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LAW·COMMISSION  
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*Study Paper 2*

PRIORITY DEBTS IN THE DISTRIBUTION  
OF INSOLVENT ESTATES  
AN ADVISORY REPORT TO THE  
MINISTRY OF COMMERCE

*October 1999*  
Wellington, New Zealand

The Law Commission is an independent, publicly funded, central advisory body established by statute to undertake the systematic review, reform and development of the law of New Zealand. Its purpose is to help achieve law that is just, principled, and accessible, and that reflects the heritage and aspirations of the peoples of New Zealand.

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## Preface

IN AUGUST 1998, the Law Commission announced it had been asked by the Ministry of Commerce to provide advice on whether existing classes of preferred creditors should continue to enjoy advantages over unsecured creditors when bankruptcy or liquidation intervened. The request for advice was made in the context of the pending review, by the Ministry of Commerce, of personal and corporate insolvency law. What follows is our report to the Ministry of Commerce which was made available to the Ministry on 26 May 1999.

In our recent report *Cross-Border Insolvency: Should New Zealand Adopt the UNCITRAL Model Law on Cross-Border Insolvency?* (NZLC R52) we referred to Wood, *Law and Practice of International Finance: Principles of International Insolvency* (Sweet and Maxwell, London, 1995) in which that learned author stated:

Insolvency law is the root of commercial and financial law because it obliges the law to choose. There is not enough money to go around and so the law must choose whom to pay. The choice cannot be avoided or compromised or fudged. The law must always decide who is to bear the risk so that there is always a winner and a loser. On bankruptcy it is difficult to split the difference. That is why bankruptcy is the most crucial indicator of the attitudes of a legal system and arguably the most important of all legal disciplines. (p 1)

The decision as to which creditors should be entitled to receive money in priority to others is the most fundamental aspect of that choice. It is the subject addressed in this study paper.

The Commission addresses the issue at two distinct levels:

- First, we consider the criteria which ought to be applied in determining whether any particular debt should be afforded preferential status; we then go on to consider what (if any) processes should be put in place to ensure a consistent approach in future legislation (see chapter 2);
- Second, we consider whether the existing preferences recorded in section 104 of the Insolvency Act 1967 and the Seventh Schedule to the Companies Act 1993 can be justified on the criteria which we have recommended (see chapters 3–6).

Insolvency law does not operate in a vacuum. As will be seen in this paper, changes in one area of insolvency law are likely to lead to consequences (adverse or favourable) in other areas of the law. We have endeavoured, so far as is practicable, to isolate some of the issues which will need further attention as a result of the recommendations we make in chapter 10 of this paper. In particular, we have referred to specific problems (which were raised with us by the Ministry of Commerce) with “phoenix companies” (chapter 8) and “gift vouchers” (chapter 9). Reference to the issue of phoenix companies was recently made in the *Independent* (“Labour pledges insolvency revamp”, “Labour urged to recarve the corporate corpse”, Wellington, New Zealand, 28 April 1999, 1 and 7). In

chapter 7 we have considered whether new priorities should be created in accordance with the principles expressed in chapter 2.

The Commissioners in charge of preparing this paper were DF Dugdale and Paul Heath QC. The research was conducted initially by Nicholas Russell and, after he left the employment of the Commission late last year, Jason Clapham. The Commission expresses its appreciation to both researchers.

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The Secretary for Commerce  
Ministry of Commerce  
PO Box 1473  
WELLINGTON

ATTENTION: Mr Mark Steel

26 May 1999

Dear Secretary

### **Priority Debts in the Distribution of Insolvent Estates**

Last year you asked the Law Commission to provide some advice to you on the question of preferential debts in insolvency.

I enclose herewith the Commission's Report. As agreed this report will be published by the Commission in due course. While we reserve the right to edit the report for publication purposes we assure you that the substantive parts of the report will not be changed.

Recommendations are set out in chapter 10 of the report. The recommendations address:

- the criteria which ought to be applied in determining whether any particular debt should be afforded preferential status;
- whether the existing preferences recorded in section 104 of the Insolvency Act 1967 and the Seventh Schedule to the Companies Act 1993 can be justified on the criteria recommended;
- whether any new statutory preferences should be considered;
- further research which may be required in the context of the insolvency law review.

As part of the first level of inquiry we have also considered whether new processes are required to ensure consistency in the application of the criteria we have recommended.

Our recommendations are based on information available to us at the date of preparation of this report. We recognise that our recommendations may require reappraisal in the context of empirical research which we have recommended be undertaken and in the light of further consultation undertaken by you.

Two other issues have been raised in discussions between your officials and representatives of the Commission which we have thought it necessary to address.

Those issues are:

- problems caused by the sale, as a going concern, of an insolvent business to a new entity which has similar, or the same, ownership as the insolvent entity (see chapter 8).
- problems in relation to gift vouchers (for instance, as occurred during the course of the *Levenes* and *Palmers Garden Centre* receiverships) (see chapter 9).

The first issue is perceived as primarily affecting employees of the insolvent entity, who may have no option but to seek employment with the new entity on very different terms from those on which they were originally engaged, without adequate redress existing for wages owing to them by the insolvent entity. The new entity is often referred to as a “phoenix company”.

While the term phoenix company connotes a transaction entered into in an endeavour to avoid an obligation imposed by insolvency law, the technique is unobjectionable provided the vendor is receiving true market value for sale of the assets. Inevitably, there will be doubts or suspicions as to its use when the business is transferred to someone who was involved with the operation of the previous entity, and the transfer has the effect of defeating valid claims of employees. In an endeavour to suggest a solution, we have referred to the Transfer of Undertakings (Protection of Employment) Regulations 1981 (UK), in particular regulation 5, as something worthy of consideration by your Ministry.

We are of the opinion that no changes should be made to the law of priorities as a result of the issues discussed in chapter 9 (gift vouchers).

Our review of the law has led us to the conclusion that to tamper with one area of insolvency law may well bring about unanticipated consequences in other areas of the law. A good example of this is the interaction between the extent of priority claims and the problem caused by the phoenix company (see chapter 8). We have endeavoured to indicate consequential problems where appropriate.

I trust that you will find our report helpful. The Commission remains willing and able to undertake further advisory work for the wider insolvency law review, should you wish us to do so.

Yours sincerely

*The Hon Justice Baragwanath*  
President



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# 1

## Introduction

### OUR BRIEF

- 1 **W**E HAVE BEEN ASKED BY THE MINISTRY OF COMMERCE to advise on the following issues:
- the criteria which ought to be applied in determining whether any particular debt should be afforded preferential status; and
  - whether the existing preferences recorded in section 104 of the Insolvency Act 1967 and the Seventh Schedule to the Companies Act 1993 can be justified on the criteria recommended.

While the Seventh Schedule is applicable to both liquidations and receiverships, we propose to refer only to liquidations unless the context requires otherwise.

- 2 In broad terms, insolvency means the inability of a person to meet debts or obligations as they fall due.<sup>1</sup> In New Zealand, an individual who is insolvent may be adjudged bankrupt. Bankruptcy can commence either on an application to the High Court by a creditor which results in an adjudication in bankruptcy<sup>2</sup> or, alternatively, the debtor may decide to file a debtor's petition in bankruptcy.<sup>3</sup> When a debtor is adjudged bankrupt, all property (as that term is defined in section 2 of the Insolvency Act 1967) passes to the Official Assignee who then realises that property for the benefit of the bankrupt's creditors.<sup>4</sup> In a bankruptcy, the assets available for distribution will also include all property acquired by, or which has devolved upon, a bankrupt prior to his or her discharge from bankruptcy.<sup>5</sup> Once the assets have been sold, the Official Assignee must pay the realised amount to the creditors of the bankrupt.<sup>6</sup>
- 3 Secured creditors<sup>7</sup> are the first to be paid in a bankruptcy. Following this, preferential debts must be paid. Any remaining proceeds are distributed rateably among the unsecured creditors. If a surplus remains, it is used to pay deferred creditors and interest to creditors. If there is still a surplus after all the creditors have been paid, it will be returned to the bankrupt.

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<sup>1</sup> *The Laws of New Zealand* (Butterworths, Wellington, 1992) vol 14, Insolvency, para 1.

<sup>2</sup> *The Laws of New Zealand*, above n 1, paras 84–112.

<sup>3</sup> *The Laws of New Zealand*, above n 1, paras 81–83.

<sup>4</sup> *The Laws of New Zealand*, above n 1, paras 81–83.

<sup>5</sup> Insolvency Act 1967, s 42(2).

<sup>6</sup> Insolvency Act 1967; see in particular s 104.

<sup>7</sup> Insolvency Act 1967, s 2(1) definition of "secured creditor". In effect, secured creditors stand outside the bankruptcy but retain a right to claim as an unsecured creditor for any shortfall on realisation of a security.

- 4 The following debts have priority over unsecured creditors in a personal bankruptcy:
- the fees and expenses incurred by the Official Assignee (section 104(1)(a));
  - costs and expenses incurred by the creditor in obtaining the adjudication of bankruptcy (section 104(1)(b));
  - arrears of wages or salary of any employee of the bankrupt, to a maximum of \$6000 per employee (section 104(1)(d)(i));
  - any money which a court orders to be paid to an apprentice of the bankrupt under section 23 of the Apprenticeship Act 1983, to a maximum of \$6000 per apprentice (section 104(1)(d)(ii));
  - holders of liens over books of the bankrupt as against the Official Assignee, to a maximum of \$100 ((s104)(d)(iii));
  - the Commissioner of Inland Revenue in respect of debts money under section 163(1) of the Child Support Act 1991 to a maximum of \$6000 (section 104(1)(d)(iv));
  - claims under section 6 of the Volunteer's Employment Protection Act 1973, by operation of section 15(1)(a) of that Act;
  - the Commissioner of Inland Revenue in respect of tax deductions held by the bankrupt (section 104(1)(e)(i));
  - the Commissioner of Inland Revenue in respect of student loan repayment deductions held by the bankrupt (section 104(1)(e)(ii));
  - the Accident Rehabilitation and Compensation Insurance Corporation in respect of earner premiums deducted from employees by the bankrupt (section 104(1)(e)(iii));
  - duty as defined by section 2(1) of the Customs and Excise Act 1996 (section 104(1)(e)(iv));
  - the Commissioner of Inland Revenue in respect of unpaid GST (Goods and Services Tax Act 1985, section 42(2)(a));
  - debts owing under the Radiocommunications Act 1989, by operation of section 183(4) of that Act;
  - levies payable to the Ministry of Agriculture and Fisheries under the Fisheries Act 1983, by operation of section 107K(3) of that Act;
  - debts owed by the bankrupt to a layby purchaser (section 11 of the Layby Sales Act 1971).
- 5 When a company becomes insolvent it can be placed in liquidation by its shareholders (section 241(2)(a) of the Companies Act 1993), its board (section 241(2)(b) of the Companies Act 1993) or by the High Court (section 241(2)(c) of the Companies Act 1993). When a company goes into liquidation its available assets are realised by the liquidator for the benefit of its creditors. A liquidator must first pay secured creditors<sup>8</sup> out of the proceeds realised. Next, the liquidator must pay those entitled to a preferential claim<sup>9</sup> and then distribute the proceeds rateably among all unsecured creditors (section 313(2) of the Companies Act 1993). If there is a surplus, it is to be distributed either in accordance with the terms of the company's constitution or in accordance with the default provisions of the Companies Act 1993.<sup>10</sup>

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<sup>8</sup> Companies Act 1993, s 2(1), definition of "secured creditor". Secured creditors may claim as unsecured creditors for any shortfall in the same way as occurs on bankruptcy: see above n 7.

