THE STACE HAMMOND GRACE LECTURE

PREFERENTIAL PAYMENTS ON BANKRUPTCY AND LIQUIDATION IN NEW ZEALAND: ARE THEY JUSTIFIABLE EXCEPTIONS TO THE PARI PASSU RULE?

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I. INTRODUCTION

It is important at the outset to state unequivocally what this article is not. It is not, and does not purport to be, a treatise on the current state of the law regarding preferential debts on insolvency. Rather the purpose of this article is to consider, from a New Zealand perspective, whether preferential payments presently in force for bankruptcies of individuals[1] and company liquidations[2] can be justified in light of the *pari passu* rule and the fundamental importance which has been attached to that rule both in New Zealand and overseas. The article also considers the policy issues underpinning preferential payments. Of necessity, in a paper dealing with such issues, the discussion will tend to be in broad terms. My intention is to highlight issues which must be addressed rather than to suggest definitive answers. On many of the issues there will be no right answer.

In his text, *Principles of Corporate Insolvency Law*,[3] Professor R M Goode said:

> The most fundamental principle of insolvency law is that of pari passu distribution, all creditors participating in the common pool in proportion to the size of their admitted claims.
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1 Insolvency Act 1967 s.104; see also *Laws of NZ Insolvency* paras 390-409.

2 Companies Act 1955, ss.209 P(c), 229 (5) and 286 and Schedule 8C; Companies Act 1993 ss 234, 255(5) and 312 and Seventh Schedule. This paper will deal only with personal bankruptcies and company liquidations; however, for the position on receivership see also Receiverships Act 1993, s.30.

3 Goode, R M *Principles of Corporate Insolvency Law* (1990).

> It is this principle of rateable distribution which marks off the rights of creditors in a winding up from their pre-liquidation entitlements. Prior to winding up each creditor is free to pursue whatever enforcement measures are open to him....The rule here, in the absence of an insolvency proceeding, is that the race goes to the swiftest....Liquidation puts an end to the race. The principle first come first served gives way to that of orderly realisation of assets by the liquidator for the benefit of all secured creditors and distribution of the net proceeds pari passu. The pari passu principle is all pervasive. Its broad effect is to strike down all agreements which have as their object or result the unfair preference of a particular creditor by removal from the estate on winding up of an asset that would otherwise have been available for the general body of creditors. The principle is buttressed by related rules on preference by which pre liquidation payments and transfers made in the run up to winding up may be avoided.[4]

Professor Goode goes on to explain that while the theory of insolvency law holds that the *pari passu* principle of distribution is fundamental and all pervasive, a rateable distribution among creditors is rarely achieved. Professor Goode points to two main reasons why this is so: first, the fact that security holders, suppliers of goods under contracts which reserve title until payment and third parties for whom the company holds assets on trust or who have proprietary tracing rights in equity to assets in the possession or under the control of the company will have prior claims; second, what the Professor describes as "huge chunks of what remains" must be applied to meet claims ranking in priority to those of ordinary unsecured creditors.[5]

While Professor Goode's comments were made in the context of corporate insolvency they are just as applicable to bankruptcies of individuals.

The learned Professor's observation that the principle of *pari passu* distribution is *"the most fundamental principle of insolvency law"* was approved, in apparently unqualified terms, by a majority of the Court of Appeal in *Attorney General v. McMillan & Lockwood Ltd.* [6] Williamson J, who was in the minority in the Court of Appeal, took the view that the *pari passu* rule had a qualified, rather than universal, application to an insolvent company. His Honour reasoned that the express provision in the statute for preferential debts qualified the general principle of equal sharing which is encapsulated in the *pari passu* rule.[7]

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4 Ibid, 59-60.

5 Ibid, 60.

6 [1991] 1 NZLR 53 (CA) at 58. The majority judgment of Richardson and Bisson JJ was delivered by Richardson J.

7 Ibid, 63.

The *pari passu* rule is reinforced in a number of ways. For example, an agreement for the post liquidation combination of accounts (otherwise known as contractual set off or netting) which goes beyond the rules of insolvency set ofR M f (e.g. because sums due from the company in liquidation to third parties are included) will be declared void by the Court as being contrary to public policy.[8] Likewise, the provisions made in both the Insolvency Act 1967 and the Companies Acts 1955 and 1993 for an insolvency administrator to set aside voidable preferences, voidable securities and voidable gifts support the basic proposition that creditors should share rateably in the distribution of the property of an insolvent debtor.[9] Although parties will not be permitted, by reason of public policy, to agree to exclude statutory provisions governing the distribution of property on insolvency, the Courts will recognise as valid the right of a party to subordinate its claim to those of others.[10]

The right of a creditor to waive equal participation in the proceeds of realisation of assets of an insolvent entity was recognised by the Court of Appeal in *Stotter v. Ararimu Holdings Ltd.* In giving the judgment of the Court of Appeal in that case Gault J said:[11]

> The rationale underlying the pari passu rule is that no creditors should receive preference over the general body of creditors in the division of assets. We see no inconsistency with that if a creditor simply assents to foregoing the entitlement to participate. We see that as no serious inroad to the Court sanctioned compromise

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8 *British Eagle International Airlines Ltd v. Compagnie Nationale Air France* [1975] 2 ALL ER 390 (HL); Goode, supra note 1, at 61. For the set off rules on bankruptcy see s.93 Insolvency Act 1967 and Laws of NZ, Insolvency paras 373-376; for set off rules on liquidation see s.284 Companies Act 1955 and s.310 Companies Act 1993. As authority for the proposition that a creditor or a debtor cannot contract out of or waive the right to effect set off on bankruptcy in the manner provided by statutes see *Rolls Razor Ltd v. Cox* [1967] 1 QB 552; [1967] 1 ALL ER 397 (CA) and *National Westminister Bank Ltd v. Halesowen Press Work and Assemblies Ltd* [1972] AC 785; [1972] 1 ALL ER 641 (HL). See also, generally, *Stein v. Blake* [1995] 2 ALL ER 961 (HL). From a conceptual standpoint insolvency set off can be categorised either as an exception to the *pari passu* rule or as a recognition of the practical consequences when mutual debts are owed.

9 For individuals, see ss.54,55, 56 and 57 Insolvency Act 1967 and s.47 Matrimonial Property Act 1976; for companies see ss.266-270 Companies Act 1955 and ss.292-296 Companies Act 1993; for additional provisions of relevance in a company liquidation see ss.271-275 Companies Act 1955 and 297-301 Companies Act 1993 respectively; generally, see s.60 Property Law Act 1952. See also *Laws of NZ*, Insolvency para 311.

10 *Stotter v. Ararimu Holdings Ltd* [1994] 2 NZLR 655 (CA).

11 Ibid, 662. See also, in this context, s.313(3) Companies Act 1993 to which Gault J refers at 661-662.

> procedure nor to the orderly administration of insolvent estates. To allow debt subordination is to recognise a commercial arrangement common internationally and to ensure that the legitimate expectations of the parties and those induced to deal in reliance on the arrangement are met.

The judgment of the Court of Appeal in *Stotter v. Ararimu Holdings Ltd* ended a long debate in New Zealand over the question whether subordination of debt in advance of liquidation or bankruptcy was contrary to public policy.[12]

II. The Pari Passu Rule and Preferential Payments

Other jurisdictions have addressed, in recent times, the inter-relationship between preferential payments and the *pari passu* rule. By way of introduction to the substantive matters to be addressed in this article, I refer to some of the more important commentaries on this topic.

In the United Kingdom, in the Report of the Committee on Insolvency Law and Practice[13] [the Cork Report] it was stated:

> It is a fundamental objective of the law of insolvency to achieve a ratable, that is to say pari passu, distribution of the uncharged assets of the insolvent among the unsecured creditors.[14]

The Cork Report went on to state (in relation to the topic of preferential debts):

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12 Generally, in relation to cases dealing with the pari passu rule and the public policy aspects of it, see also the earlier New Zealand decisions in *re Walker Construction Co Ltd (in Liquidation)* [1960] NZLR 523, *Rendell v. Doors & Doors Ltd (In Liquidation)* [1975] 2 NZLR 191, *re Orion Sound Ltd* [1979] 2 NZLR 574, *Re Faberge NZ Ltd (In Liquidation)* (1992) 6 NZCLC 68,369 and *Attorney General v. McMillan & Lockwood Ltd* [1991] 1 NZLR 53 (CA). For relevant judgments from other jurisdictions see generally *First National Bank of Hollywood v. America Foam Rubber Corp* 530 F 2nd 450 (1976), *Ex parte De Villiers: Re Carbon Developments (Pty) Ltd (in Liquidation)* 1993 (1) SA 493, *Canada Deposit Insurance Corp v. Australia and New Zealand Banking Group Ltd* (1993) 11 ACLC 707, *Re NIAA Corporation Ltd (In Liquidation)* (1993) 12 ACLC 64, *British Eagle International Airlines Ltd v. Compagnie Nationale Air France* [1975] 2 ALL ER 390 (HL), *National Westminister Bank Ltd v. Halesowen Presswork & Assemblies* [1972] AC 785 and *Re Maxwell Communications Corp PLC (No.2)* [1994] 1 ALL ER 737.

