# COVERSHEET

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| 23 September 2019 | *Insolvency Law Reform* | *Office of the Minister of Commerce and Consumer Affairs* |
| 23 September 2019 | *Insolvency Law Reform: Annex One - Minor Changes* | *Office of the Minister of Commerce and Consumer Affairs* |
| 23 September 2019 | *CAB-19-MIN-0491* | *Cabinet Office* |
| 23 September 2019 | *Regulatory Impact Statement: Insolvency Law Reform – Gift Cards & Vouchers* | *Ministry of Business, Innovation and Employment* |
| 23 September 2019 | *Regulatory Impact Statement: Insolvency Law Reform – Reckless Trading Claims* | *Ministry of Business, Innovation and Employment* |
| 23 September 2019 | *Regulatory Impact Statement: Insolvency Law Reform - Voidable Transactions* | *Ministry of Business, Innovation and Employment* |

**Information redacted** **YES**

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# Impact Summary: Voidable transactions clawback period for related and unrelated parties

## Section 1: General information

| Purpose |
| --- |
| The Ministry of Business, Innovation & Employment is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with policy change to be taken by Cabinet. |

**Key Limitations or Constraints on Analysis**

The objective of this analysis is to review whether liquidators should clawback transactions that have taken place up to two years before a company goes into liquidation.

This was the most significant issue identified by the Insolvency Working group **(IWG)** in the second of its two reports (**Report No. 2**). IWG was formed in 2015 as part of the Government's review of corporate insolvency law. It comprised an independent chair, two insolvency practitioners, two insolvency law specialists, a credit industry expert and a representative of the Official Assignee.

The issue relates to the length of current clawback period for transactions that have already been made before a company goes into liquidation. Currently, the Companies Act sets out a "two year" clawback period for transactions that could be "voided" – i.e. liquidators could demand the payment be paid back, as they are inconsistent with an insolvency law principle that creditors should be treated equitably. For example, an electrician might have been paid in full before its customer went into liquidation, while other unsecured creditors of the customer – such as its supplier, would only get 20 cents in the dollar in the customer's liquidation.

The IWG has identified a concern that two years are too long for a payment to be re-opened, if those that received payments have done so in good faith. It results in excessive commercial uncertainty for these creditors. It recommended to

- reduce it to six months for unrelated parties transactions, and
- increase it to four years for relate parties transactions.

*Subjective judgement on the appropriate length of clawback periods*

The main limitation is that decisions around the claw back period are ultimately a subjective judgement and there is limited data to enable the effect of our preferred option to be quantified. However, we believe the proposed length of clawback periods fall within the spectrum of what is considered reasonable, and is consistent with international practice.

Consultation of the IWG report was undertaken with various stakeholders. There was wide support from stakeholders and insolvency practioners that the current two years for related party transactions would provide too much scope for manipulation by directors, and should be increased to four years as proposed by the IWG.

Almost all submitters agreed the two-year period of vulnerability for genuine third parties was

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too long and leads to excessive business uncertainty for unrelated parties who accept payment in good faith. However, three submitters suggested that the period of vulnerability should be reduced to twelve months instead of six months.

As a result, we have not included “the status quo” as an option in this analysis. Given the strong support on increasing the vulnerability period for related party transactions, we do not propose a different option from the IWG’s recommendation.

For unrelated party transactions, we have included the IWG recommended six months and the suggested twelve months by some stakeholders in our analysis. Our preferred option is the IWG recommendation. Although it is ultimately a judgement call, our rationale was that twelve months would still an excessive amount of time for individual creditors to be uncertain about the validity of payment they have received in good faith, given businesses could be exposed to a large amount of trading in the course of any twelve-month period. In addition, twelve months would be long by international standards.

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# Section 2: Problem definition and objectives

## 2.1 What is the policy problem or opportunity?

This RIA provides analysis on options that best balance the collective interests of creditors with that of individual creditors, when liquidators claw back transactions that have been made by a company to its creditors before it went into liquidation.