<sup>9</sup> Companies Act 1993, s 312, and Seventh Schedule to the Companies Act 1993.

<sup>10</sup> Companies Act 1993, s 313(4).

- 6 The preferential claims which apply in the case of a company insolvency are set out in the Seventh Schedule to the Companies Act 1993.<sup>11</sup> That schedule also applies to companies which are placed in receivership (section 30 of the Receiverships Act 1993). The following have priority over unsecured creditors of an insolvent company in liquidation:
- the fees, expenses and remuneration of the liquidator;
  - the reasonable costs of the creditor in obtaining the order that the company be put into liquidation;
  - actual expenses necessarily incurred by the liquidation committee;
  - wages or salary owed to employees for work done in the four months before liquidation, to a maximum of \$6000 per employee;
  - holiday pay payable to employees, to a maximum of \$6000 per employee;
  - any deductions from an employee's wages or salary made to satisfy an obligation of the employee, to a maximum of \$6000 per employee;
  - the Commissioner of Inland Revenue in respect of debts money under section 163(1) of the Child Support Act 1991 to a maximum of \$6000;
  - holders of liens over books of the company as against the liquidator, to a maximum of \$500, by operation of section 263 of the Companies Act 1993;
  - any money which the Employment Tribunal orders to be paid to an apprentice of the company under section 23 of the Apprenticeship Act 1983;
  - where the liquidated company is a licensee company under the Motor Vehicle Dealers Act 1975, any sum which the Motor Vehicle Dealers Institute Incorporated is entitled to recover from the company under section 42 of that Act;
  - claims under section 6 of the Volunteers Employment Protection Act 1973, by operation of section 15(1)(a) of that Act, to a maximum of \$200 per claimant;
  - debts owed by the company to a layby purchaser or seller under sections 9 or 11 of the Layby Sales Act 1971;
  - the costs incurred in organising and conducting a meeting of creditors under section 234 of the Companies Act 1993;
  - Goods and Services Tax owed by the company under Part III of the Goods and Services Tax Act 1985;
  - the Commissioner of Inland Revenue in respect of tax deductions made by the company under the PAYE rules of the Income Tax Act 1994, non-resident withholding tax (NRWT) under the NRWT rules of the same Act, and resident withholding tax (RWT) under the RWT rules of the same Act;
  - debts owing under the Radiocommunications Act 1989, by operation of section 183(4) of that Act;
  - levies payable to the Ministry of Agriculture and Fisheries under the Fisheries Act 1983, by operation of section 107K(3) of that Act;
  - duty as defined by section 2(1) of the Customs and Excise Act 1996.
- 7 If a landlord or other person has seized goods or effects of a company in lieu of payment (distrained) within the month preceding the commencement of liquidation, the claims to which priority is given by the Seventh Schedule to the Companies Act 1993 become a first charge on the goods or effects or the proceeds from their sale. Where, however, money is paid to the distrainor under

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<sup>11</sup> This schedule is applied by s 312(1) of the Companies Act 1993.

any such charge the distrainor is subrogated to the rights of the preferential creditor (clause 11 of the Seventh Schedule to the Companies Act 1993). No similar provision exists under the Insolvency Act 1967.

## A POSSIBLE PROBLEM

- 8 Those portions of a debenture which are subject to a fixed charge currently take priority over the preferential debts listed in the Seventh Schedule to the Companies Act 1993. This may soon change. If the Personal Property Securities Bill (presently before Parliament) is passed in its present form, the distinction between fixed and floating portions of a debenture will have no legal significance. This is because the Personal Properties Securities Bill creates a new regime which involves perfected security interests. If that concept was carried through to its logical conclusion, the floating portion of a debenture (once the debenture is perfected) becomes, in effect, a fixed charge over circulating assets of the company. The present Bill seeks to continue the present regime, in a de facto sense, by creating a right to priority over accounts receivable and inventory of a company.<sup>12</sup>
- 9 On 16 February 1999, Fisher J delivered judgment in *Re Brumark Investments Limited (in receivership)* (High Court, Auckland, M753/98). His Honour held that it was legally possible to create a fixed charge over both existing book debts and future choses in action. As a result of that decision, the rights of the debenture holder to the book debts prevailed over the rights of preferential creditors in that case. To some extent, the case turned on the wording of the clause in the debenture.
- 10 It is clear that the proposed clause 9A is intended to bring about a result different from that reached by Fisher J in *Brumark Investments*. Thus, on the current wording of clause 9A, the rights of preferential creditors would prevail over the debenture holder in all cases to which the Bill applied.
- 11 Our provisional view is that the proposed clause 9A of the Bill reflects the proper balance between the interests of secured and preferential creditors. It creates a rule, known to all parties when a decision to lend is made, which provides an answer in all cases. The contrary position makes availability of "accounts receivable" for preferential creditors dependent on the wording of the particular instrument which creates the security interest. The cost involved for other creditors to review those clauses before deciding whether, and if so on what terms, to provide credit is likely to increase the cost of credit.
- 12 The Personal Property Securities Bill is presently being considered by a Select Committee. No doubt the issues which arise out of *Brumark Investments* will be considered by the Select Committee. As presently advised, we see no need for the Bill to be changed as a result of that case.

## CONSULTATION

- 13 We have written to interested organisations to seek submissions. All of the various agencies (both government and otherwise) which have responsibility

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<sup>12</sup> See the proposed new clause 9A of the Seventh Schedule to the Companies Act 1993 and the consequential amendment to s 30(1) of the Receiverships Act 1993. These are set out in Schedule 1 to the Personal Property Securities Bill.

for preferences were asked to provide submissions. We have received very thoughtful submissions ranging across a vast philosophical spectrum. At one end of the spectrum we received submissions based on a deontological approach; at the other, we received economic analyses. We are grateful for all submissions and also for the opportunity to debate issues of principle with members of the Joint Insolvency Committee established by the New Zealand Law Society and the Institute of Chartered Accountants of New Zealand. A complete list of all of those who made submissions is reproduced as Appendix A. We note, however, that the extent of our consultation has been influenced by the fact that this is an advisory report intended to focus issues for debate as part of the wider insolvency law review. For that reason, we have not undertaken any empirical research ourselves.

- 14 In Appendix B we reproduce the public announcement made by the Law Commission that it was reviewing the question of preferential debts at the request of the Ministry of Commerce. As Appendix C we reproduce a standard form letter which was sent to each of the entities responsible for administering the types of debt which are currently given preference.
- 15 The structure of this report is as follows:
  - In chapter 2 we deal with the factors which should be taken into account in assessing whether a particular debt should or should not receive priority on liquidation or bankruptcy.
  - In chapter 3 we deal specifically with administration costs.
  - In chapter 4 we deal with employee-related claims.
  - In chapter 5 we deal with revenue-related claims.
  - In chapter 6 we deal with the miscellaneous debts which, for various reasons, have been afforded priority.
  - In chapter 7 we consider whether any additional priorities should be recommended and, if so, the basis on which they can be justified.
  - In chapter 8 we deal with the topic of phoenix companies.
  - In chapter 9 we deal with the gift voucher issues raised by Ministry of Commerce officials.
  - In chapter 10 we conclude with our recommendations.

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## 2

# The basis for priority: principles and process

### THE PRINCIPLES

- 16 **T**HE CORK REPORT,<sup>13</sup> in its review of insolvency law in the United Kingdom said that:

Since the existence of any preferential debt militates against the principle of *pari passu* distribution and operates to the detriment of ordinary unsecured creditors, we have adopted the approach that no debt should be accorded priority unless this can be justified by reference to principles of fairness and equity which would be likely to command general public acceptance.<sup>14</sup>

- 17 In Australia, the Harmer Report expressed the principle in these terms:

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:

- It should not intrude unnecessarily upon the law as it otherwise affects property rights and securities and
- It should encourage the effective administration of insolvent estates.

Any departure from this approach should only be countenanced by reference to clearly defined principles or policies which enjoy general community support.<sup>15</sup>

- 18 The Harmer Report accepted the proposition that:

Insolvency law should, so far as it is convenient and practical, support the commercial economic processes of the community. (para 33)

but rejected a wider role which sees insolvency law:

As the guardian of values that seem appropriate in the conduct of the credit economy and as:

The vehicle for regulating the credit economy by imposing sanctions . . . upon those who misuse or abuse the credit facilities that are made available to them.<sup>16</sup>

- 19 In our view, the purpose of insolvency law is to provide rules based on notions of fairness and justice, which can be applied in any given case to avoid

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<sup>13</sup> *Insolvency Law and Practice Report on the Review Committee* Cmnd 8558, 1982, HMSO. (the "Cork Report")

<sup>14</sup> Cork Report, above n 13, para 1398, emphasis added.

<sup>15</sup> Australian Law Reform Commission, *General Insolvency Inquiry* (Report 45, 1988) (the "Harmer Report").

<sup>16</sup> Harmer Report, above n 15, para 33. See also Darvas, *Employees' Rights and Entitlements and Insolvency: Regulatory Rationale, Legal Issues and Proposed Solutions* (1999) 17 *Company and Securities Law Journal* 103, 106.

inefficiencies which would result from an individualised resolution of claims within a bankruptcy or liquidation. In an insolvency, it is axiomatic that loss will be suffered. The issue is how the incidence of loss will be borne. The granting of priority status to a creditor affects the incidence of loss as particular creditors may be paid in full while others receive little or nothing.<sup>17</sup>

20 We agree with Professor Goode that the fundamental principle of insolvency law:

is that of *pari passu* distribution, for creditors participating in the common pool in proportion to the size of their admitted claims. (Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell, London, 1990) 59)

Compelling reasons are required to justify departure from the *pari passu* rule.