13 Cmnd 8558 1982 (Chairman: Sir Kenneth Cork).

14 Ibid at para 1396.

> We have received a considerable volume of evidence on this subject, most of it critical of the present law, and much of it deeply hostile to the retention of any system of preferential debts. We are left in no doubt that the elaborate system of priorities accorded by the present law is the cause of much public dissatisfaction, and that there is a widespread demand for a significant reduction, and even a complete elimination, of the categories of debts which are accorded priority in an insolvency.[15]

In Australia, the Australian Law Reform Commission's report, *General Insolvency Inquiry* [the Harmer Report], stated that the principle of equal sharing between creditors should be retained and in some areas reinforced as a fundamental principle to guide insolvency law reform.[16] The Commission stated:

> Equal sharing has long been regarded as a fundamental principle of insolvency law. The Commission's review of the priority provisions of the legislation was guided by this principle and was the basis of the Commission's recommendation that the priority of the Commissioner of Taxation which (in some areas of taxation) provides a substantial advantage to the Commissioner over other creditors, should be abolished. The principle of equal sharing is also evident in the Commission's recommendations for the distribution of trust property.[17]

Further, after referring to the extract from the Cork Report qoted above,[18] the Harmer Report continues:

> Despite this principle, the objective of equal distribution is rarely, if ever, achieved because of the extensive range of creditors upon whom statutory priority is conferred. It is the view of the Commission that, to the maximum extent possible, the principle of equality should be maintained by insolvency law subject to these qualifications:
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> ♦ It should not intrude unnecessarily upon the law as it otherwise affects property rights and securities and
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> ♦ It should encourage the effective administration of insolvent estates.
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> Any departure from this approach should only be countenanced by reference to clearly defined principles or policies which enjoy general community support.[19]

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15 Ibid para 1397.

16 General Insolvency Inquiry; Report No.45 of the Australian Law Reform Commission, 1988 (Chairman, Mr Ronald Harmer). See in particular para 33 at p 16 and para 713 at pp 290-291.

17 Ibid at para 33, p 16.

18 Supra note 14.

19 Ibid at para 713, pp 290-291.

In the Canadian report entitled *Proposed Bankruptcy Act Amendments: Report of the Advisory Committee on Bankruptcy and Insolvency*[20] [the Colter Report] a Canadian committee also dealt with the interaction between preferential claims and the *pari passu* rule. The Colter Report put the problem in the following way:

> The proliferation of statutory deemed trusts and liens has created significant uncertainty and confusion in the distribution of a bankrupt's property. The priority attributed to Crown claims, either by way of statutory deemed trusts and liens or under s.107 of the Bankruptcy Act, has reduced the ability of a debtor to make a proposal to its creditors. Frequently the requirement that claims of the Crown be paid in full before there is any distribution to the unsecured creditors prevents an effective reorganisation.
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> Unsecured creditors often do not take an active interest in the administration of a bankruptcy because all the proceedings of any recovery will go to the Crown as a preferred creditor. The Crown, either federal or provincial seldom involves itself in the administration of a bankrupt estate. In many instances, a representative of the Crown will not attend the first meeting of creditors or will not act as an inspector. It is also most unusual for the Crown to advance any money to recover assets for a bankrupt estate. Crown corporations also have the advantage of the same priority, and this creates unfair competition against private sector companies in the market place. [21]

The Colter Report went on to consider other preferred claims and said:

> When the original [Bankruptcy Act] was passed, the legislators determined that certain groups of creditors required additional protection. The question at issue today is whether these groups still need such assistance.[22]

Finally, I refer briefly to the position in Scotland. The common law of Scotland recognised three categories of preferred debts (deathbed and funeral expenses, wages of farm and domestic servants for the term current at the date of sequestration, and a year's rent of the house where the bankrupt died).[23] Subsequently, in 1707, Crown priority was introduced

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20 January 1986; Chairman, Mr G F Colter. I am indebted to Mr David Baird QC of Tory, Tory, DesLauriers & Binnington, Barristers and Solicitors, Toronto (who was a member of the Colter Committee) for supplying me with a copy of this report.

21 Ibid at 77-78.

22 Ibid at 79.

23 Laws of Scotland, Bankruptcy para 1426 Erskine, Institute III, 9.43; third category doubted in Goudy, H *A Treatise on the Law of Bankruptcy in Scotland* (4th ed, 1914) p 516.

by statute.[24] In subsequent years many additional classes of preferred debts were created by statute and

> ...the effect of these was severely to restrict the availability of funds to meet the claims of ordinary creditors. No topic provoked more discussion when the reform of bankruptcy legislation was being contemplated. The Scottish Law Commission recommended the virtual abolition of all Crown preferences and a restriction of other preferences to employee's wages and related matters.[25]

The recommendations of the Scottish Law Commission were not adopted in full but some modifications were made to the number of preferred debts.[26]

Overall, from this survey, it can be seen that (for a variety of reasons) general dissatisfaction with the system of preferential payments has been expressed in a number of jurisdictions which operate similar insolvency regimes to those in New Zealand.

III. The Issues

On other occasions I have expressed the view that the over-riding requirement of insolvency law is to determine which of two or more innocent parties will, ultimately, bear a loss. As I have stated previously, it is inherent in any insolvency administration that loss will be suffered. The only question is: who will bear it? While this is, to some extent, implicit in the principle of equal sharing, it is worth stating explicitly (if only to emphasise) that all creditors are not treated equally: only creditors of equal priority are treated equally.[27]

It is easy to understand why those who have made submissions on insolvency law reform should have focused specifically on the question of preferential debts. The increasing number of preferential debts means

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24 Exchequer Court (Scotland) Act 1707, s.7; see also *Admiralty v. Blair's Trustee* 1916 SC247, 1916 1 SLT 19.

25 Laws of Scotland, Bankruptcy, para 1426; see also Bankruptcy and Related Aspects of Insolvency and Liquidation (Scottish Law Commission no 68, 1982) ch 15.

26 Laws of Scotland, Bankruptcy para 1426.

27 Heath, "How Can Creditors Ever Achieve Certainty? A Commentary" (1993) *NZ Law Conference, Conference Papers*, Vol.2 p. 187 at 189 para 5.2 and Heath, "Voluntary Administration - Proposals for NZ" in *Essays on Corporation Restructuring and Insolvency* Charles Rickett, ed (1996), 91, in particular p. 97.

that unsecured creditors receive less on bankruptcy or liquidation. Ultimately questions of policy and principle arise when one asks the question: who must bear the loss? In each case it is necessary to ask whether there is any justification for Creditor A (the preferred creditor) to receive payment before Creditor B (the unsecured creditor) and (if so) to articulate that reason. Unless preferential treatment can be justified by some social, economic or political reason the payment to Creditor A ought not, I suggest, be given preferential status.[28] Furthermore, in my view good reason needs to exist to depart from the *pari passu* rule. Despite the recommendations of the Harmer Report, Australian law still recognises a number of preferential payments for both corporate and non corporate insolvencies.[29] What stance should New Zealand take?

This article endeavours:

(a) to ascertain the underlying basis in principle or in policy for the preferential payments presently in force in New Zealand;

(b) to consider whether these preferential payments can be justified; and

(c) to consider whether it is possible to apply a litmus test to any further type of preferential payment which may be introduced to determine whether it is appropriate or inappropriate that such a priority payment be enacted.

The time is opportune to consider these issues for three reasons. First, there is a general insolvency law review in the wind at present. Second, there have been recent attempts to safeguard further the interests of employees on the insolvency of an employer: see the Status of Redundancy Payments Bill introduced into Parliament in 1996. Third, there have been recent proposals by the Reserve Bank in relation to netting indebtedness and (so called) "payments finality" which could, if adopted, undermine the *pari passu* rule further.[30]

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28 This general proposition appears to accord with the observations made in the Harmer Report supra note 16, at (para 713) and the Colter Report supra note 20 (at 77-79) about the underlying rationale for preferential payments.

29 See Corporations Law, s.556 and Bankruptcy Act 1966 (Cth); s.109 as both amended by the Insolvency (Tax Priorities) Legislation Amendment Act 1993 (Cth).