*Background and current status of the voidable transactions regime*

The Companies Act establishes the voidable transactions regime, which allows liquidators to claw back a payment made by a company to a creditor if:

- The company was insolvent when it made that payment;
- The payment took place less than two years before liquidation started; and
- The creditor received more than they would have received in the liquidation.

The voidable transactions regime recognises that debtor companies are typically insolvent for months, or even years, before liquidation commences. It supports the *pari passu* (equal sharing) principle that is a cornerstone of insolvency law and, therefore, protects the collective interests of all creditors.

For example, if an ordinary unsecured creditor was paid in full, but there were only sufficient funds in the liquidation to pay all ordinary unsecured creditors 20 cents in the dollar, then the payment would be voidable (i.e. liquidators can seek to get the creditor to return the payment). That creditor would only be entitled to 20 cents in the dollar and would have to return the rest of the payment they had received.

In another example, the regime allows liquidators to challenge transactions that directors made when they close a debt-laden company after transferring its assets to another company, leaving the debt behind. Liquidators can therefore protect the creditors of the first company, who would otherwise be deprived of the value of those assets and, therefore, receive a lower dividend, or no dividend at all.

*Problems with the current regime*

The key issue is whether the voidable transactions regime appropriately balances the collective interests of creditors and that of the individual creditors. The IWG noted that a main problem with the regime was that the two-year clawback period conflicted with the societal interest of providing certainty to businesses (those that were unrelated to the debtor company) that they could rely on the validity of payments. The IWG has recommended that the clawback period be changed, reducing it to six months for unrelated parties and increasing it to four years for related parties:

- *Unrelated parties*

Two years would provide excessive business uncertainty where the creditor receiving payment is an unrelated party. The risks to commercial confidence under the current law are significant because businesses can be exposed to a very large amount of trading over the course of any two year period. It can be particularly harsh if what appears to be a normal, everyday commercial transaction is re-opened long after the event. There needs to be a better balance between the collective interests of creditors and the interests of individual creditors that have received payment in good faith. Two years is also very long by



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international standards (six months for the UK and Australia, and three months for the US and Canada).

- *Related parties*

The current regime also does not differentiate whether a creditor is a related party of the debtor company or not. This is unusual when compared to other jurisdictions, where it is common to have much longer periods if the debtor company and the preferred creditor are related parties, due to the mischief often associated with related party transactions and the potential harm to innocent third parties.

## 2.2 Who is affected and how?

The reduction of clawback period for unrelated parties from two years to six months will have four effects:

1) Individual creditors (that are unrelated to the debtor company) that received payments in good faith 2 years to 6 months before the liquidation will no longer be subject to claw back by the liquidator. This change will have positive compliance cost reduction for ordinary unsecured creditors. It will particularly benefit small businesses that do not have the resources to seek legal advice when served with voidable transaction notices by liquidators.

2) It will improve the commercial confidence for businesses because they can rely on the validity of any payment received in the 6-24 month period.

3) Collectively, unsecured creditors will be negatively impacted as the change will reduce the total amount available to be returned to the pool of assets. In practice this change will mainly impact on preferential creditors such as the Inland Revenue Department.

4) Having no voidable transactions in the 6-24 month period will reduce the costs of operating the voidable transactions regime. Liquidators and companies will no longer incur the associated administration costs or the legal costs associated with negotiating an agreed outcome, often via exchanges of solicitors' letters.

The proposal to increase the voidable transactions period for related parties from two years to four years will reduce the scope for debtor company directors to manipulate the liquidation commencement date as a way of avoiding the voidable transactions regime. It should also increase the total amounts recovered from related parties.

## 2.3 Are there any constraints on the scope for decision making?

The issue of voidable transaction regime was identified by the IWG, an independent group of insolvency experts. The strong support from stakeholders through consultation demonstrated that it was evident that the issue should be dealt with and not left unaddressed.

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# Section 3: Options identification

## 3.1 What options have been considered?

As discussed in Section 1, we do not think the status quo should be included in our analysis given the overwhelming support for change. The main question is what the clawback period should be changed to.

The IWG's proposal to increase the clawback period to four years for related party transactions received strong support. Insolvency practioners also noted that four years would make manipulation by directors very difficult. We have therefore not included an alternative option for related party transactions.