21 The *pari passu* rule was enshrined as a rule of public policy by the House of Lords in *British Eagle International Airlines Limited v Compagnie Nationale Air France* [1975] 1 WLR 758; [1975] 2 ALL ER 390 (HL).<sup>18</sup> In New Zealand, the majority of the Court of Appeal in *Attorney-General v McMillan & Lockwood Limited* [1991] 1 NZLR 53 (CA), 58, approved Professor Goode's proposition that the principle of *pari passu* distribution is "the most fundamental principle of insolvency law".<sup>19</sup>

22 A number of rules have been developed to facilitate the orderly administration of insolvent estates which all recognise the overriding importance of the *pari passu* principle. Some examples are set out below:

- The right of an Official Assignee (on bankruptcy of an individual) or a liquidator (on liquidation) to seek recovery of property of an insolvent entity which has been disposed of in circumstances which gives a creditor an unfair advantage over other creditors of like priority.<sup>20</sup> Examples are the voidable gift, preference and securities provisions contained in sections 54, 56 and 57 of the Insolvency Act 1967, and the voidable transaction and charge provisions contained in sections 292 and 293 of the Companies Act 1993.<sup>21</sup>

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<sup>17</sup> This was emphasised recently by the Court of Appeal in *Fortex Group Limited (In Receivership) and (In Liquidation) v Mackintosh* [1998] 3 NZLR 171 in which it noted, in the context of a remedial constructive trust claim, that the courts should be wary of granting relief which would have the effect of re-ordering priorities on insolvency.

<sup>18</sup> More recently, however, it has been made clear in New Zealand that the *pari passu* rule does not prevent a creditor from waiving the right to participate in a distribution of assets at a lower priority than that to which it may otherwise be entitled: see *Stotter v Ararimu Holdings Limited* [1994] 2 NZLR 255 (CA) and, now, s 313(3) of the Companies Act 1993.

<sup>19</sup> The minority judge, Williamson J, noted however, that the *pari passu* rule had a qualified rather than a universal application to an insolvent company. The judge referred (at 63), by way of example, to the express provision for preferential debts and to indirect preferences such as those which existed for subcontractors under the Wages Protection and Contractors' Liens Act 1939. We discuss that Act in chapter 7.

<sup>20</sup> See *Gray v Chilton Saint James School* (1997) 8 NZCLC 261, 306 for the reasons why the disposition must be to a creditor of the insolvent entity and so give to that creditor an unfair advantage over other creditors of like priority.

<sup>21</sup> However, there have been difficulties encountered with the new Companies Act 1993 provisions as a result of the change from a regime based on "preferential intent" to "preferential effect", particularly in regard to the change to the wording of the "alteration of position defence". Those matters are discussed fully in Baragwanath J's judgment in *Re Excel Freight Limited (In Liquidation)*; *Tranz Rail Limited v Meltzer* (1999) 8 NZCLC 261, 827 at 261, 836 et seq. That issue, together with the vexed question of what constitutes a transaction entered into in the ordinary course of business, is one which will require further consideration in the wider insolvency law review.

- The provisions entitling a liquidator to attack transactions which have taken place for inadequate consideration (section 297 of the Companies Act 1993), transactions with related parties (sections 298 and 299 of the Companies Act 1993), and provisions which enable orders pooling the assets of related companies or requiring a contribution from one company to the other to be made (sections 271 and 272 of the Companies Act 1993).<sup>22</sup>
  - The legislative provisions which invalidate claims to preferential treatment by creditors who have levied, but have not completed, execution prior to the commencement of bankruptcy or liquidation (see section 50 of the Insolvency Act 1967 and section 251 of the Companies Act 1993). The intention is to ensure that only those creditors who have actually received the benefits of execution shall be entitled to retain those benefits as against an Official Assignee or Liquidator. The effect of that rule is to treat an execution creditor who has not completed execution as an unsecured creditor who must receive a distribution *pari passu* with other creditors.
- 23 Our starting point is that after payment of secured creditors, the proceeds of realisation of property of an insolvent entity should be distributed *pari passu* to remaining creditors *unless* there are compelling reasons to justify giving preferential status to a particular debt. No submissions made to us seriously challenged that starting proposition.<sup>23</sup>
- 24 We have endeavoured to articulate the policy factors which should be taken into account when determining whether compelling reasons exist to grant preferential status to any particular type of debt. We have come to the view that the following are the relevant policy factors:
- The existing policy which can be gleaned from legislation outside of the insolvency law framework. We would include, within that general framework, policy factors plainly discernable from international obligations undertaken by the New Zealand Government.<sup>24</sup>
  - The balancing of private rights should *generally* be given precedence over public interest issues. Because insolvency law draws lines which determine which creditors suffer more loss than others, it is the competing rights of those creditors which should be given paramountcy. While certain types of priority may be considered desirable on public interest grounds (for example, the desirability of protecting the country's revenue base,<sup>25</sup> the social

<sup>22</sup> The pooling and contribution orders have a bearing on the "Group" issue discussed in the context of phoenix companies and gift vouchers: see chapters 8 and 9.

<sup>23</sup> But see the submission of the Motor Vehicle Dealers Institute Inc. to which we refer at para 168.

<sup>24</sup> In the context of priority debts there is a particular issue involving International Labour Organisation Convention 173 to which reference is made at paras 45, 50, 62, and 66. Although New Zealand is a member of the International Labour Organisation (and was at the time the Convention was made) the Convention has not been ratified. For a discussion of the extent to which the courts can take into account policy underlying such a Convention, see *The Treaty Making Process: Reform and the Role of Parliament* (NZLC R 45, 1997) at paras 87–93. With respect to the International Labour Organisation, the same report noted that on one day in 1938, 22 Conventions of the International Labour Organisation were ratified in New Zealand (para 44 and fn 51) while no International Labour Organisation Treaty had been ratified in New Zealand for the 20 years preceding their report (para 156).

<sup>25</sup> See revenue priorities granted by, for example, cl 5 of the Seventh Schedule to the Companies Act 1993. See also chapter 5.



imperative involved in protecting employees,<sup>26</sup> and, in other jurisdictions, the priority afforded to the costs of remedying environmental damage),<sup>27</sup> the issue is whether it is appropriate *in the particular case* for these matters to be taken into account for insolvency law purposes. Care should be taken to ensure that social imperatives that might be taken into account cannot be met more readily through social welfare or other legislation.

- The need to create incentives for creditors to manage credit efficiently. The granting of preferential status to a class of debt may tend to reduce the incentive for a creditor to manage credit efficiently, as that creditor is more likely to receive payment from the realised assets of the insolvent. The cost of any laxity will be borne by other (unsecured) creditors.<sup>28</sup>
- The desirability of encouraging those who make credit available to fix the price of credit as low as possible. Fixing the cost of credit is an exercise in judgment based on the risk of non-recovery of the debt. Such encouragement can be given by limiting the number of creditors entitled to preferential status in an insolvency so that it is easier to assess whether a dividend is likely should the debtor be adjudged bankrupt or placed in liquidation. At present, unsecured creditors are unable to gauge accurately the extent to which preferential debts will bite into the realised assets of any particular insolvent. Accordingly, they are unable to take such debts into account fully when determining the terms upon which they are prepared to grant credit.<sup>29</sup>
- That, so far as possible, fine distinctions should not be drawn between various classes of creditors causing one class of creditor to bear a greater burden of unpaid debt.
- The impact (if any) which the (proposed) preferential debt has on transaction<sup>30</sup> or compliance costs.<sup>31</sup>

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<sup>26</sup> See the employee-related priorities granted by, for example, cl 2 of the Seventh Schedule to the Companies Act 1993; more generally see chapter 4.

<sup>27</sup> Martin and Ilchenko, *Amendments to the Bankruptcy and Insolvency Act – Bill C-5, Environmental Liabilities of Trustees and Receivers* (1997) 14 National Insolvency Review 19 (April 1997) and 40 (June 1997); see s 14.06(7) of the (Canadian) Bankruptcy and Insolvency Act 1982 (as amended in 1997) for the “super priority” charge given to the costs of remedying environmental damage caused by the debtor.

<sup>28</sup> It is noted that the Social Services Committee of the House of Representatives, when reporting on their Status of Redundancy Payments Bill, quoted statistics provided by the Ministry of Commerce indicating that in the period from 1 July 1997 to 31 January 1998 a nil dividend was declared to the general body of creditors in 88 per cent of personal bankruptcy proceedings and 96 per cent of corporate liquidation proceedings. We are unsure, however, whether these statistics relate solely to administrations carried out by the Official Assignee.

<sup>29</sup> Most secured indebtedness of companies can be ascertained from searching the Register of Companies or the Land Transfer Registry. Secured indebtedness of an individual can be established, at least to some extent, through searches of the Land Transfer Registry and the Chattels Transfer Registry established under the Chattels Transfer Act 1924. Accordingly, it is possible for creditors to make inquiry as to secured indebtedness in determining whether to extend credit. The same cannot be said in relation to preferential indebtedness. There are no means by which a creditor can establish the amount which may be owing as a preferential debt on bankruptcy or liquidation.

<sup>30</sup> For example, see para 11 which raises this issue in the context of the Personal Property Securities.

<sup>31</sup> As to compliance costs, see *Inquiry into Compliance Costs for Business, Interim Report of the Commerce Committee* (May 1998) and *Final Report of the Commerce Committee* (November 1998) to the House of Representatives.

Obviously, any other policy considerations relevant to a particular type of debt should also be taken into account.

- 25 In our view, having balanced the considerations to which we have just referred, it is necessary to stand back and make an objective judgment as to whether the proposed priority:
- is one which can be justified by reference to principles of fairness and equity likely to command general public acceptance;
  - intrudes unnecessarily upon the law as it otherwise affects property rights and securities; and
  - provides encouragement for the effective administration of insolvencies or, at least, does not provide any disincentive to administer insolvent estates efficiently.<sup>32</sup>

While we have taken the view that, generally, the balancing of private rights should be given precedence over public interest issues, there will, no doubt, be occasions when community expectations demand that public interest considerations be given primacy. In our view, it is entirely appropriate in a democracy for community expectations to be the value underpinning a priority, *provided* the grounds for the expectation are articulated clearly so that proper debate can take place as to whether priority status is the best way of achieving the policy goal.<sup>33</sup>

- 26 We address, in chapters 3, 4, 5, 6, and 7, various types of preferential debts with the above principles and policy considerations in mind.

## THE PROCESS

- 27 It is desirable that all preferential debts be scheduled in a clear, definitive, and unambiguous fashion, so that business people and those who administer insolvencies can readily identify the debts which will be given priority. This is not currently the situation. Preferences can be created not only through amendment to the Insolvency Act 1967 or the Companies Act 1993 but also by other statutes. For instance, preferences are contained in the Layby Sales Act 1971, Volunteers Employment Protection Act 1973, the Fisheries Act 1983, the Goods and Services Tax Act 1985, and the Radiocommunications Act 1989. Consequently, it is possible for preferential debts to be created without there being any consideration of the wider insolvency law implications. We add that the desirability of considering such matters in a wider context seems to have been endorsed by the Social Services Select Committee when reporting on the Status of Redundancy Payments Bill.<sup>34</sup>
- 28 In our view, a possible solution is to enact a provision akin to section 7 of the New Zealand Bill of Rights Act 1990 in the Insolvency Act 1967 and the Companies Act 1993. Under section 7 of the New Zealand Bill of Rights Act 1990, the Attorney-General is obliged, on introducing any Bill into the House of Representatives, to bring to the attention of the House any provision which

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<sup>32</sup> See Cork Report, above n 13, para 1398, and Harmer Report, above n 15, para 713.