30 See the two papers entitled *Netting: A Discussion Paper* and *Payments Finality: Proposed Changes to Insolvency Law* (Reserve Bank of New Zealand, August 1996). The value of the proposals contained in the Payments Finality paper is dependent upon acceptance of the Netting proposals.

Before embarking upon a discussion of the issues I have raised, I propose to set out expressly the philosophical basis upon which I propose to address the issues. There are a number of philosophical bases upon which insolvency law reform can proceed:[31] it is therefore necessary to identify the basis upon which my discussion of the issues proceeds.

IV. Philosophical Perspective

In an essay entitled "Voluntary Administration - Proposals for New Zealand"[32] I discussed the philosophical basis upon which insolvency law reform should proceed in New Zealand in the context of considering whether a voluntary administration regime should be enacted. So far as the underlying philosophical basis for insolvency law reform is concerned there is no difference between the points made in that essay (which considered voluntary administration) and the issues which arise in the context of this article (preferential payments).

In that essay, I offered some tentative conclusions on this topic. I noted that the underlying philosophy of insolvency law in New Zealand was something which had received little attention either from law reform agencies or from those making submissions to such agencies. I then said (by reference to definitions of the competing philosophies in a paper by Professor Axel Flessner):

> My own view is that our current law presently combines elements of the capitalist philosophy and pragmatism. I do not see the capitalist philosophy and pragmatism (as defined by Professor Flessner) as being mutually exclusive. Because insolvency law attempts to cover diverse business operations there will clearly be occasions on which liquidation is necessary; equally there will be many occasions where the business of the trading entity can be saved or preserved for sale as a going concern for the benefit of all creditors. Pragmatism simply recognises the need for flexibility in dealing with the diverse array of circumstances with which an insolvency practitioner will be faced from time to time.[33]

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31 See Flessner, A "Philosophies of Business Bankruptcy Law: An International Overview" in Ziegel (ed) *Current Developments in International and Comparative Corporate Insolvency Law* (1994).

32 *Essays on Corporate Restructuring and Insolvency*,supra note 27 at 94-100. See also the comments by Prof. Farrar in *Essays on Corporate Restructuring and Insolvency* at 69-70 and see also Flessner, supra note 31.

33 *Essays on Corporate Restructuring and Insolvency,* ibid at 114. See, generally, ibid at 113-115.

Four philosophies were identified by Professor Flessner in relation to insolvency law regimes,[34] labelled "pragmatism", "Government activism", "capitalist" and "enterprise". Pragmatism is said to take bankruptcy law as it is with a view to applying it on a case by case basis according to business necessities. Government activism is said to flourish in countries where the state is strongly involved in economic activity: examples are Italy and France. The capitalist philosophy focuses on the debts of the estate with the objective of maximising returns to creditors. The enterprise philosophy was described by Professor Flessner as "centre left;" it focuses on the nature of the business enterprise and the preservation of it as a going concern rather than on maximising recoveries for creditors from the sale of assets. It is in that context that I concluded that our current law presently combines elements of the capitalist philosophy and pragmatism.

I have also expressed the view that insolvency law, in a country such as New Zealand which had adopted wholeheartedly free market philosophies, should, first and foremost, have clear rules as to priorities which apply in the event of the business entity becoming insolvent and being required to realise assets to meets its debts in accordance with statutory priorities. Furthermore, I said that these rules should be made on a principled basis. Once creditors know that priorities are fixed in advance they can assess the risk of giving credit with more confidence.[35]

V. Preferential Payments: History in New Zealand

Under present New Zealand law for both individuals and corporations a number of different tiers of debts are established.[36] First, secured debts are taken into account on the basis that they fall outside (except for any

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34 Flessner, supra note 31. The summary which follows in the text is taken from Farrar, J "Voluntary Administration in Australia and the United Kingdom - A Comparative Study" in *Essays on Corporate Restructuring and Insolvency*,supra note 27 at 69-70.

35 *Essays on Corporate Restructuring and Insolvency* supra note 27 at 98. For a general discussion of issues of principle which impact on preferential payments see Cantlie, S "Preferred Priority in Bankruptcy" in Ziegel, supra note 31at 413.

36 Insolvency Act 1967, s.104, Companies Act 1955, ss.209P(c), 229(s) and 286 and Schedule 8C; Companies Act 1993, ss.234, 255(s) and 312 and Schedule 7.

shortfall on realisation of securities) the insolvency regime.[37] Second, come the preferential debts with which I deal in this article.[38] Third, there are the ordinary unsecured claims.[39] Finally, there are some deferred debts.[40] As this paper addresses only the underlying reasons for preferential debts being exceptions to the *pari passu* rule, I confine my discussion of historical developments to preferential debts only.

The first insolvency statute in New Zealand was the Imprisonment for Debt Ordinance 1844. The Ordinance had been enacted because it was considered:

> ...desirable that provision be made for the relief of persons imprisoned for debt, who have become indebted without any fraud or gross or culpable negligence, by releasing the persons of such debtors from imprisonment, so as nevertheless their estates may still remain liable for satisfaction of their debts:....[41]

In essence, the purpose of the Act was to enable a person imprisoned for the debt to be discharged from custody provided a full and true statement in writing was given by the prisoner of all debts then due or accruing due to him or to any person in trust for him and to require the prisoner to execute a power of attorney in favour of any creditor who had sought to detain him (or to one of the detaining creditors on behalf of the body of creditors) enabling the creditor to sue for the debts. All monies which were then received under the power of attorney were to be paid into Court

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37 Insolvency Act 1967, ss.3(3) and 90; See also Laws New Zealand, Insolvency paras 377-389. Companies Act 1955 , s.286; Companies Act 1993, s.312. The expanding categories of secured indebtedness need to be taken into account in this regard. In particular issues are raised as to the appropriate scope of liens by the judgments of Thomas J in *Re Papesch* [1992] 1 NZLR 751 and *Re H & W Wallace Ltd* [1994] 1 NZLR 235 respectively. Proprietary claims are sometimes difficult to separate from secured claims in this context. Further consideration of the types of interest which ought to fall outside the scope of insolvency legislation is timely but beyond the scope of this paper.

38 Insolvency Act 1967, 2.104(1)(a)-(e); Companies Act 1955, Schedule 8C; Companies Act 1993, Schedule 7.

39 Insolvency Act 1967, s.104(1)(f); Companies Act 1955, s.287(1)-(2); Companies Act 1993, s.313(1) - (2).

40 Insolvency Act 1967, s.104(1)(g)-(i); Companies Act 1955,s.287(3)-(4); Companies Act 1993,s.313(3)-(4); Partnership Act 1908,s.6.

41 Imprisonment for Debt Ordinance 1844, preamble.

and, after deducting the expense of the power of attorney, be divided among the creditors at whose suit the prisoner had been detained.[42] But, Crown debts were not covered by the Ordinance of 1844.[43]

The next insolvency statute to be passed in New Zealand was the Debtors and Creditors Act 1862 which repealed the Imprisonment for Debt Ordinance 1844. The Act of 1862 was more sophisticated in its nature and allowed for the first time a creditor to petition the Court for sequestration of the debtor's estate.[44] By s.43 of the Act Crown debts were not covered by this process. Section 43 of the Act provided, in similar terms to s.14 of the Imprisonment for Debt Ordinance 1844:

> This Act shall not extend to discharge any debtor with respect to any debt due to Her Majesty or Her successors or to any debt or penalty with which he shall stand charged at the suit of the Crown or of any person for any offence committed against any Act or Ordinance enforced within this Colony relative to any branch of the Public Revenue or at the suit of any sheriff or other Public Officer upon any Bail Bond entered into for the appearance of any person prosecuted for any such offence unless his Excellency the Governor shall certify under his hand his consent that such person may apply to take the benefit of this Act.

No other special provisions were contained in the Debtors and Creditors Act 1862 for the payment of debts preferentially.

The Bankruptcy Act 1867 received the Royal Assent on 10 October 1867 and repealed the Debtors and Creditors Act 1862.[45] This statute has been described as the "first real bankruptcy legislation in New Zealand".[46] By Part XIV of the Bankruptcy 1867 issues of (inter alia) preferential payments were addressed. For the first time preferential claims were set out in the legislation. In particular, where a bankrupt was indebted "to any servant

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42 Ibid ss.5-8. Note, however, that a debtor could still be imprisoned for contracting debts fraudulently (s.10 of the Ordinance) or for having fraudulently concealed or misrepresented his state of affairs (s.11 of the Ordinance).

43 Ibid, s.14. The Governor of New Zealand retained a discretion to certify that any person mentioned in the section seeking to recover Crown debts could apply to take the benefit of the Ordinance; otherwise a prisoner was not liable to be discharged from imprisonment so long as any debt remained due to the Crown.