Our focus is therefore on unrelated party transactions. The options we have considered are:

1. reducing the clawback period from the current two years to twelve months (suggested by some submitters); or
2. reducing the two year clawback period to six months (the IWG recommendation and our preferred option)

In the voidable transactions context, the main challenge is to balance the need to protect the collective interests of all creditors with the need to provide commercial certainty to individual creditors who have received payments in good faith. The three objectives we used for assessing the options were based on some of the underlying principles of insolvency law:

**A. Consistency with the equal sharing principle**

This objective is achieved if all unsecured creditors are treated equally in relation to insolvent transactions that pre-date the commencement of the liquidation.

**B. Fairness to individual creditors**

This objective is achieved when there is business certainty and a preferred creditor's interests are not materially harmed if they are required to pay or repay money or return property. As the Supreme Court has noted, it can be particularly harsh if what appears to be an ordinary everyday transaction is opened long after the event (*Allied Concrete v Meltzer*). Fairness can be viewed at an individual creditor level, but can also be looked at a "class" level. Rules that benefit a particular class or group of creditors over another (e.g. employees, lenders, or trade creditors) are unlikely to be viewed objectively fair even if they serve another public policy objective.

**C. Administrative and compliance efficiency**

This is achieved when the following costs are minimised as far as possible:

- costs associated with the processes for a liquidator to take possession of, protect and realise, and distribute the assets of the company to its creditors, and
- compliance costs for creditors against whom claims are made.

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## 3.2 Which of these options is the proposed approach?

Our preferred approach is option 2.

It is clear from the IWG report and from submissions that the current two-year clawback period is much too long for commercial uncertainty reasons. The main question is therefore how much it should be shortened to. Both of these options fall within a spectrum of reasonable period for clawback period, and ultimately it is a subjective call as to whether twelve or six months are more appropriate.

*Pari Passu and Fairness with individual creditors*

Submitters that suggested reducing clawback period to twelve months noted that the first six months the onus should lie with the creditor on the basis of presumed insolvency. The second six month period the onus should be on the liquidator to prove insolvency. They believed that if the clawback period was reduced to six months, there would be increased scope for directors/shareholders to manipulate the formal date of insolvency in order to defeat voidable claims, in order to preserve their personal position for guarantees that may be outstanding.

Our view is that six months would be more appropriate than twelve months when taking into account the need for commercial certainty. Twelve months would still be a significant period for any business to not be able to reply on a payment that they have received in good faith. In practice, it would mean that unrelated party creditors would be protected against the risks of commercial uncertainty by ensuring that transactions could not be re-opened if they took place more than six months prior to the commencement of the liquidation. We consider that this would be a more appropriate balance between the collective interests of creditors and the interests of individual creditors that have received payment in good faith.

Option 2 also has the benefit of being aligned with similar regimes in jurisdictions such as Australia, Canada, UK and US, where the clawback periods for unrelated parties range from three to six months.

*Administrative efficiency*

Option 2 is likely to be more administrative and compliance efficient because there should be fewer voidable transactions, and fewer creditors are required to return the payments they have already received.

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## Section 4: Impact Analysis (Proposed approach)

### 4.1 Summary table of costs and benefits

| **Affected parties** *(identify)* | **Comment**: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks | **Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts* |
|---|---|---|
| Additional costs of proposed approach, compared to taking no action | | |
| Regulated parties | Ordinary unsecured creditors will receive less in a liquidation as the amounts that would otherwise be recovered from voidable transactions will not be available for re-distribution.<br><br>There will be lower liquidator fees and costs. | Low, as there should be reduced costs for liquidators (however we do not have any data on that). |
| Regulators | | |
| Wider government | On occasions, the reduction in total recoveries by liquidators will reduce the amount received by Inland Revenue and Customs as preferential creditors. | Low, as IR and Customs will only be negatively impacted if they would have been entitled to any dividends otherwise |
| Other parties | | |
| **Total Monetised Cost** | | |
| **Non-monetised costs** | | ***LOW*** |
| Expected benefits of proposed approach, compared to taking no action | | |
| Regulated parties | Individual unrelated creditors that received payments at least six months before liquidation of the debtor company are able to rely on the validity of those payments, not only giving them the financial security but also commercial confidence amongst business sector<br><br>Less liquidator fees/costs as liquidators are likely to have fewer voidable transactions to clawback, reducing the administrative fees and costs associated with the clawback process. | Medium, as for an individual business, the volume of business transactions/payments over an 18 months period could be significant |
| Regulators | | |
| Wider government | | |
| Other parties | | |
| **Total Monetised** | | |