<sup>33</sup> An example of community expectations in this context is the indirect preference granted through the operation of s 9 of the Law Reform Act 1936: see *Some Insurance Law Problems* (NZLC R46) paras 46–112.

<sup>34</sup> Status of Redundancy Payments Bill, Social Services Select Committee Report, 6.

appears to be inconsistent with any of the rights and freedoms contained in the Bill of Rights. That statutory obligation is supported by Standing Order 260 of the House of Representatives.

- 29 We favour the insertion of a similar provision into both the Companies Act 1993 and the Insolvency Act 1967. This provision would make it clear that any member of Parliament introducing a Bill into the House must indicate whether there is anything in the Bill which would affect the order of priorities set out in either section 104 of the Insolvency Act 1967 or the Seventh Schedule to the Companies Act 1993.
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## 3 Administration costs

### FEES AND EXPENSES OF LIQUIDATOR/ASSIGNEE

- 30 **U**NDER CLAUSE 1 OF THE SEVENTH SCHEDULE to the Companies Act 1993, the liquidator can meet his or her fees and expenses out of the funds realised from a company liquidation. The costs of the person who applied to the Court for an order putting the company into liquidation must also be paid out of the fund. These expenses must be paid before any of the company's debts are paid. The actual out-of-pocket expenses necessarily incurred by a Liquidation Committee in fulfilling its obligations under the Companies Act 1993 are also afforded priority by clause 1 of the Seventh Schedule.
- 31 Under section 104(1)(a) of the Insolvency Act 1967, the Assignee in a personal bankruptcy must pay, out of the funds collected: first, the remuneration of and the fees and expenses incurred by the Assignee; and secondly, the costs and expenses incurred by the creditor in procuring the order of adjudication.
- 32 Administration costs (except for costs and expenses incurred by the creditor which has procured the order of adjudication or liquidation) are not, strictly speaking, debts of the company. Rather, they are the collective costs of all creditors involved in realising the assets of the insolvent entity and distributing those assets among creditors in accordance with statutory priorities.
- 33 Submissions made to us generally reflected the need to continue this priority. The priority was accepted as an appropriate price to pay for proper co-ordination and management of the bankruptcy or liquidation process. It was suggested that nobody would be prepared to administer an insolvent estate if their costs were not given preferential status.
- 34 There was also general support for the priority status accorded to a creditor who incurred expenses to procure an order of adjudication or liquidation. It was suggested to us that if a creditor could not recover his or her expenses in procuring the bankruptcy or liquidation order, there would be no incentive to bring appropriate proceedings.

### CONCLUSIONS

- 35 In our view, it is clear that administration costs should receive priority for the following reasons:
- Administration costs are not pre-existing debts of the insolvent entity; they are costs incurred on behalf of the general body of creditors which should be borne by the creditors;
  - It would be difficult, if not impossible, to get qualified people to act as insolvency administrators if their costs were not met as a first charge on the estate.

- 36 We are also of the view that the existing priority for costs and expenses incurred by a creditor in procuring either an order of adjudication or an order of liquidation should retain preferential status. However, in our view, the amount of priority should reflect more closely the actual costs incurred by the creditor so that creditors do not issue such proceedings and suffer further loss. Both bankruptcy and liquidation proceedings are brought on behalf of the general body of creditors and, therefore, may not be withdrawn without leave of the court.<sup>35</sup> If a creditor is given leave to withdraw after receiving payment for a debt, and there is subsequently an order of adjudication or liquidation made at the request of a substituted creditor,<sup>36</sup> the first creditor will be at risk of losing the fruits of its proceeding as a result of the application of the doctrine of relation back.
- 37 In our view, a petitioning creditor should be entitled to preferential status for the reasonable solicitor/client costs and disbursements incurred when procuring an order. The amount can be left to the liquidator or the Official Assignee to assess. They have a good sense of what is reasonable in this context. If the Official Assignee or liquidator disallows any portion of the claimed costs, there should be a right for the creditor to appeal in the same way that a creditor currently appeals to the court against an Official Assignee's or a liquidator's decision to reject a proof of debt.<sup>37</sup>
- 38 We take the view that the actual expenses incurred by a Liquidation Committee should receive priority. Members of the Liquidation Committee serve as representatives of the general body of creditors and are performing a function for the collective benefit of creditors. Accordingly, their out-of-pocket expenses should be paid. But, we would go further and recommend that where a majority in number and 75 per cent in value of creditors resolve to pay remuneration to members of a Liquidation Committee that remuneration should also be treated as an administration cost. To safeguard the possibility of abuse by creditors, we would suggest that any creditors who object to the resolution have a right to apply to the court to reverse it. In our view, the court should only interfere if satisfied that there has been an abuse of process in the sense that the resolution is not bona fide or has been made for an ulterior purpose. Generally, we foresee the Court's supervisory jurisdiction only arising in cases of "tainted votes" of the type discussed in *Re Farmers' Co-operative Organisation Society of New Zealand Limited* [1992] 1 NZLR 348 in the context of a scheme of arrangement under section 205 of the Companies Act 1955. The right to pay remuneration to members of a Liquidation Committee may be particularly beneficial in large or complex liquidations, especially where expert assistance is needed to realise assets.
- 39 There is also a need to synthesize the provisions of the Insolvency Act 1967 and the Companies Act 1993 in relation to the granting of remuneration to those assisting the Official Assignee or liquidator in an official capacity. Section

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<sup>35</sup> For example, Insolvency Act 1967, s 26(10).

<sup>36</sup> As to the right to substitute, see, for example, s 26(9) of the Insolvency Act 1967.

<sup>37</sup> For example, Insolvency Act 1967, s 89.

104 of the Insolvency Act does not deal with this matter specifically, but it is clear that such costs are given status as administration costs under section 41<sup>38</sup> of the Insolvency Act 1967. We recommend that an amendment be made to the Insolvency Act 1967 to reflect the changes which we have proposed for remuneration to a Liquidation Committee.<sup>39</sup>

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<sup>38</sup> Insolvency Act 1967, s 41(1) and (2) which gives creditors powers to approve remuneration of an expert or a committee of creditors to be paid out of the estate as a cost of administration. Under s 41(2), the Court's approval is needed to approve remuneration to committee members.

<sup>39</sup> See paras 38 and 241.

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## 4

# Employee-related claims

### INTRODUCTION

- 40 **S**ECTION 104(1)(d) OF THE INSOLVENCY ACT 1967 provides that the third preferential payment to be made in a bankruptcy is:
- all arrears of wages or salary of any servant or worker, whether or not earned wholly or in part by way of commission, and whether payable for time or for piece work, due at the adjudication in respect of services rendered to the bankrupt during the 4 months immediately preceding the adjudication, including all holiday pay becoming payable to any servant or worker (or in the case of his death to any other person in his right) on the termination of his employment before or by the effect of the adjudication
- 41 Clause 2 of the Seventh Schedule to the Companies Act 1993 provides that after paying the administration costs of the winding up, the liquidator must next pay:
- (a) . . . all wages or salary of any employee, whether or not earned wholly or in part by way of commission, and whether payable for time or for piece work, in respect of services rendered to the company during the 4 months preceding the commencement of the liquidation . . .
- (b) . . . holiday pay becoming payable to an employee (or where the employee has died, to any other person in the employee's right) on the termination of the employment before or by reason of the commencement of the liquidation:
- (c) Amounts due in respect of any compensation or liability for compensation under the Workers' Compensation Act 1956 accrued before the commencement of the liquidation:
- (d) . . . amounts deducted by the company from the wages or salary of an employee in order to satisfy obligations of the employee:
- 42 The preference is limited to \$6000 in both company and personal insolvencies (section 104(1)(d)(i) of the Insolvency Act 1967 and clause 6 of the Seventh Schedule to the Companies Act 1993).<sup>40</sup> The preference is limited to wages due to an employee in respect of services rendered by the employee to the insolvent during the four months preceding the bankruptcy.<sup>41</sup>

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<sup>40</sup> When the Status of Redundancy Payments Bill was reported back to Parliament by the Social Services Committee a suggestion was made by the minority members (Labour and Alliance) that redundancy compensation should apply within the \$6000 cap, as an interim measure, until the insolvency law review was complete. The minority members said, in support of that, that the evidence before the committee did not identify the \$6000 cap as a specific problem with regard to wages and holiday pay (pp 6 and 7).

<sup>41</sup> Insolvency Act 1967, s 104(1)(d), and Companies Act 1993, cl 2(a), Seventh Schedule.

## THE ISSUES

- 43 A number of issues arise when considering preferential debts for employees. In this chapter we consider issues in relation to: employees, contractors, directors, redundancy, Wage Earner Protection Funds, and the Volunteers Employment Protection Act.
- 44 In considering the preference for employee-related claims, it is helpful to bear in mind the following observations of Judge Learned Hand in *Re Lawsan Electric Co Inc* 300 F 736 (SDNY 1923) where the judge said:
- Priority of payment was intended for the benefit of those who are dependent upon their wages, and who, having lost their employment by the bankruptcy, would be in need of such protection.
- The statute was intended to favour those who could not be expected to know anything of the credit of their employer but must accept a job as it comes, to whom the personal factor in employment is not a practical consideration.
- 45 It is also useful to remember:
- that employee-related claims are given some degree of protection throughout the world;<sup>42</sup>
  - that New Zealand is a member of the International Labour Organisation which prepared the Convention on the Protection of Worker's Claims (Employer Insolvency) 1992. The Convention requires the protection of workers' claims to be achieved either by grant of a privilege or by a guaranteed institution such as a Wage Earner Protection Fund. Although New Zealand is a member of the International Labour Organisation, the Convention has not yet been ratified in New Zealand.<sup>43</sup>

## EMPLOYEES<sup>44</sup>

- 46 Those who have submitted that the employee priority should be removed completely have put forward the following reasons to support that view:
- The priority infringes the *pari passu* rule.
  - The humanitarian aim of protecting employees is better accomplished through social welfare legislation than through priorities created in insolvency law. The humanitarian objective is a matter of public interest and social

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<sup>42</sup> This conclusion is reinforced both by Wood (Wood, *Law and Practice of International Finance: Principles of International Insolvency*, 24, paras 1–39) and the survey of preferential debts carried out by the Bankruptcy Legislation Sub-Committee of Committee J of the International Bar Association through its Taskforce on Priority Claims in Insolvency Administration presented to its meeting in New Orleans, USA on 11 October 1993. The countries which responded to the survey were Australia, Bermuda, Bulgaria, Canada, Czech Republic, Denmark, England and Wales, Finland, Ireland, Italy, New Zealand, Norway, Poland, Romania, Spain, Sweden and USA.