44 Debtors and Creditors Act 1862 s.6.

45 Bankruptcy Act 1867 s.3.

46 Spratt & McKenzie, Law of Insolvency, Butterworths 1972 para [0/1]; see also *Official Assignee v. NZI Life Superannuation Life Nominees Ltd* [1995] 1 NZLR 684 at 692 per Blanchard J.

or clerk for wages or salary" the trustee in bankruptcy was required to pay so much as was due which did not exceed three month's wages or salary or £50, with the servant or clerk proving for any sum exceeding that amount.[47] Likewise, where a bankrupt was indebted to any artisan, labourer or workman, whether skilled or unskilled, in respect of wages or labour, the trustee in bankruptcy was entitled to pay so much as was due not exceeding one month's wages at current rates to the artisan, labourer or workman; the artisan, labourer or workman was entitled to prove for any sum exceeding that amount.[48] An order of adjudication was also to be a complete discharge of any deed or articles of apprenticeship and if any money had been paid by or on behalf of an apprentice to the bankrupt as an apprentice fee, the Court, on proof of that, had a discretion to award such sum as it thought reasonable to be paid out of the estate as a preferential debt.[49]

Trustees in bankruptcy were also given a discretion to make an allowance to the bankrupt if they thought that necessary for the support of the bankrupt and his family with the caveat that such an allowance could not be made for any period after the adjournment of the bankrupt's last examination sine die.[50]

The position in respect of Crown debts was set out in s.127 of the Bankruptcy Act 1867 in the following terms:

> The order of discharge [from bankruptcy] shall not discharge the bankrupt from any debt due to the Crown or any debt or penalty with which he stands charged at the suit of the Crown or of any person for any offence against a statute relating to any branch of the public revenue or at the suit of the sheriff or other Public Officer on a Bail Bond entered into for the appearance of any person prosecuted for any such offence unless the Colonial Treasurer for the time being certify in writing his consent to the bankrupt being so discharged.

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47 Bankruptcy Act 1867 s.216.

48 Ibid s.217.

49 Ibid s.218.

50 Ibid, s.219.

Notwithstanding the express terms of Part XIV and s.127 of the 1867 Act, the Supreme Court held, in 1885, that in the administration of a bankruptcy in New Zealand, the Crown was entitled to priority over all other creditors.[51]

The next bankruptcy statute was the Bankruptcy Act 1892. This statute was more sophisticated still and provided in much greater detail for the administration of a bankrupt estate. This was the first New Zealand bankruptcy statute to state expressly that it bound the Crown.[52] It is interesting to note that no Crown debts were, in fact, granted priority in the preferential debts set out in the Act of 1892.[53]

Under s.120 of the Bankruptcy Act 1892 the monies received by the Official Assignee on behalf of creditors of the bankrupt were to be applied in the following manner: firstly, and rateably *inter se*, the costs and expenses of the Official Assignee, the costs of the petitioning creditor and the costs of the petitioning debtor; secondly, the Official Assignee's commission and supervisors' remuneration; thirdly, rent due for any period not exceeding six months actually due and payable by the bankrupt at the date of adjudication in respect of which there were goods on the premises on which, but for the bankruptcy, the landlord may have distrained; fourthly, and rateably *inter se*, wages or salary of any clerk or servant, artisan, labourer or workman or apprentice up to specified levels. One can immediately see that the list of preferential creditors had expanded between 1867 and 1892 to include administration costs and rent due in certain

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[51] Re *Donne* (1885) 4 NZLR SC 321. For some discussion of the Crown prerogative in this context see also (inter alia) *Federal Commissioner of Taxation v. Official Liquidator of EO Farley Ltd* (1940) 63 CLR 278 (HCA), *re Mutual Traders (Aust and NZ) Ltd* [1943] NZLR 254 and *Re Arnold Trading Co Ltd* [1983] NZLR 445 (C A) at 460. Note that, in re *Donne*, Johnston J, for some reason which is unclear from the report of the judgment, refers to provisions of the English Bankruptcy Act 1883 and to the Bankruptcy Act Amendment Act 1884 (NZ) which adopted some of the new provisions contained in the 1883 English Statute: the judgment does not refer at all to s.127 of the Bankruptcy Act 1867 although that section is consistent with the result in *Re Donne* in the sense that it puts Crown debts generally outside the scheme of the Act.

[52] Bankruptcy Act 1892 s.148.

[53] Compare s.120 Bankruptcy Act 1892 with s.148 of the Act. It was not until 1943 that this view of the law was adopted with regard to the administration of an insolvent company: see *Re Mutual Traders (Aust. and NZ) Limited (In Liquidation)* [1943] NZLR 254 at 260-261 per Kennedy J; see also *Tasman Fruit Packing Association Limited v. The King* [1927] NZLR 518 at 520 per Alpers J.

circumstances. It is also notable that both of those expenses were given priority over monies payable to persons who may be broadly called "employees" who previously enjoyed priority over those debts by the Act of 1867. This highlights the fact that preferential payments are set having regard to the social, economic and political considerations of the day.

Finally, by way of historical development, one comes to the Bankruptcy Act 1908. This was the last bankruptcy statute before the passing of the Insolvency Act 1967. The Crown's position remained the same as under the Bankruptcy Act 1892.[54] The provisions dealing with preferential creditors remained the same as those contained in the Act of 1892 except that the priority payments for employees were elevated to a third priority with rental arrears being demoted to fourth priority.[55]

So far as company liquidations were concerned, they were governed, at all material times, by the provisions of the Companies Acts then in force. It would lengthen unduly this particular paper to go through at length the provisions contained in various Companies Acts to review priority. To a large extent, the priorities allowed under company legislation tended to reflect priorities established under the insolvency legislation for bankrupts. It should be noted, however, that until the passing of the Companies Act 1933, the right of priority by Crown prerogative seems to have remained in force in respect of company liquidations. As Sir Clifford Richmond observed, in delivering the judgment of the Court of Appeal in *Re Arnold Trading Co Ltd*: [56]

> ...the position in New Zealand, after the enactment of the Companies Act 1933, was that the Crown prerogative had been for most practical purposes removed in the case of a winding up. See *Re Mutual Traders (Aust and NZ) Ltd* [1943] NZLR 254..

Having set out the history of priority payments in New Zealand under the bankruptcy statutes, it is now appropriate to review the current position starting with the Acts still in force; the Insolvency Act 1967 (for individuals) and the Companies Acts 1955 and 1993 (for companies).

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54 Cf Bankruptcy Act 1892 s.148 and Bankruptcy Act 1908 s.148.

55 Bankruptcy Act 1908 s.120.

56 [1983] NZLR 445 (CA) at 460.

VI. Preferential Payments: The Current New ZealandPosition

1. Introduction

Insolvency law in New Zealand can be divided into two general categories. First, individual insolvencies (including partnerships) which are governed by the Insolvency Act 1967. Second, there are corporate insolvencies which are governed by the Companies Act 1955, the Companies Act 1993 or the Receiverships Act 1993.[57] Although there are other types of insolvency regimes in operation in New Zealand, it is unnecessary to consider those in any detail in this paper as the principles applicable to them, so far as they refer to preferential debts, will be no different from the principles discussed in respect of either the Insolvency Act or the Companies Acts.[58]

It is, of course, possible for both individuals (particularly partnerships) and companies to be involved in business activities. Thus, although the Insolvency Act 1967 will apply to consumer debtors as well as to those involved in business, I propose to review the types of preferential payments in existence from the perspective of debtors (whether corporate or non corporate) who are involved in business activities.

In essence, both individual and corporate preferential debts can be divided into four distinct categories; ie, first, administration costs; second, employee related claims; third, Crown related claims; and fourth, miscellaneous debts which have, for one reason or another, been afforded priority. Some of the priority payments in the miscellaneous category seem to reflect (on the face of it) an ability for a certain interest groups to lobby Government rather than any particular reason in principle or policy for the debt to have preferential status.[59]

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57 From this point on I will refer (in the context of companies) to the Companies Act 1993 as, for most practical purposes, it will be the sole governing statute for those companies which go into liquidation after 1 July 1997.

58 For a summary of the types of insolvency administration which operate in New Zealand see *Laws of NZ*, Insolvency para 3.

59 In this category I refer, in particular, to the Companies Act 1993 Schedule 7 clause 2(h) which provide priority for all sums that the Motor Vehicle Dealers Institute Inc. is entitled to recover from a defaulting licensee company under s.42 of the Motor Vehicle Dealers Act 1975 in the event of the company being put into liquidation.

