and it would be useful to have more information about the returns to creditors when assessing the overall effectiveness of the voidable transactions regime.

Question 12(a): *What are your views about the Insolvency Working Group's comments on the corporate restructuring processes in New Zealand? (paragraphs 173-177)*

We agree that there are no major issues with Parts 14,15 or 15A of the Companies Act. Voluntary administration remains overall underused and the Government may wish to consider whether there are reforms to the VA regime that would make it more attractive for both insolvency practitioners and creditors.

We agree that it would be useful to keep an eye on the proposed changes to corporate insolvency law in Australia with a view to adopting successful reforms in the future.

Question 12(b): *Does New Zealand's insolvency regime meet the OECD's objectives outlined in paragraph 173?*

We consider that these objectives are met in part, but not whole. The restructuring of viable firms often comes at high cost and there are aspects of the voluntary administration regime (which was intended to assist corporate rescue) which see that process continue to be under-utilised in New Zealand. We perceive that the liquidation of non-viable firms is generally a cost-effective process. The introduction of third party litigation funding into New Zealand in the last decade has seen liquidators become more proactive in pursuing litigation.

In terms of balancing the interests of parties involved in an insolvency, the interests and perspective of non-preferential unsecured creditors are often paid little attention. In part, this is because of the priority scheme.

As to the timely resolution of insolvency, it can take several years for a liquidation to complete and the reasons for delay are not always explicable.

Question 12(c): *How important is it for New Zealand's insolvency regime to be aligned with the Australian regime?*

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[10] In this respect, please see *Grant & Khov v Johnston* [2016] NZCA 157 at [94].
[11] Page 56 of the Report.

Ideally, the two regimes will be aligned. Commenting on the voidable transaction regime, we see no reason, on questions of substance, why New Zealand and Australia's systems should be any different, particularly since the 2006 reforms sought to align the New Zealand position with that in Australia. We are surprised that Parliament did not employ the phrase 'valuable consideration' used in s588FG(2) of the Australian Corporations Act 2001 instead of 'gave value' when it amended the s296(3) defence.

This difference in wording gave rise to a series of court cases providing conflicting authority on whether the creditor must have given value subsequent to the impugned transaction, or whether value given prior to the impugned transaction was sufficient for the defence.[12] In Australia, providing "valuable consideration" means providing value that is real, substantial and has a commercial quality to it.[13] It does not mean that "full consideration" must be given.[14]

New Zealand court decisions prior to the Supreme Court in *Allied Concrete* were contrary to the Australian interpretation of the defence. Australia has 'valuable consideration' and a six month vulnerability period for transactions. The question therefore arises as to why can New Zealand not keep 'gave value' and reduce the vulnerability period to six months? It is unclear to us, from the Report, to what extent (if at all) the IWG considered recommending an amendment to s296(3) so that it completely aligned with the Australian legislation – which was Parliament's intention in the first place.

Question 13: *Are there any other changes to corporate insolvency law not covered in Report No. 2 that should be made?*

We refer the IWG's first report, published in August 2016. That report recommended co-regulation of insolvency practitioners and we very much support that recommendation.

We also refer to s255 of the Companies Act. That section provides for liquidators to "forthwith" give notice of their appointment to the public[15] and notify the Registrar of Companies within 10 working days of their appointment.[16] With the benefit of modern technology, liquidators should be able to notify the public and the Registrar of their appointment within a day or so. We suggest that s255 be amended so that liquidators be obliged to notify the public and the Registrar of their appointment within two working days.

While liquidators can be sanctioned by the court for failing to comply with their duties,[17] the Government may wish to consider whether the Registrar should be empowered to issue infringement notices with fines for insolvency practitioners who fail to promptly notify their appointment or file their statutory reports. As the vast majority of insolvency practitioners are already up to speed with their obligations, this step is designed to address a non-compliant minority.

We would also like liquidators to be encouraged to include more meaningful information in their first reports. While we appreciate that liquidators don't have long to prepare their first reports, creditors do look to them for information about what went wrong and what assets (if any) a company may have to satisfy claims.

Implications for personal insolvency law

[12] See Paragraphs [11] to [18] of Annex 4 of the Report.
[13] Harris and Murray *Keay's Insolvency: Personal and Corporate Law and Practice* (8th ed, Thompson Reuters, Sydney, 2014) at [14.220].
[14] *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* [2011] NSWCA109 at [162].
[15] Section 255(2)(a).
[16] Section 255(2)(b).
[17] Sections 284 and 286 of the Companies Act.

Question 14: *Do you agree that if recommendations 1-13, 15, 17 and 24-27 were implemented, that these changes should also be made to the Insolvency Act 2006?*

Yes.

Other comments

Question 15: *Do you have any other comments on Report No. 2?*

Thank you for the opportunity to comment on the IWG's second report. We look forward to further opportunities to comment on insolvency law reform.

Yours faithfully
Kensington Swan

Partner

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Partner

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