<sup>43</sup> See n above 24 where further reference is made to the International Labour Organisation Committee.

<sup>44</sup> We have not given consideration in this Report to the "sacred" lien given by admiralty law which entitles a seaman to recover wages by maritime lien against a ship. Such a lien outranks even contractual securities such as a mortgage over a ship. We note that this lien constitutes a possible anomaly in relation to the preferential status given to land-based employees: in para 24 we recognise that fine distinctions should not be drawn between various classes of creditors. We are of the view that it is necessary, when considering whether claims for wages



order whereas the priority regime is a rules-based mechanism to allocate risk among creditors and is, therefore, a matter of private law.

- The establishment of a Wage Earner Protection Fund, such as that operated in the United Kingdom, would achieve the objective of ensuring employees were paid without impacting adversely on other creditors.<sup>45</sup>
- Employees (contrary to conventional wisdom) may be less prejudiced by insolvency than other creditors because, generally, employers continue to pay wages even after they start to default on other debts. In many cases, employees will only miss one single payment of wages. Other creditors may remain unpaid for a significant period of time.

47 Those who support retention of the priority do so for the following reasons:

- An employee is less able, either at the commencement of employment or periodically thereafter, to evaluate the financial position of an employer. Even if it were possible for such an assessment to be made, it is unlikely that an employee would have the same flexibility as a contractor or creditor to withdraw their services from the market. Employees may not be aware that the employer is facing financial distress and are unlikely to be able to diversify risk or obtain security for earnings.
- If employees were relegated to the status of unsecured creditors, there may be stronger incentives for them to act collectively to demand more frequent wage payments or to desert a firm which shows signs of financial distress.<sup>46</sup>
- The employment relationship is one qualitatively different from other trading relationships and is founded on implied mutual obligations of trust and confidence (see *Aoraki Corporation Limited v McGavin* [1998] 3 NZLR 276 (CA) at 285 (per Richardson P, Gault, Henry, Keith, Blanchard and Tipping JJ and at 305 per Thomas J)). Emphasis has been placed on the implied mutual obligations of trust and confidence and also on the fact that, generally, there will be but one employer and one source of income for any one employee.

48 One submission we received suggested that the maximum amount payable should be increased from \$6000 per employee to \$20 000 per employee.<sup>47</sup> However, in its thoughtful and moderate submission, the New Zealand Council of Trade Unions suggested retaining the \$6000 limit for priority while expanding the categories of entitlements which fall within it.<sup>48</sup>

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should be preferential, to consider whether there are any valid distinctions remaining between arrears of wages owing to maritime employees and those who work on land. However, as there is a much wider (and international) issue relating to the protection of seamen's wages we prefer simply to note the anomaly and to indicate that we are prepared to consider the issue further should the Ministry wish us to do so. In the meantime we draw the Ministry's attention to a very helpful paper by Gollin, *Sacred Liens and Preferential Claims: Should the Wage Claims of Seamen Continue to Outrank those of Other Employees of an Insolvency Debtor?* (dissertation for a Master of Commercial Law degree, University of Auckland, 1998).

<sup>45</sup> See paras 85–89 where Wage Earner Protection Funds are discussed.

<sup>46</sup> The New Zealand Council of Trade Unions reminded us of the (possibly) apocryphal story of the trade union official who suggested that wages should be paid daily at lunchtime: "We'll trust the boss in the morning, he can trust us in the afternoon!"

<sup>47</sup> Submission by National Distribution Union dated 30 October 1998, 2.

<sup>48</sup> See further paras 79–82.

- 49 We now address some specific issues raised in the context of employee-related claims.

## THE RIGHT TO PRIORITY

- 50 We are of the view that compelling reasons exist that justify a priority for wages to employees on insolvency of the employer. Our reasons for reaching that view can be summarised as follows:
- Outside of insolvency law, there is clear evidence of an intention to protect employees. For example, sections 4, 5 and 12 of the Wages Protection Act 1983 ensure that no deduction can be made from wages payable to an employee without written consent and, further, prohibit the imposition of any requirement by an employer that an employee expend wages in any particular way.<sup>49</sup> Another example is the right of an employee to apply to the Employment Tribunal or the Employment Court for remedies as a result of any personal grievance.<sup>50</sup> The implied mutual obligations of trust and confidence to which we refer at paragraph 47 are entirely consistent with this approach.
  - New Zealand is a member of the International Labour Organisation which has produced a Convention<sup>51</sup> called the Protection of Workers' Claims (Employer Insolvency) Convention 1992. That Convention requires that workers' claims be protected either by grant of privilege on insolvency or by a guaranteed institution such as a Wage Earner Protection Fund.<sup>52</sup> Although the New Zealand Parliament has not incorporated the provisions of the Convention into municipal law, New Zealand's membership of the International Labour Organisation and the adoption of the Convention by that body might be treated as evidence of New Zealand public policy by a court.<sup>53</sup>
  - The object is to protect the vulnerable employee. An employee at arm's length from the employer (compare our discussion of director employees at paragraphs 51–55) is less able to evaluate the financial position of an employer at any given time. Accepting the public policy considerations which are relevant to protecting the vulnerable, we believe it can be fairly be said that there is a community expectation that employees should be protected to a degree on the insolvency of their employer. Community outrage which followed the non-payment of employees in both New Zealand and Australia in cases involving stevedores<sup>54</sup> is a recent manifestation of this community expectation.

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<sup>49</sup> Such protections stem back to the Truck Acts in the United Kingdom during the reign of Edward IV. Legislation was passed in the 19th century to prevent employers from paying employees in the form of vouchers redeemable only at shops operated by the employer where goods were often sold at inflated prices: for background see *Davies v Dulux NZ Limited* [1986] 2 NZLR 418, 421–424.

<sup>50</sup> Employment Contracts Act 1991, ss 26–42.

<sup>51</sup> International Labour Organisation, Convention 173.

<sup>52</sup> Protection of Workers' Claims (Employer Insolvency) Convention 1992, article 3.

<sup>53</sup> Generally, see *A New Zealand Guide to International Law and its Sources* (NZLC R34, 1996) at para 70 and *The Treaty Making Process: Reform and the Role of Parliament* (NZLC R45, 1997) at paras 87–93. See also *Van Gorkom v Attorney-General* [1977] 1 NZLR 535 at 542–543 and *Re Drummond Wren* [1945] 4 DLR 644.

<sup>54</sup> We refer to New Zealand Stevedoring Company Limited and its subsidiaries (in New Zealand) and *Patrick Stevedores Operations No 2 Pty Limited v Maritime Union of Australia* (1998) 72 ALJR 873 to which we refer in more detail in chapter 8, see in particular para 222.

For the reasons we have given, we believe that the existing priority can be justified and that the factors we have raised supporting it outweigh those to the contrary. The priority should be expressed as being limited to employees who have the right to bring a personal grievance under the Employment Contracts Act 1991.<sup>55</sup>

## THE EXTENT OF PRIORITY

### *Director employees*

- 51 Consideration also needs to be given to the possibility that directors of a company may enter into employment contracts which have benefits on liquidation akin to those received by employees. A director of a company (if also a shareholder) may, by these means, elevate himself or herself in status from a shareholder (entitled to payment after *all* creditors have been paid) to a preferred creditor (who receives lost remuneration before the general body of unsecured creditors).
- 52 The position of a director is quite different to that of a typical employee. Ordinarily, directors will have access to financial information about the company on an ongoing basis, and will also be involved in the decision-making processes of the company. Some jurisdictions have dealt with this problem by expressly excluding directors from the employee priority. For example, in Canada, an officer or a director of a company is not eligible to receive preferential wages or salary (section 140 of the Bankruptcy and Insolvency Act 1992).<sup>56</sup> Similarly, in Norway, preferential wages will be denied if considerable influence could have been, or was, exerted over the management of the company by the claimant.<sup>57</sup>
- 53 In our view, a person who is in a management role within a company, and is, therefore, involved in the decision-making processes of the company, should not be treated as a preferential creditor on bankruptcy. The aim of the preference is to protect the vulnerable employee who is not engaged in management and does not have access to the financial information of the employer. A provision which expressly excludes directors from priority will avoid the possibility of directors writing for themselves favourable employment contracts which, effectively, elevate themselves to the status of preferred creditor.
- 54 The term “director” is already defined in wide terms by section 126 of the Companies Act 1993 to include those who are in a management role: that is, *de facto* as well as *de jure* directors. We do not see any particular difficulty arising from the possibility of beneficial employment contracts being written for relatives who do not carry out the work; in a claim for wages, a liquidator would have to be satisfied that there was a bona fide employment contract under which the employee was entitled to remuneration. Otherwise, the claim would be rejected.
- 55 We have also considered whether shareholders of a company should be denied priority for wages owing to them. We have decided against this because a shareholder may be employed by a company yet have neither any say in the

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<sup>55</sup> See para 59.

<sup>56</sup> In Canada, a director is also personally liable to pay unpaid employee debts: Business Corporations Act, s 119.

<sup>57</sup> Para 9–3 of the Satisfaction of Claims Act 1994 (Norway). See also, Cantlie, “Preferred Priority in Bankruptcy” in Ziegel (ed) *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, Oxford, 1994) 415.

management of its affairs nor access to financial information on the basis of which the company trades. Accordingly, we can see no basis on which to deprive shareholders, per se, of preferential entitlement in respect of wages. A shareholder who is involved in the management of a company is likely to be caught by the prohibition against priority for director employees because of the wide definition of "director" which we think should be adopted.