I propose to review each of the four categories of debt to which I have referred in turn and to discuss, in respect of each category, the questions set out earlier in this article: i.e. under each heading I will endeavour to discuss and determine the underlying basis in principle or policy for the particular type of preferential payments and consider whether the preferential payments can be justified. After discussing payments under each of the categories mentioned, I will discuss (when setting out my conclusions) whether it is possible to apply a litmus test to further types of preferential payments which may be introduced to determine whether it is appropriate or inappropriate that preferential status be granted in respect of such debts.

2. *Administration Costs*

Administration costs are not, strictly speaking, preferential debts because they are not debts which would otherwise have been payable by the insolvent entity *pari passu* with other creditors. It is self evident that administration costs would not have been incurred had there been no bankruptcy or liquidation. Thus, in my view, it is not really appropriate to regard administration costs as a preferential debt when considering whether particular preferential debts are justifiable exceptions to the *pari passu* rule.

There are good reasons why administration costs should be a first charge against the bankruptcy or the liquidation. First, there is a public interest in ensuring that liquidations and bankruptcies are administered professionally and competently: if persons qualified to administer such insolvencies were asked to administer without guarantee of costs being recovered as a first charge on the estate, it would be difficult to encourage qualified people to take on the position of an insolvency administrator. Second, as the Harmer Report put it:

> The creditors have a community of interest in having a common agent to maximise a fund for distribution among them.[60]

In New Zealand administration costs rank first in priority in both liquidations[61] and bankruptcies.[62]

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60 Harmer Report, supra note 16, para 717; see also *Re Universal Distributing Co Ltd (in Liquidation)* (1933) 48 CLR 171.

61 Companies Act 1993 Schedule 7 clause 1.

62 Insolvency Act 1967 s.104(1)(a) as amended by s.3(1) Insolvency Amendment Act 1994. See also, generally, Laws NZ, Insolvency para 391.

3. Employees

There is a variety of payments which are intended to protect the interests of employees which are made preferential on insolvency. Under the Insolvency Act 1967 and the Companies Act 1993, the references are to "any servant or worker" (under the Insolvency Act)[63] and to "any employee" (under the Companies Act 1993)[64]. While different terms are used in each statute, the difference in terminology seems to reflect the era in which the statute was drafted rather than any discernible difference in meaning. In each situation the question is whether preferential status is justifiable to the extent allowed. For convenience I will use the more modern expression ("employee") from now on.

It is the nature of the employee's relationship with the insolvent employer that is said to provide justification for preferential treatment. As Mr Bruce Gleig wrote:

> When an employer becomes insolvent, a free market economy treats the employee in the same manner as it treats other unsecured creditors. The employee is assumed to have recognised that unpaid wages form an unsecured loan to the employer and to have anticipated the possibility of bankruptcy. Before agreeing to the loan, the employee is expected to have determined the risk involved by analysing the financial health of the employer and to have minimised this risk by negotiating some form of security, such as a lien or mortgage, for the loan. Finally, the employee is expected to have negotiated sufficient compensation to offset the cost of the remaining risk of non payment. An employee who fails to fulfil these expectations, is then assumed to self insure by maintaining an income reserved for use when the employer fails to pay.[65]

Mr Gleig argues that those assumptions are unrealistic. He says:

> The employee is unlikely to have considered the possibility of the employer failing to pay earned wages. The topic of bankruptcy probably never arose during the negotiation of the employment contract between the employer and the job applicant; the employer simply agreed to pay the wages on a periodic basis as they were earned. Furthermore, even an employee who had contemplated the possibility is unlikely to have had the requisite bargaining power to extract the financial information and wage protection from the employer. This is especially so if the employee is not part of a collective

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63 Insolvency Act 1967, s.104(1)(d)(i).

64 Companies Act 1993, Schedule 7, clause 2 (a) and (b).

65 Gleig, B "Unpaid Wages In Bankruptcy" (1987) 21 UBC Law Review 61.

> bargaining unit. Finally, the assumption that an employee self insures ignores the employee's inadequate bargaining power to command compensation for an anticipated loss; the assumption merely states the result: in a bankruptcy, an employee is expected to absorb the loss of unpaid wages.[66]

The New Zealand solution to these problems has been (in general terms) to accord preferential status to employees in certain circumstances; i.e. at present, to meet all arrears of wages or salary (including holiday pay entitlements and other specified benefits) of any employee due from the date of adjudication in respect of services rendered during the four months immediately preceding adjudication up to a limit of $6,000.00 per employee.[67] Or, in the case of an apprentice, up to three months wages will be considered preferential if ordered by the Employment Tribunal.[68]

The question is: Does the nature of the employee's contractual relationship with the employer justify preferential status for all or any part of a debt owing to the employee on the bankruptcy or liquidation of the employer? Put another way, is the employee's position so different from any other supplier of goods or services which may be owed money on insolvency as to justify special treatment of the employee?

The difficulty, of course, is that creditors of an insolvent entity have many manifestations. Some may be large financial institutions which may be able to obtain financial information about the debtor, assess the risk of insolvency and seek security or alter interest rates to protect their positions. There may be other, smaller, traders who cannot in reality protect themselves from the insolvency of their paymaster: generally tradesmen and subcontractors fall into this category.[69] Furthermore, many smaller

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66 Ibid at 62.

67 Insolvency Act 1967 s.104(1)(d)(i) and Companies Act 1993 Schedule 7 clauses 2(a),(b),(d) and (e) and 6.

68 Insolvency Act 1967 s.104(1)(d)(ii) read in conjunction with Apprenticeship Act 1983 s.23 (as saved by s.16 of the Industry Training Act 1992; Companies Act 1993 Schedule 7 clause 2(g).

69 Note, however, how socio-economic bases can change quite quickly. Before 1 July 1988 a subcontractor would have received a form of preferential treatment if steps had been taken under the Wages Protection and Contractors Liens Act 1939: see the observations of Williamson J on this issue in his dissenting judgment in *Attorney-General v. MacMillan & Lockwood Ltd* [1991] 1 NZLR 53 (C A) at 67-68. Note also that the Crown had priority under the 1939 Act. See also *Andrew v. Rockell* [1934] NZLR 1056; Wilson, Contractors' Liens and Charges (2nd ed, 1976) at p2; Wages Protection and Contractors Liens Act 1939, s.50 and Acts Interpretation Act 1924, s.5(k). As to the philosophy of the 1939 Act see *Re Williams, ex parte, Official Assignee* (1899) 17 NZLR 712 at 719 (CA) and *Farrier-Waimak Ltd v. Bank of New Zealand* [1965] NZLR 426 at 443 (PC).

tradesmen may be just as reliant on one customer as the employee is reliant on his or her employer. The Harmer Report recognised this type of problem when it discussed the extent of the definition of the term "employee".[70] At para 729 of the Harmer Report, it was noted that creditors who may be particularly vulnerable on bankruptcy or liquidation include persons who are not employees but are in employee-like relationships with the insolvent entity. The report referred specifically to sub-contractors and the limited protection given to such persons in some Australia states.[71] In the New Zealand context an owner-driver "working" for a transport company is another example which springs to mind.[72] When assessing whether priority should be given to employees one must also bear in mind the consequences of excluding the wider class of claimant of this type and also the danger of according priority to a class of creditor which naturally includes working shareholders who function in a management role (for the employer) and who also have contracts of employment.

These issues have become more important given the move this year to improve the position of employees on bankruptcy, liquidation or receivership.[73] If enacted, the Status of Redundancy Payments Bill will add to the list of employee priorities all amounts due to any employee in respect of any redundancy agreement or clauses which were negotiated or documented as part of any relevant employment contract or as separate agreements.[74] Furthermore, so far as the Seventh Schedule to the

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70 Harmer Report, supra note 16, paras 728-732 at pp 297-299.

71 Ibid, para 729. See also Subcontractors' Charges Act 1974 (Qld) and Workmen's Liens Act 1893 (SA).

72 It seems clear that generally an "owner-driver" will not be regarded as an "employee" for preferential purposes. This issue arose in the context of the Employment Contracts Act 1991 when an owner-driver sought to invoke the personal grievance remedies available to an "employee" (but not to an "independent contractor") when his contract was terminated by the company by which he was engaged. In *TNT Worldwide Express (NZ) Ltd v. Cunningham* [1993] 3 NZLR 681 the Court of Appeal held the owner-driver could not claim under the Employment Contracts Act 1991 as he was a genuine independent contractor. See, in particular, the judgments of Cooke P at 687-689, Casey J at 694 and Robertson J at 701. Compare with observations of Mr D E Hurley, sitting as an Adjudicator in the *Cunningham* case at first instance: [1992] 1 ERNZ 956 (Employment Tribunal).