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| Benefit | | |
|---|---|---|
| **Non-monetised benefits** | This proposal is likely to result in an increase of commercial confidence for the business sector. | **Medium** |

### 4.2 What other impacts is this approach likely to have?

The clawback period changes should overall improve the fairness and efficiency of the voidable transactions regime because:

- Individual creditors will get commercial certainty that transactions which took place more than six months earlier would not be re-opened;
- Related party creditors will face more uncertainty. This is justified because there is a higher risk for mischief, given that related party creditors are likely to have more information about the debtor company's financial status and would have more opportunities than unrelated parties to take advantage of that knowledge to harm the interests of unrelated party creditors. Feedback from practioners was that risks of manipulation would be much lower if clawback period is extend to four years;
- Ordinary unsecured creditors as a whole should not be affected much;
- There should be slightly less liquidation administrative fees from fewer clawback transactions with unrelated parties, although there may be more fees in relation to clawback proceedings against related parties.

While there is a risk that the changes to six months and four years for unrelated and related parties are largely a subjective judgement call, we believe they are appropriate as they are within a spectrum of reasonable ranges, and are aligned with international practices.

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# Section 5: Stakeholder views

## 5.1 What do stakeholders think about the problem and the proposed solution?

The IWG Report No.2 recommended changing the clawback period together with repealing another rule that provides a defence for some creditors. We have not taken this approach of linking these two recommendations, because the time limit applies to all creditors, but the rule in question only applies to creditors acting in good faith.

Almost all submitters agreed that the two year period of vulnerability was too long and led to excessive business uncertainty for unrelated parties who accepted payment in good faith. Three submitters suggested that the period of vulnerability should be reduced to 12 months, not the six months proposed by the IWG.

There was widespread support for increasing the period of vulnerability for voidable transactions from two to four years where the debtor company and preferred creditor are related parties.

There were also comments to the effect that the primary beneficiaries of voidable transactions are liquidators and their advisors. We do not think this is an issue because the task of insolvency administration is inherently expensive. It involves highly skilled and experienced professionals converting any remaining assets into cash and paying as many creditors as possible with those funds. The process of investigating the debtor company's accounting records can be exacting, particularly if the accounting records are in a poor state or deliberately deceptive. Liquidators are less likely to be incentivised if they are not going to be paid.

We have considered the suggestions, but decided that 12 months would still be an excessive period for individual creditors to be uncertain about the validity of payment they have received in good faith. Businesses can be exposed to a large amount of trading in the course of any 12 months period, and the extent of uncertainties may trigger these businesses to come under financial difficulties themselves, a domino effect. In addition, 12 months would also be long by international standards.

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## Section 6: Implementation and operation

| 6.1 How will the new arrangements be given effect? |
| --- |
| It will be necessary to amend the Companies Act to give effect to the changes to the clawback periods for related and unrelated party creditors. Liquidators will be enforcing these requirements. The same change will also be made to the Insolvency Act 2006, which governs personal insolvency. It is expected the new arrangements will come into effect in 2021. |

## Section 7: Monitoring, evaluation and review

| 7.1 How will the impact of the new arrangements be monitored? |
| --- |
| There are no aggregate data at present. However, the Insolvency Practitioners Act provides for regulations to be made requiring liquidators to collect and publish data. When making regulation on data collection, we will consider collecting clawback information to help us review the effectiveness of the change to clawback periods |
| **7.2 When and how will the new arrangements be reviewed?** |
| We consider that it would be appropriate to undertake an internal review 5 years after the changes to clawback provisions have come into place. |

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