### *Contractors*

- 56 An issue arises as to whether independent contractors who are dependent upon a particular person for their income should be entitled to the same preference as employees (for example, an owner-driver who earns income exclusively for one company).<sup>58</sup> There were differing views among those who made submissions to us on this issue. The opposing arguments can be summarised as follows:
- To differentiate between an employee and an independent contractor who works exclusively for a particular party draws too fine a distinction. Any person who is contracted (whether by an employment contract or otherwise) to carry out work for hire or reward should be included in the priority status.
  - A person who operates as an independent contractor has a degree of flexibility which is not possessed by a person subject to an employment contract. Indeed, flexibility of working hours and non-exclusivity of service are generally terms to be found in contracts providing for independent contractors. To that extent, an independent contractor's position is more closely analogous to that of a trade creditor who supplies products to the debtor. Such a supplier might also be entirely dependent upon a particular customer for business viability.
- 57 In our view, compelling reasons do not exist to treat independent contractors on the same footing as employees. While it is true that there are some independent contractors whose situations are closely analogous to those of employees (for example, those who are entirely dependent upon one particular entity for the whole of their income) there remains, nevertheless, a fundamental difference, enshrined in the way in which the Employment Contracts Act 1991 is drafted, between a contract of service (an employment contract) and a contract for services (an independent contractor).<sup>59</sup>
- 58 Cooke P observed, in *TNT Worldwide Express (NZ) Limited v Cunningham*,<sup>60</sup> that section 2 of the Employment Contracts Act 1991 is plainly intended to

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<sup>58</sup> This issue is discussed in P Heath, "Preferential Payments on Bankruptcy and Liquidation in New Zealand: Are they Justifiable Exceptions to the Pari Passu Rule?" (1996) 4:2 Waikato Law Review 24, 43. Some support for this view can be found in the approach of the Court of Appeal to distress damages which, while held not to be generally claimable in a commercial relationship (*Bloxham v Robinson* (1996) 7 TCLR 122 (CA)), may be ordered to an owner-driver who, while an independent contractor, is regarded as in a position analogous to an employee who could seek distress damages under s 40(1)(c)(i) of the Employment Contracts Act 1991: *Andrews v Parceline Express Limited* [1994] 2 ERNZ 385 (CA).

<sup>59</sup> *TNT Worldwide Express (NZ) Limited v Cunningham* [1993] 3 NZLR 681 (CA) at 687–689 (Cooke P), 694 (Casey J) and 701 (Robertson J). This should be compared with the observations of Mr D E Hurley sitting as an adjudicator in the Employment Tribunal at first instance in *Cunningham v TNT Worldwide Express (NZ) Limited* [1992] 1 ERNZ 956 to which Casey J referred as an "interesting and careful decision" (see 693 of *Cunningham* in the Court of Appeal) and *New Zealand Couriers Limited v Curtin* [1992] 3 NZLR 562.

<sup>60</sup> [1993] 3 NZLR 681 (CA) at 689.

preserve existing distinctions between a contract of service and a contract for services. Furthermore, no adequate distinction can be drawn between an independent contractor who provides labour to a particular entity on which he or she is dependent for income and a business which is entirely dependent on a particular buyer for goods which it manufactures. The latter has no statutory priority rights on insolvency.

- 59 We take the view that independent contractors should not be entitled to the same priority as that enjoyed by employees. It is clear that the Employment Contracts Act 1991 did not intend to alter the historical distinction drawn between employees and independent contractors and so, we conclude, that protection should remain only for employees.

### *Redundancy payments*

- 60 Differing views have been expressed as to whether the priority should be extended to cover redundancy payments. The opposing arguments are:

- Given the discretionary and indeterminate nature of payments for redundancy compensation, it would be difficult to justify a higher priority for redundancy payments than for other debts owing to unsecured creditors. It is argued that redundancy payments are not remuneration but represent compensation for the loss of an employment opportunity and that employees can negotiate for higher wages instead of redundancy payments;
- In those cases where entitlement to redundancy is linked to wages received or to holiday pay, they are contractual entitlements which are part of the employment contract package. It is argued that it is inappropriate for some entitlements under an employment contract to be granted priority while others are not.

- 61 An attempt was made in 1996, following the collapse of the Weddel freezing works, to add redundancy payments to the list of employee benefits entitled to preferential treatment on insolvency. The Explanatory Note accompanying the Bill, introduced by Mr R Barker MP as a Private Member's Bill, stated:

The initial idea for such a bill arose in the wake of the collapse of the Weddel meat works. The workers found that they had to line up with other unsecured creditors for their redundancy payments. It seems unlikely that any of Weddel's unsecured creditors will ever see what is owed them.

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 contracts.

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.

- 62 While New Zealand has not ratified the International Labour Organisation's Convention 173,<sup>61</sup> it has been ratified by Australia. In Australia, priority status has been afforded to retrenchment of payments (analogous to redundancy payments) in company law by section 556(1)(e) of the Corporations Law.

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<sup>61</sup> See paras 24, 45, 50, and 66.

- 63 The Select Committee reporting on the Status of Redundancy Payments Bill recommended that the Bill should not proceed because the issues raised before the Select Committee should be considered in the context of the insolvency law review.<sup>62</sup> However, the minority view of Labour and Alliance members of the Select Committee was that, as an interim measure until the insolvency law review was complete, redundancy compensation should apply within the existing \$6000 limit for wage claims which had preferential status.<sup>63</sup>
- 64 In support of the view that redundancy payments should be included within the preferential debt for wages, it can be said that:
- As a member of the International Labour Organisation, New Zealand has an international obligation on which it should act by either creating a Wage Earner Protection Fund or providing preferential status to redundancy payments;<sup>64</sup>
  - There is no suggestion in the literature on this topic in Australia that ratification of the International Labour Organisation's Convention and the granting of preferential status to retrenchment payments has caused any economic difficulty.<sup>65</sup>
- 65 Despite the absence of any empirical evidence from Australia suggesting difficulties caused by the addition of the redundancy priority, there are some genuine concerns of both an economic and consequential nature.<sup>66</sup> These are the impact of an extended priority on the cost of credit and whether giving preferential status to one set of employees could transfer the hardship of insolvency to another set of employees. The position is, perhaps, best put by the Joint Insolvency Committee<sup>67</sup> in a submission to the Select Committee considering the Status of Redundancy Payments Bill:

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.<sup>68</sup>

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<sup>62</sup> Report on Status of Redundancy Payments Bill, above n 34, vi.

<sup>63</sup> Report on Status of Redundancy Payments Bill, above n 34, vi–vii.

<sup>64</sup> Report on Status of Redundancy Payments Bill, above n 34, v–vi.

<sup>65</sup> However, it might be inferred that the extent of preferential debts is a factor in corporate structuring which has led to the problems caused through the use of the phoenix company. See further chapter 8, paras 221–230.

<sup>66</sup> Discussed in detail in P Heath, "Preferential Payments on Bankruptcy and Liquidation in New Zealand: Are they Justifiable Exceptions to the *Pari Passu* Rule?" (1996) 4:2 *Waikato Law Review* 24, 43–46.

<sup>67</sup> Established in February 1994 by the New Zealand Law Society and the Institute of Chartered Accountants of New Zealand to consider insolvency law reform issues.

<sup>68</sup> Joint Insolvency Committee "Submission to the Labour Select Committee on the Status of Redundancy Payments Bill".

- 66 We are not prepared to recommend, at this stage, extension of the employee priority to cover redundancy payments. Should the New Zealand Government give effect to its international obligations to which the Select Committee referred,<sup>69</sup> it can do so by more than one means. Either it can grant preferential status to redundancy payments or it can establish a Wage Earner Protection Fund.<sup>70</sup> We believe that empirical research is required before deciding whether:
- it is appropriate in New Zealand to give redundancy payments priority on bankruptcy, receivership or liquidation; or
  - a Wage Earner Protection Fund should be established; or
  - no change should be made to the existing law.

### *Award for lost wages*

- 67 So far as awards under the Employment Contracts Act 1991 are concerned, there is a case for including, among preferential wages, awards made under section 40(1)(a) of the Employment Contracts Act which constitute reimbursement of wages lost as a result of wrongful dismissal. We see no case for giving priority to awards under section 40(1)(c) of the Employment Contracts Act. All forms of distress damages would need to be preferential to justify such an approach. They are not; and there is no suggestion they should be.
- 68 In our view, a claim under section 40(1)(a) of the Employment Contracts Act should be covered by the employee priorities to the extent that it relates to wages. It would still need to fall within other relevant time limitations; that is, the obligation to pay should have arisen within the relevant four-month period.
- 69 Other money lost by the employee as a result of the grievance which the Tribunal or Court may order be reimbursed should not be given priority status *unless* it would have had priority if the court had not intervened.<sup>71</sup>

### *Apprentices*

- 70 Apprentices are given priority under clause 2(g) of the Seventh Schedule to the Companies Act 1993 and under section 104(1)(d)(ii) of the Insolvency Act 1967. Clause 2(g) of the Seventh Schedule to the Companies Act 1993 provides that any amount under section 23 of the Apprenticeship Act 1983 (which is deemed to form part of an apprenticeship contract by virtue of section 16 of the Industry Training Act 1992) which is ordered to be paid to an apprentice by the Employment Tribunal is a preferential debt. Section 23 of the Apprenticeship Act 1983 provides that where an employer of an apprentice is wound up, the court may award the apprentice three months wages to be paid as a preferential debt. The Apprenticeship Act 1983 was repealed in 1992 by the Industry Training Act 1992. The Industry Training Act 1992 provides that section 23 of the Apprenticeship Act applies to apprenticeship contracts which were registered under the Apprenticeship Act and which were in force immediately before 1 July 1992.<sup>72</sup>

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<sup>69</sup> See para 64.

<sup>70</sup> See discussion at paras 85–89.

<sup>71</sup> See the discussion of employee deduction debts in chapter 5 at paras 108–133.

<sup>72</sup> Industry Training Act 1992, s 16.

- 71 Section 104(1)(d)(ii) of the Insolvency Act 1967 provides that sums ordered by the court to be paid to an apprentice under section 83 of the Insolvency Act 1967 are preferential debts. Section 83 of the Insolvency Act originally provided that if any money had been paid by an apprentice to a bankrupt employer as an apprentice fee or premium, the Court may order a sum to be paid out of the bankrupt's estate to the apprentice. Section 83 was amended in 1983 by the Apprenticeship Act. Section 83, as amended, no longer provides that the court can order sums to be paid to an apprentice.
- 72 The Department of Labour has advised us that there are likely to be few, if any, of these contracts still in force. The Department has told us that it is aware of only two awards made under section 23 of the Apprenticeship Act in the Employment Tribunal since the Industry Training Act came into force, both in 1993. The Department stated that "it is unlikely that the issue of priorities under section 23 would arise now in practice". The Department of Labour did not support the retention of the preference.<sup>73</sup>
- 73 As the reasons for the apprentice preference are now largely spent, it is unnecessary to retain the preference. Accordingly, we recommend abolition of the preferences granted for apprentices under both the Companies Act 1993 and the Insolvency Act 1967.

#### *Volunteers Employment Protection Act*

- 74 Section 15 of the Volunteers Employment Protection Act 1973 provides that any sum ordered or adjudged to be paid as compensation under section 6 of that Act shall be a preferential debt both in bankruptcy and liquidations (see also clause 2(i) of the Seventh Schedule to the Companies Act 1993). The priority is limited to \$200.<sup>74</sup>
- 75 Section 6 of the Volunteers Employment Protection Act provides that every employer commits an offence if the employment of an employee is terminated because the employee volunteered for, or underwent, any protected voluntary service or training. Where an employer has committed an offence against section 6, the Court may order the employer to pay to the worker a sum not exceeding an amount equal to 16 weeks of the employee's remuneration.<sup>75</sup>
- 76 Compensation under section 6 of the Volunteers Employment Protection Act 1973 relates to dismissal. Other awards made as compensation for dismissal do not currently have priority status; although, we recognise that we are recommending incorporation of relevant wage reimbursement awards as part of the wages priority.<sup>76</sup>
- 77 We are of the view that objection can be taken to the assessment of compensation on a different basis to that which applies to other employees. Another point of objection is the link between the criminal behaviour of the employer and the

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<sup>73</sup> Department of Labour submission dated 29 October 1998, 3.