73 Status of Redundancy Payments Bill introduced into Parliament in 1996 as a Private Member's Bill.

74 Note that New Zealand has not yet ratified the Protection of Workers' Claims (Employer's Insolvency) Convention 1992 which has been adopted by the International Labour Organisation. The Convention requires preferential status to be given to certain employee related claims or protection by a guaranteed fund. The reason why the Convention has not been adopted in New Zealand appears to be that it includes redundancy payments. Redundancy payments have been adopted as a priority payment in Australia where the Convention has been ratified.

Companies Act 1993 is concerned, the Bill would repeal clause 6 which is the clause which limits priority given under the headings in clause 2 of the schedule to $6,000.00 in the case of any one employee.[75] The Long Title to the Bill states the purpose of the Bill as being:

> ...to protect the status of redundancy of all workers by amending the schedules of preferential claims in both the Companies Act 1993 and the Companies Act 1955 to include redundancy payments as negotiated in or documented within or in addition to the relevant employment contracts when companies go into liquidation or receivership.

The *Explanatory Note* to the Bill makes it clear that the Bill arose as a result of the collapse of the Weddel meatworks: the fact that workers at the meat works found that they stood in line with other unsecured creditors for redundancy payments being the catalyst for the Bill. The *Explanatory Note* continues:

> Those workers believed, quite rightly, that should their employment with the company cease, they would be in some measure compensated for the loss of their employment through redundancy agreements negotiated as part of their collective employment contract.
>
> This Bill is an attempt to ensure that no other workers will find themselves in such a situation again, particularly as the Minister of Agriculture is predicting that other meat works will go into receivership in the future.

The *Explanatory Note* also goes on to state the intention of the Bill to amend the schedules for preferential claims in both the Companies Act 1955 and the Companies Act 1993 and also to remove the $6,000.00 limit on all amounts due to employees. In fact, the Bill as presently drafted only removes that limit in relation to the schedule to the 1993 Act. The Explanatory Note also suggests that the Insolvency Act 1967 will be amended to give priority to redundancy payments owed to employees of individuals; it was also suggested that the limit on the amount that the employee can recover for wages or salaries owed and holiday pay would be removed from the Insolvency Act. Again, as a matter of fact, the Bill as drafted does not achieve that objective.

The Joint Insolvency Committee which has been set up by the New Zealand Society of Accountants and the New Zealand Law Society to consider

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75 Ibid clause 5(2).

issues of insolvency law reform[76] has made submissions to the Labour Select Committee on the Status of Redundancy Payments Bill.[77]

The Joint Insolvency Committee pointed out that one of the consequences of giving redundancy payments preferential status could well be to transfer the hardship of insolvencies from one group of workers to another. The Committee said:

> The experience of members of this committee, some of whom are insolvency practitioners, is that in many liquidations there is no secured lender or other secured creditor. If redundancy payments are granted preferential status (particularly unlimited amounts as the Bill proposes) this will inevitably mean that there are substantially fewer funds available to meet the claims of general trading and other unsecured creditors - the consequence could be that the additional losses suffered by those creditors will jeopardise the viability of the creditors and thus the continuing employment prospects of their employees. In the committee's experience, most companies which fail employ less than 10 staff. The redundancy claims of those staff could be disproportionately large when considered against the claims of trading and unsecured creditors, thus leaving nothing for those creditors.[78]

The Committee also pointed out that the preferential status presently given to unpaid wages and salary relates to work or services actually rendered whereas redundancy pay is contractually agreed compensation from the employer, usually made on some scale based on length of service, to remove some of the employees' immediate financial worry associated with losing their job. It was noted that in some cases employees received a windfall as they were able to obtain other employment after being made redundant. The Committee said:

> The committee has difficulty in identifying any policy grounds social or economic, for according redundancy compensation priority over the claims of trading and other unsecured creditors.[79]

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76 The Joint Insolvency Committee was established in February 1994. Its membership at the relevant time comprised Michael Webb and Michael Whale (Joint Conveners), Peter Hassell, Paul Heath, Robert McInnes, Peter Chatfield, Don Francis and John Vague.

77 *Submissions of Joint Insolvency Committee to Labour Select Committee on the Status of Redundancy Payment Bill.* The submissions note that the reference in the *Explanatory Note* to amendments being made to the Insolvency Act 1967 has not been effected; it was also pointed out that the limit under the Insolvency Act 1967 for preferential claims by employees of the type contemplated was in fact $6,000 rather than $1,500 as set out in the *Explanatory Note*.

78 Ibid, p 2 para 2.

79 Idem.

Just as an employee [Creditor A] at the Weddel meatworks expected his or her redundancy payments to be met in full so too did the trade creditor [Creditor B] expect to be paid in full for goods or services rendered. Why then should the claims of Creditor B be deferred to those of Creditor A?

The Joint Insolvency Committee also pointed out that there could be unintended consequences if working shareholders and directors wrote favourable redundancy clauses into their own employment contracts thereby elevating their own claims from last (qua shareholder) to preferred status (*pari passu* with other employees).[80] Finally the Joint Committee also pointed out implications for providers of business credit and potentially for the cost of credit. One possible consequence of the enactment of the Bill would be insistence by credit providers on businesses ensuring that employment contracts include provisions making it clear that employees would not be entitled to redundancy compensation.[81]

It is clear that a tension exists between the need to protect employees (who are not able to negotiate on equal terms with an employer) on the insolvency of the employer[82] and the need to ensure that the protection or level of protection given to employees does not cause undue detriment to other creditors or cause harm to the overall economy. All of these issues must be carefully weighed before any decision is made in relation to the Status of Redundancy Payments Bill. Indeed the Status of Redundancy Payments Bill is but a microcosm of the wider issues involving preferential payments.

It is difficult to see the New Zealand Parliament withdrawing preferential status for employees. Historically, employees have been in a preferred

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80 Ibid, p 3 para 5. In this respect, I note that both Canadian and Norweigan legislation may provide an answer to this problem. By s.140 Bankruptcy and Insolvency Act 1992 (RSC 1992, c 27) (Canada) no person can receive preferential wages or salary if that person was an officer or director of the company. Similarly, under para 9-3 of the Satisfaction of Claims Act 1994 (Norway) preferential wages will be denied if considerable influence could have been or was exerted over the management of the company by the claimant. I also note the comments of Susan Cantlie on this issue in her article "Preferred Priority in Bankruptcy" (supra note 35, 414 at 415) where Ms Cantlie suggests a potential deficiency in the Canadian formulation in respect of high ranking executives who are not, as a matter of law, "directors or officers" for the purposes of s.140 Bankruptcy and Insolvency Act 1992. The wider Norwegian formulation may be a better answer overall - though the width of the provision necessarily raises questions about the certainty of the law. See also Houlden & Morawetz, *Bankruptcy and Insolvency Law of Canada* (1993, 3rd ed) para G75 at 5-110.

81 Ibid, 3 para 7.

82 See Gleig, supra note 65 at 61-62.

position on bankruptcy since 1867; protections afforded to apprentices have been in existence since the same time.[83] In my view, the two most difficult issues affecting preferential treatment for employees are: (a) how one can validly distinguish an employee from an independent contractor who is reliant upon a particular customer for work; and (b) the extent to which any protection afforded should be given.

There is, however, an additional option to protect employees. In the Harmer Report the Australian Law Reform Commission said:

> In the Commission's view the interests of employees would be best protected by the creation of a wage earner protection fund. Such a fund would ensure that employers are paid in every insolvency. But the Commission accepts that there is strong support for the retention of the existing priority accorded to employees. However as to the range of benefits that should be available (such as leave, retrenchment payments, superannuation) and whether there should be a ceiling on benefits the Commission makes no recommendation. This is a matter of policy that is more appropriate for the Government to determine as part of, or in the light of, its overall social welfare and income support policies. Since, however, the existence of priority runs contrary to the fundamental principle of equal sharing, the Commission would urge that the interests of other unsecured creditors should not be overlooked when determining that policy.[84]

Similarly, in Canada, a recommendation was made in the Colter Report that a wage earner protection fund be established:[85]

> It is recommended that a wage earner protection fund be established because no other solution ensures prompt and certain payment to employees. The fund should be financed by contributions from employers and employees. Such financing spreads the burden of paying the claims of employees among all employers and employees and avoids any impact on a particular lender. A lender to a labour-intensive industry would not deem it necessary to restrict the amount of credit it would otherwise extend. Thus, there would be no impact on current lending practices.[86]

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83 Bankruptcy Act 1867 s.217

84 Harmer Report, supra note 16, para 727 at pp 296-297 (emphasis added).

85 Colter Report, supra note 20, at 31-34.

86 Ibid p 32. At 33-34 the Committee recommended that contributions to the wage earner protection fund be collected monthly from employers and employees with the ultimate object of having a self financing fund. See also the comparative table of wage earner protection funds operated by Belgium, Denmark, United Kingdom, France, Germany, the Netherlands and Italy which is summarised in the *Colter Report*, supra note 20 at 26-27.

The recommendations made in both Australia and Canada for the creation of a wage earner protection fund were rejected by the respective Governments. Given the other countries which operate such schemes, however, it is not an option which should be dismissed out of hand in New Zealand. In essence, the object of the exercise is for the fund to pay out the employees immediately and then be subrogated to the rights of the employees on insolvency. Thus, while the creation of a wage protection fund would alleviate the immediate needs of the employees (which, otherwise, would have to be met from state income support payments) a question would still remain as to whether present preferential rights should remain for subrogation purposes.

When addressing the extent to which any preferential treatment should be given to an employee one must examine the types of rights which may be protected so that a proper assessment may be made in each case as to whether justification for the protection exists. At present there are a number of headings under which preferential treatment falls: first, "wages or salary of any employee" is given preferential status whether or not earned wholly or in part by way of commission and whether payable for time or for piecework in respect of services rendered during the four months preceding the commencement of the bankruptcy or the liquidation.[87] Second, holiday pay is given preferential status.[88] Third, amounts deducted by the employer from the wages or salary of an employee in order to satisfy obligations of the employee are given preferential status.[89] Fourth, preferential status is given to amounts payable to the Commissioner of Inland Revenue as deductions from wages for child support purposes.[90] In addition where an employee would have been able to make a claim for preferential wages or salary but for the fact that monies were specifically advanced to meet such salary by a third party, that third party will have a subrogated right of priority in respect of the money advanced to the same extent as if the employee had not been paid the money.[91]

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87 Insolvency Act 1967 s.104(1)(d)(i); Companies Act 1993 Schedule 7 clause 2(a).

88 Insolvency Act 1967 s.104(1)(d)(i); Companies Act 1993 Schedule 7 clause 2(a).

89 Companies Act 1993 Schedule 7 clause 2(d). This priority would include contributions made, out of the salary of the employee, to a superannuation fund on behalf of the employee - but would not include contributions payable by the employer to any such superannuation scheme.

90 Insolvency Act 1967 s.104(1)(d)(iv) read in conjunction with s.163 Child Support Act 1991; Companies Act 1993 Schedule 7 clause 2 (e).

91 Insolvency Act 1967 s.104(2); Companies Act 1993 Schedule 7 clause 7.

Questions arise as to what is meant by the term "wages or salary". Wide definitions have been given of these terms in other contexts: for example, it is possible to argue that an employer contribution to a superannuation plan might fall within the term "wages or salary" on the basis that the payment by the employer is an incident of the employee's overall remuneration.[92]

Finally, it should be noted that there are a wide variety of methods by which the policy issues arising in relation to employees can be addressed. Different countries have adopted different approaches and, in the end, it will be a matter of determining which approach is best from the New Zealand perspective. The following are some examples of the way in which the problem has been approached elsewhere.[93] In Canada, directors of a company can be liable personally for employee related debts on the insolvency of the company.[94] Claims of employees arising from their employment in the three years preceding the commencement of the insolvency proceeding are claimable in the Czech Republic.[95] In Finland there are only priorities for child support payments and claims of that nature.[96] In the United States of America preferential treatment is given for wages, salaries or commissions, certain contributions to employee benefit plans, claims of producers of grain and certain debts payable to fishermen.[97]

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92 By way of analogy, see *Parry v. Cleaver* [1970] AC 1 (HL), *The Halcyon Skies* [1977] QB 14 and *Barber v. Guardian Royal Exchange Assurance Group* [1990] 2 ALL ER 660 (CJEC). In this respect see also observations made by members of the Court of Appeal in *Re UEB Industries Ltd Pension Plan* [1992] 1 NZLR 294 at 297-298 (per Cooke P) and *Cullen v. Pension Holdings Ltd* (1993) 1 NZSC 40, 259 (CA); in particular the judgments of Cooke P and Richardson J. See also *Davies v. Dulux NZ Ltd* [1986] 2 NZLR 418 at 424 - 425 (in the context of the Wages Protection Act 1964) and *Coburn v. Human Rights Commission* [1994] 3 NZLR 323 at 336 - 337 (in the context of the Human Rights Act 1993).

93 The following examples are drawn from a survey conducted by The Bankruptcy Legislation Sub Committee of Committee J of the International Bar Association through its Task Force on Priority Claims in Insolvency Administration which was presented to the Committee J meeting in New Orleans USA on 11 October 1993 by the Task Force Co-Chairs, Dr Ole Borch and Mr Timothy L'Estrange of Copenhagen and Sydney respectively. I am indebted to Dr Ole Borch for supplying me with a complete set of the answers provided by the Country Chairs of the 17 nations which responded to the survey. The countries which responded were: Australia, Bermuda, Bulgaria, Canada, Czech Republic, Denmark, England and Wales, Finland, Ireland, Italy, New Zealand, Norway, Poland, Romania, Spain, Sweden and USA.

94 Canada Business Corporations Act s.119.

95 Bankruptcy Composition Act (No.328/1991) s.32 (Czech Republic).

96 Lag om den ordning i vilken borgenär skall få betalning (Finland).

97 Bankruptcy Code, s.507(USA) .

4. Crown Debts

A variety of Crown debts are given statutory priority on bankruptcy and liquidation. There are two broad categories into which Crown debts will fall for preferential purposes: the first category consists of taxation debts; the second category consists of payments to reimburse the Government for benefits conferred by the Government.

Although a laudable attempt was made when the Companies Act 1993 was passed to set out those debts which are preferential on liquidation, it is a labyrinthine task for anyone to establish the true priority structure at any given time. This is because both the Insolvency Act 1967 and the Companies Act 1993 are affected by some debts being granted preferential status by other Acts of Parliament.[98] This involves the busy practitioner in much searching to ascertain the mysterious preferential payments which are not expressly stated. This position is clearly undesirable. It is imperative that steps are taken under both Acts to list in definitive terms those debts which are accorded priority on bankruptcy or liquidation.

The Crown debts which remain preferential can be summarised as follows: (a) Goods and Services Tax;[99] (b) tax deductions made by the employer under the PAYE rules of the Income Tax Act 1994;[100] (c) non resident withholding tax deducted by an employer under the NRWT rules of the Income Tax Act 1994;[101] (d) resident withholding tax deducted under the RWT rules of the Income Tax Act 1994;[102] (e) all duties payable under the Customs Acts;[103] (f) fisheries' management levies payable under the Fisheries Act 1983;[104] (g) accident compensation levies;[105] (h) certain preferential claims under the Radiocommunications Act 1989;[106] (i)

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98 For example, Goods and Services Tax Act 1985, s.42(2)(a), Volunteers Employment Protection Act 1973, s.15(1)(a), Fisheries Act 1983, s.107K, Radiocommunications Act 1989, s.183 and Layby Sales Act 1971, s.11(2)(c). As to goods and services tax see also *District Commissioner of Inland Revenue v. Bain* (1990) 14 TRNZ 534.

99 Goods and Services Tax Act 1985 s.42; Companies Act 1993 Schedule 7 clause 5(a).

100 Companies Act 1993 Schedule 7 clause 5(b) as amended by Income Tax Act 1994 s.YB1. See also Tax Administration Act 1994, s.167(2).

101 Ibid clause 5(b) as amended by Income Tax Act 1994 s.YB1.

102 Ibid clause 5(d) as amended by Income Tax Act 1994 s.YB1.

103 Ibid clause 5(e) as amended by the Customs Amendment Act 1995 s.2.

104 Fisheries Act 1983 s.107K(3).

105 Insolvency Act 1967 s.104(1)(e) as substituted by s.169 of the Accident Rehabilitation and Compensation Insurance Act 1992; see also ss.115(3) and (17) of the Accident Rehabilitation and Compensation Insurance Act 1992.