<sup>74</sup> Volunteers Employment Protection Act 1973, s 15(2); Companies Act 1993, 7th Schedule, cl 8.

<sup>75</sup> "Protected voluntary service or training" means service or training in the Armed Forces necessitating an absence from employment, Volunteers Employment Protection Act 1973, s 2.

<sup>76</sup> See paras 67–69.



preferential status of wages. That link does not provide a basis for priority in respect of other employees.

- 78 In our view, the protection provided under the Volunteers Employment Protection Act 1973 cannot be justified on the criteria which we have outlined. In our view, an employee who obtains an order for reimbursement for lost wages should have priority on that basis already outlined. We therefore recommend abolition of the priority as fixed by the Volunteers Employment Protection Act on the grounds that it is no longer needed. If our recommendation for priority for wage-related awards under section 40(1)(a) of the Employment Contracts Act was not adopted, we would still recommend abolition of this preference, but on the ground that no similar claims were entitled to priority.

### *Scope of priority*

- 79 The present priority is for a maximum sum of \$6000 per employee. That sum was considered appropriate by the New Zealand Council of Trade Unions. However, quite rightly, the Council pointed out to us that it is difficult to discern the precise basis upon which the maximum sum of \$6000 was assessed.<sup>77</sup>
- 80 The Council of Trade Unions suggested that a formula be set in relation to average earnings. The Council of Trade Unions said:

50% above such earnings would seem to be a minimum. How many weeks unpaid wages and holidays should be allowed for? Again, since fortnightly pay is common, and four weeks annual leave is common, a minimum of six weeks accumulated pay and untaken leave should be a minimum. Should any allowance be made to compensate for days in lieu of public holidays? Three such untaken days would not be uncommon in areas where public holidays are worked. 6.6 weeks at 1.5 times the average wage equals \$6,340, so by accident the level of the cap has a sort of logic in equity.

Workers will not have access to pay if they have taken annual leave, or not accumulated days in lieu for work on a public holiday. The point is, that if they have, what is the *maximum total* arrears that should have *preference*. \$6000 is not unreasonable, but it should not be allowed to be eroded by inflation or to become miserly in relation to average earnings.

A regular review mechanism is required.<sup>78</sup>

- 81 We agree that the maximum should be set on some rational basis and, as presently advised, the basis suggested by the New Zealand Council of Trade Unions seems reasonable. However, we have not sought alternative views on this issue. It may be more appropriate for the question of how a maximum should be fixed to be considered further by the Ministry of Commerce, having regard to the matters raised by the New Zealand Council of Trade Unions. We do agree, however, that it is necessary to have a regular review mechanism. We would suggest a mechanism by which the amount would be reviewed every two years. This would be consistent with the way in which the protected sums have been assessed on insolvency for Matrimonial Property Act purposes.<sup>79</sup> We recommend that a similar mechanism be established accordingly.

<sup>77</sup> Submission of the New Zealand Council of Trade Unions dated 15 November 1998, 4.

<sup>78</sup> Above n 77, 5, emphasis of New Zealand Council of Trade Unions.

<sup>79</sup> See Matrimonial Property Act 1976, s 20(2), and the Matrimonial Property (Specified Sum) Order 1996 (SR 1996/176).

- 82 No objection has been made to the extent of the existing priority so far as the time limits are concerned. We therefore recommend that the time limits contained in the employee priority provisions of both the Insolvency Act 1967 and the Companies Act 1993 be retained in their present form. The four-month period should run from the date of appointment of the insolvency administrator.

### *Workers' compensation*

- 83 A priority for workers' compensation payments under the Workers Compensation Act 1956 was retained in company law preferences by the Seventh Schedule to the Companies Act 1993<sup>80</sup> but is not included in the priorities established by the Insolvency Act 1967.
- 84 The Workers Compensation Act 1956 was repealed by section 179(1) of the Accident Rehabilitation and Compensation Insurance Act 1992. It can safely be regarded as spent in its application. As no submissions were made in favour of retaining this priority we recommend abolition on that basis.

### WAGE EARNER PROTECTION FUNDS<sup>81</sup>

- 85 Wage Earner Protection Funds have been established in the United Kingdom, Belgium, France, Sweden, Finland, Norway, Spain, Austria, Denmark, Germany, Netherlands, Switzerland, Italy, Israel, Greece, Ireland, Portugal, Argentina, two provinces in Canada, and one state in the United States of America.<sup>82</sup>
- 86 A Wage Earner Protection Fund was recommended for Australia by the Harmer Report.<sup>83</sup> However, that recommendation was not accepted. The Harmer Report identified the advantages of a guaranteed fund as:
- guarantee of payment;
  - prompt payment;
  - reduction in the amount of litigation over priorities; and
  - the limited amount of Government funding required to maintain such a fund.<sup>84</sup>
- 87 The disadvantage of the fund was identified by the Harmer Report as its being an undue imposition upon successful businesses, as the cost might fall unfairly on sectors of the business community, including those with no employees, if it was a universal levy.<sup>85</sup> It has also been suggested that if the levy is calculated on a per employee basis, the amount due from very small companies might not even be cost-effective to collect.<sup>86</sup>

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<sup>80</sup> Clause 2(c).

<sup>81</sup> The concept of such a fund is discussed in Symes, *The Protection of Wages when Insolvency Strikes* (1997) 5 *Insolv LJ* 196, 200–203, and in Bronstein, *The Protection of Workers' Claims in the Event of Insolvency of their Employer: From Civil Law to Social Security* (1987) 126 *International Labour Review* 715.

<sup>82</sup> Symes, above n 81, 201

<sup>83</sup> Harmer Report, above n 15, para 723.

<sup>84</sup> Harmer Report, above n 15, para 723.

<sup>85</sup> Harmer Report, above n 15, para 723.

<sup>86</sup> Gleig, *Unpaid Wages in Bankruptcy* (1987) 21 *University of British Columbia Law Review* 61, 81.

88 Consideration of Wage Earner Protection Funds does not fall specifically within our terms of reference. However, it is clear that a number of models for a Wage Earner Protection Fund exist and that there is widespread support for such funds. While a fund was not adopted in Australia, the Harmer Report makes it clear that many of those who made submissions to the Australian Law Reform Commission were in favour of the creation of such a fund.<sup>87</sup> It is possible to give the fund subrogation rights in both bankruptcy and liquidation.<sup>88</sup> After analysing the way in which the fund operates in the United Kingdom, Keay and Walton say:

The preferential debts regime appears to benefit the Crown and employees. However, once employees' rights under [the Employment Rights Act 1996 (UK)] are factored into the overall picture it can be seen that the Crown, by subrogation, takes over the claims of employees in a very large proportion of cases and is often the sole preferential creditor. (p 30)

We deal generally with the question of subrogation in relation to preferential entitlement in chapter 7.<sup>89</sup>

89 It seems to us timely to consider, in the context of the insolvency law review, whether the establishment of a Wage Earner Protection Fund would be a better means of securing the protection for the vulnerable employees at whom the priority is directed. Many funds operate around the world, and empirical evidence as to the advantages and disadvantages of a fund no doubt exists. We recommend that the Ministry of Commerce considers this issue. We are happy to further assist if required.

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<sup>87</sup> Harmer Report, above n 15, para 725.

<sup>88</sup> In the United Kingdom, for example, the Fund has subrogation rights both as a preferential and an unsecured creditor. Keay and Walton note that as at 31 March 1996, £762 million was owed by insolvent employers to the Fund, of which £177 million ranked as preferential. The Fund was an unsecured creditor for the remaining £585 million. The preferential portion of the debt is approximately 23 per cent (A Keay and P Walton *The Preferential Debts Regime in Liquidation Law: In the Public Interest?* (1999) 3 *Company Financial and Insolvency Law Review* 84). We are grateful to Professor Keay for making available to us an advance copy of the paper.

<sup>89</sup> See paras 207–209.

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## 5 Revenue-related claims

### INTRODUCTION

90 **U**NTIL THE PASSING OF THE BANKRUPTCY ACT 1892,<sup>90</sup> all revenue-related debts owed to the Crown enjoyed an absolute priority on insolvency, due to the operation of the royal prerogative. This ancient prerogative dated from, at least, feudal times and had two aspects:

First, the Crown had the right under a writ of *exendi facias* to seize and sell a debtor's assets and apply the sale proceeds to repay Crown debts of record. Secondly, the Crown was entitled in the event of a debtor's bankruptcy to priority over all other *unsecured* debts owed by the bankrupt.<sup>91</sup>

91 In the case of individuals, the prerogative was abolished by section 148 of the Bankruptcy Act 1892. So far as companies are concerned, it remained in force until the passing of section 280 of the Companies Act 1993.<sup>92</sup>

92 The Crown is bound by the Insolvency Act 1967 and the Companies Act 1993; both of which grant a number of revenue-related debts priority over the general body of unsecured creditors. These are:

- PAYE (Paye As You Earn);
- GST (Goods and Services Tax);
- RWT (Resident Withholding Tax);
- NRWT (Non-Resident Withholding Tax);
- deductions for child support payments;
- deductions for student loan repayments;
- accident compensation levies;
- customs and excise duties;
- fishing levies; and
- levies under the Radiocommunications Act 1989.

93 The revenue-related debts which are given priority can be grouped broadly into three categories:

- deductions from monies paid to employees (see paragraphs 108–133);
- quasi-trust revenue debts (see paragraphs 134–146); and
- duties or levies payable to the Crown (see paragraphs 147–165).

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<sup>90</sup> Bankruptcy Act 1892, s 148.

<sup>91</sup> M Gedye, *A Receiver's Liability for GST and Other Taxes* (1994) NZJTLT 5; see generally pp 5–6 for a summary of the common law position. See also Keay and Walton, *The Preferential Debts Regime in Liquidation Law: In the Public Interest?* (1999) 3 Company Financial and Insolvency Law Review 84 for a more detailed history.

<sup>92</sup> See the comments made in 1927 on the applicability of the prerogative in *Tasman Fruit-Packing Association Limited v The King* [1927] NZLR 518.

- 94 When considering the legitimacy of revenue-related debts which have priority on bankruptcy or liquidation, it is important to note that:
- income tax generally is afforded no priority;
  - the amounts claimable by way of preference from an employer in respect of sums deducted from an employee's wages are not priority payments if claimed against an insolvent employee who has primary liability to make the payment; and
  - the quasi-trust revenue debts are, with the exception of GST, not priority payments in the estate of the person on whose behalf the tax is paid.