106 Radiocommunications Act 1989 s.183.

monies payable under the student loan scheme regime[107] and (j) monies payable to the Commissioner under the Child Support Act 1991.[108]

The Harmer Report successfully recommended that Crown priorities in Australia be removed completely:[109]

> In recent years there has been a significant reduction of the priority accorded to Crown debts in Australia. The Senate Standing Committee on Constitutional and Legal Affairs recommended the total abolition of all Crown priority (which included the Commissioner of Taxation) in its 1978 Report *Priority of Crown Debts*. This report was partially accepted....However the priorities which relate to employers and other persons being required to collect tax money and remit it to the Commissioner have largely been left untouched.[110]

The Harmer Report also noted that it had considered the option of limiting priority by reference to time or quantum of debt but that:

> ...in view of the overwhelming support for total abolition it has concluded that limiting the priority in this way is not appropriate.[111]

The overseas evidence is equivocal: in a number of countries (notably Australia, Denmark, Norway, Sweden and Finland) priority for taxation debts has been completely abolished whereas in other countries it remains - indeed, in some countries, on wider terms than those which apply in New Zealand at present.[112]

It is possible to make out a case for a system which would allow a priority payment for PAYE and GST (and possibly accident compensation levies) on the basis that, in essence, those are funds which should have been held

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107 Insolvency Act 1967 s.104(1)(e)(i),(ii) and (iii) as substituted by s.90(1) of the Student Loan Scheme Act 1992.

108 Insolvency Act 1967, s.104(1)(d)(iv) and Companies Act 1993, Schedule 7, cl.2(e). This debt may be better categorised as a wage related debt: see supra note 91.

109 Crown priorities on both bankruptcy and liquidation were removed as from 1 July 1993 by the Insolvency (Tax Priorities) Legislation Amendment Act 1993 ss.20-28.

110 Harmer Report, supra note 16, para 736 p 301.

111 Ibid, para 741 at p 303.

112 In particular I refer to Poland, where, under the Bankruptcy Law taxes and other public dues for a period of two years preceding the declaration of bankruptcy are payable as a priority debt; I also refer to the Republic of Ireland where up to one year's unpaid tax for capital gain tax, corporation tax, income tax and value added tax is payable as a priority together with up to 12 month's local property rates.

on trust for the Government by those who deduct the funds from source. But any such case would meet opposition in the form of the Tax Administration Act 1994 and the Income Tax Act 1994. First, under the PAYE rules, the Commissioner has the right to claim unpaid PAYE from the employee as well as the employer.[113] Second, unpaid tax deductions are made a charge on all real and personal property of the employer - though the insolvency consequences of this are uncertain.[114] Third, the Commissioner has an ability (in circumstances prescribed by the statute) to pursue unpaid tax liabilities under the Income Tax Act 1994 (which includes PAYE,[115] resident withholding tax[116] and non resident withholding tax[117]) against directors and shareholders of a company which has been unable to meet its tax obligations.[118] Given these additional protections for the Commissioner it is difficult to justify continued preferential status of such debts. Further, it is difficult to make a case for unlimited protection (in terms of time or quantum) for (particularly) GST and PAYE deductions when returns are made regularly to the Commissioner of Inland Revenue in respect of both of those items and the Commissioner is, therefore, probably in the best position of any creditor to determine when the debtor is getting into financial difficulties. GST and PAYE are usually the first payments to fall into arrears in such circumstances. A truly incentive based economy would require the Commissioner to act on the information which he or she was getting and therefore any priority accorded to such payments should be limited in time: a period of three months immediately preceding the commencement of the bankruptcy or liquidation process would be sufficient.

So far as other Crown priorities are concerned, it is difficult to make out a case for their retention as they mostly relate to ordinary debts and it is difficult to see why the Crown should be placed in any better position than ordinary citizens. There is no basis, in my view, for protecting the overall tax base in these ways to the detriment of trading creditors.

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[113] Tax Administration Act 1994, s.168(2). This rule extends to payments under s.115 of the Accident Rehabilitation and Compensation Insurance Act 1992 (where applicable): s.168(1).

[114] Ibid, s.169(2). This rule extends to payments under s.115 of the Accident Rehabilitation and Compensation Insurance Act 1992 (where applicable): s.169(1).

[115] Income Tax Act 1994, ss NC1-21.

[116] Ibid, ss NF 1-13.

[117] Ibid, ss NG 1-17.

[118] Ibid, s HK11(3) and (4).

All of the arguments for and against preferential status for Crown debts seem to have been considered in the Harmer Report. Some of the arguments which were rejected in the Harmer Report were that (a) taxation debts were owed to the community rather than to an individual; (b) the need to protect the revenue of the Crown and (c) the fact that the Commissioner has a statutory relationship with the taxpayer rather than a contract. The primary reason which persuaded the authors of the Harmer Report to recommend abolition of Crown preferential debts was that the Commissioner's priority assured the Revenue of payment and consequently operated as a disincentive for the Commissioner to recover debts in a commercial manner. If the Commissioner was allowing debts to aggregate the position of other unsecured creditors could be seriously disadvantaged.[119]

5. *Miscellaneous Priorities*

Finally, I come to the miscellaneous priorities. These appear to be a hotch-potch of items which from time to time appear to have gathered sufficient momentum to receive priority on bankruptcy or liquidation. In many cases, however, it is difficult to justify these priority payments. In some cases, the level of priority is so low that it has little effect in any event.

Examples of the miscellaneous priorities are: (a) claims made by persons who would otherwise be entitled to liens over books and papers of the insolvent entity;[120] (b) all sums that the Motor Vehicle Institute Incorporated is entitled to recover from a defaulting licensee under s.42 of the Motor Vehicle Dealers Act 1975 in the event of the company being put into liquidation;[121] (c) up to a limit of $200 per claimant, any sum ordered or adjudged to be paid under the Volunteers Employment Protection Act;[122] (d) monies paid in relation to lay-by sales;[123] and (e) amounts payable to a landlord in lieu of destraint.[124]

I do not propose to go through each of these miscellaneous priorities one by one. In each case it is necessary to test the justification for the payments before continuing to afford priority. In my view it would be difficult to make out any case whatsoever for continued preferential status for those classes of debts with the possible exception of layby sales.

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119 Harmer Report supra note 16, paras 734 and 735 at 299-301.

120 Insolvency Act 1967 s.104(1)(d)(iii); Companies Act 1993 Schedule 7 clause 2(f).

121 Companies Act 1993 Schedule 7 clause 2(h).

122 Volunteers Employment Protection Act 1973 s.15(1)(a); Companies Act 1993 Schedule 7 clause 2(i).

123 Layby Sales Act 1971 s.11(1) and (2)(c) and Companies Act 1993 Schedule 7 clause 3.

124 Companies Act 1993 Schedule 7 clause 11.

VII. Conclusions

As a result of the matters discussed in this paper I offer the following conclusions:

1. There is a need for all preferential debts to be scheduled in a clear, definitive and unambiguous manner.

2. For New Zealand purposes there is insufficient empirical research material to determine whether there remains a justifiable need for preferential payments other than administration costs. Such research is required before final views can be expressed on the justifiability of preferential debts as exceptions to the *pari passu* rule.

3. It is difficult to formulate a single litmus test against which preferential status can be judged. The Harmer Report suggested that preferential debts should not intrude unnecessarily on the law as it affects property and security rights and could encourage efficient insolvency administration.[125] The Colter Report pointed to the need to remove confusion and uncertainty in the distribution of an insolvent's realisable assets.[126] Both of those objectives are responsible and desirable.

4. I suggest that in determining whether a debt should be given preferential status the following questions should be asked:

a) What are the reasons which justify the type of debt in issue being paid in preference to debts owed to other unsecured creditors?

b) What factors militate against the grant of preferential status?

c) Is the proposed preferential debt likely to impact adversely on property and security rights? If so, in what way?

d) Is the granting of preferential status to the debt consistent with efficient insolvency administration?

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[125] Harmer Report, supra note 16, para 713 at pp 290-291.

[126] Colter Report, supra note 20, at 77-78.

The answers must then be weighed and a judgment made as to whether preferential status is justified.

5. The need for employee protection and the extent of it (including the possible extension of protection to persons in employee-like positions) needs careful consideration. As stated earlier the adoption of a Wage Earner's Protection Fund should not be dismissed out of hand. Protections given to the Crown also need careful thought. I tend at present to favour abolition of the Crown's preferential status but favour retention of employee preferential status in some form: However, relation to the latter, empirical research will need to be done before firm views can be expressed - particularly in light of the comments made by the Joint Insolvency Committee on the Status of Redundancy Payments Bill.

6. Overseas experience shows that there may be some merit in including as a preferential debt the costs incurred trying to put together a compromise for creditors when, ultimately, the compromise is unsuccessful.[127] Further consideration needs to be given to this issue.

As I have indicated, this article may do no more than skim the surface of an important and far reaching issue. I hope that it will act as a starting point for deeper consideration of the issues by law reform agencies.

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[127] In a discussion paper circulated to members of Committee J of the International Bar Association following the survey to which reference is made in fn 94 supra, this type of preference was recommended based on the results of the survey. This class of debt was to extend to debts contracted in "a reconstruction phase" if incurred with the authority of an official "supervisor".