## PROTECTION OF TAX SYSTEM

- 95 The background against which revenue-related priorities are to be considered is the obligation placed upon Ministers and officials to protect the integrity of the tax system. Every Minister and every officer of any government agency with responsibility under the Tax Administration Act 1994, or any other Act in relation to the collection of taxes,<sup>93</sup> must use their best endeavours to protect the integrity of the tax system.<sup>94</sup> The term "the integrity of the tax system" includes:<sup>95</sup>
- taxpayer perceptions of that integrity;
  - the rights of taxpayers to have their liability determined fairly, impartially, and according to law;
  - the rights of taxpayers to have their individual affairs kept confidential and treated with no greater or lesser favour than the tax affairs of other taxpayers;
  - the responsibilities of taxpayers to comply with the law;
  - the responsibilities of those administering the law to maintain the confidentiality of the affairs of taxpayers; and
  - the responsibility of those administering the law to do so fairly, impartially, and according to law.
- 96 Also, section 6A of the Tax Administration Act 1994 makes it clear that the Commissioner of Inland Revenue is responsible for collecting the highest net revenue *that is practicable within the law*, having regard to:<sup>96</sup>
- the resources available to the Commissioner;
  - the importance of promoting compliance by all taxpayers with the Inland Revenue Acts; and
  - the compliance costs<sup>97</sup> incurred by taxpayers.

<sup>93</sup> "Tax" is defined in the Tax Administration Act 1994 as a sum payable under a "tax law". "Tax law" is defined as an "Inland Revenue Act" (this includes the Goods and Services Tax Act and the Income Tax Act (s 2)). "Taxpayer" is defined as a person who is liable to comply with a "tax law" (s 4A).

<sup>94</sup> Tax Administration Act 1994, s 6(1).

<sup>95</sup> Tax Administration Act 1994, s 6(2).

<sup>96</sup> Tax Administration Act 1994, s 6A(3). In *Suspended Ceilings (Wellington) Limited v Commissioner of Inland Revenue* (1997) 8 NZCLC 261, 318, the Court of Appeal, emphasised the qualified nature of the Commissioner's duty under s 6A(3) of the Tax Administration Act 1994 and pointed also to the Commissioner's discretionary power to remit penalties under Part XI of the Tax Administration Act 1994. The Court emphasised that the Commissioner had not, in that case, chosen to exercise his discretion to remit penalties and added that the importance of these statutory provisions must not be overlooked.

<sup>97</sup> See *Inquiry into Compliance Costs for Business, Interim Report of the Commerce Committee* (May 1998) and *Final Report of the Commerce Committee* (November 1998) to the House of Representatives.

97 The employee-deduction debts and the quasi-trust revenue debts (apart from GST) are considered in the context of obligations imposed by section 167 of the Tax Administration Act 1994. That section provides:

(1) The amount of every tax deduction or combined tax and earner premium deduction made under the PAYE rules and, where applicable, section 115 of the Accident Rehabilitation and Compensation Insurance Act 1992, shall be held in trust for the Crown, and any amount so held in trust shall not be property of the employer liable to execution, and, in the event of the bankruptcy or liquidation of the employer or of an assignment for the benefit of the employer's creditors, shall remain apart, and form no part of the estate in bankruptcy, liquidation, or assignment.

(2) Where a tax deduction or combined tax and earner premium deduction has been made under the PAYE rules and, where applicable, section 115 of the Accident Rehabilitation and Compensation Insurance Act 1992 [or section 285 of the Accident Insurance Act 1998], and the employer has failed to deal with the amount of the deduction or any part of the deduction in the manner required by subsection (1) or the PAYE rules, the amount of the deduction for the time being unpaid to the Commissioner shall, in the application of the assets of the employer, rank as follows:

(a) Where the employer is, or one of whom is, an individual, upon the employer's bankruptcy or upon the employer's making an assignment for the benefit of the employer's creditors, the amount of the deduction shall rank without limitation in amount, and notwithstanding anything in any other Act, in order of priority immediately after preferential claims for wages or other sums payable to or on account of any servant or worker or apprentice or articed clerk, and in priority to all other claims:

(b) Where the employer is a company, upon the liquidation of the company, the amount of the tax deduction shall have the ranking provided for in the Seventh Schedule to the Companies Act 1993 (whether or not the company has been incorporated or registered under that Act); and

(c) Where the employer is a company, upon the appointment of a receiver on behalf of the holder of any debenture given by the company secured by a charge over any property of the company, or upon possession being taken on behalf of the debenture holder of the property, the amount of the tax deduction shall have the ranking provided for in the Seventh Schedule to the Companies Act 1993 (whether or not the company has been incorporated or registered under that Act), as if the receiver were a liquidator.

(3) This section shall apply notwithstanding anything in any other Act, and in particular section 308 of the Companies Act 1955 shall apply subject to this section.

(4) In this section—

"Floating charge" includes a charge that conferred a floating security at the time of its creation but has since become a fixed or specific charge:

"Tax deduction", or "combined tax and earner premium deduction", does not include any [late payment penalty or any shortfall penalty].

## THE COMPETING ARGUMENTS

98 The arguments put to us to justify the retention of the priority for revenue-related debts are:

- priority is necessary to protect the revenue. Without priority, the burden of taxation would fall unfairly on solvent taxpayers;

- in contrast to employees,<sup>98</sup> revenue debts are often the last debts to be paid. Many debtors will pay off other creditors before paying tax or other revenue-related debts;
- the Commissioner of Inland Revenue is an involuntary creditor; and
- some of the debts, notably PAYE, RWT, NRWT, accident compensation levies, child support, and student loan deductions, represent monies payable by the debtor to the Commissioner on behalf of another person. Thus, it is argued that there is an analogy with the law of trusts so that the debts should be afforded priority even though the monies may have been mingled with other fungibles, and are therefore no longer traceable.<sup>99</sup>

99 The arguments in favour of abolition of the priority for revenue-related debts are:

- priority infringes the *pari passu* rule;
- the abolition of priority is likely to lead to a greater incentive for the Commissioner to take steps to collect debts more quickly;
- in the case of PAYE and GST, the Commissioner receives regular returns from taxpayers (or at least should know if a regular return has not been made) which gives the Commissioner *more* information on which to base a decision to take action to collect arrears of revenue than most trade creditors would have;
- the Crown is better able to absorb debt than many traders;
- it is inherently unfair for the Commissioner to have a priority over other unsecured creditors because:
  - the provisions of the Tax Administration Act 1994 and other revenue statutes provide the Crown with remedies that facilitate the collection of debts, whereas similar procedures are not available to ordinary unsecured creditors;
  - the Commissioner has significant powers to impose penalties for non-payment of tax.<sup>100</sup> Interest rates also apply at much higher rates than would be awarded if a creditor sought to recover a debt in court;<sup>101</sup>
  - the Commissioner has the power to require a third party to pay a debt from monies held on behalf of a taxpayer;<sup>102</sup> and
  - the Commissioner can seek orders from the High Court for the recovery

<sup>98</sup> As to which see chapter 4, especially para 46.

<sup>99</sup> As to tracing rights see *Re Goldcorp Exchange Limited (In Receivership): Kensington v Liggett* [1994] 3 NZLR 385 (PC).

<sup>100</sup> Tax Administration Act 1994, s 139.

<sup>101</sup> Compare Tax Administration Act 1994, ss 120 with s 87 Judicature Act 1908. Under s 120 of the Tax Administration Act, “taxpayers” are liable to pay interest on unpaid “tax”. Under s 139, taxpayers are liable to pay a “late payment penalty” if the “taxpayer” does not pay the assessed “tax” on time. Under ss 143A and 143B, a person commits an offence if he or she either uses a tax deduction for any purpose other than paying it to the Commissioner or does not make a tax deduction as required. If a person is convicted of such an offence, the Commissioner must publish the person’s name in the *Gazette*.

<sup>102</sup> Tax Administration Act 1994, s 157 provides that where a person has made default in the payment of any “income tax”, the Commissioner may require any person to deduct an amount from money the person owes the debtor and pay that sum to the Commissioner. (“Income tax” is defined as including a tax deduction to which s NC 15 of the Income Tax Act 1994 applies (Tax Administration Act, s 157(10)). Section NC 15 concerns tax deductions made by employers under the PAYE rules.)

of tax even though no judgment may have been entered against the debtor.<sup>103</sup>

- 100 We deal immediately with the argument that the Crown should have priority as it is better able to absorb losses. This argument says no more than the proceeds of an insolvency should be distributed first among those who can least afford a loss. Such an argument would support small private creditors obtaining priority over large private creditors. Such an argument is, in our view, untenable.
- 101 This argument is considered in the Cork Report.<sup>104</sup> In the Report, it is stated that the very fact that Crown preferences result in a benefit to the general community at the expense of an individual is a reason for condemning the principle. It approved the comments of Lord Anderson in *Admiralty v Blair's Trustee* in which Lord Anderson said:

Why should individuals be made to suffer for the general good, especially in a case like the present, where the general benefit is infinitesimal but the individual loss substantial.<sup>105</sup>

Lord Anderson also pointed out that the preference was contrary to the *pari passu* principle.

- 102 It has also been suggested to us that if priorities for PAYE and GST are retained, there should be a time limit to restrict the amount of the debt which may be afforded priority over other creditors. This argument is based on the notion that the Commissioner receives regular returns from taxpayers (or at least should know if a regular return has not been made) which give the Commissioner *more* information on which to base a decision to take action to collect arrears of revenue than most trade creditors would have.

## THE RIGHT TO PRIORITY

- 103 The Harmer Report rejected arguments which would justify preferential status for Crown debts.<sup>106</sup> Three of the arguments expressly rejected by the Harmer Report were that:
- taxation debts are owed to the community rather than to an individual;
  - there is a need to protect the revenue of the Crown; and
  - the Commissioner has a statutory rather than contractual relationship with the taxpayer.

The primary reason the Harmer Report recommended abolition of Crown preferential debts was that the Commissioner's priority assured the payment of revenue and consequently operated as a disincentive for the Commissioner to recover debts in a commercial manner. If the Commissioner allows debts to aggregate, the position of other unsecured creditors can be seriously disadvantaged.

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<sup>103</sup> Under ss 169 and 172 of the Tax Administration Act 1994, where a person fails to make a deduction or is liable to pay any sum to the Commissioner under PAYE or RWT, an amount equal to the amount unpaid is a charge on all of the real and personal property of the person. A High Court may make an order for the sale of the property the subject of the charge or for the appointment of a receiver of the rents, profits, or income from the property, and for the payment of the amount of the charge and the costs of the Commissioner out of the proceeds of the sale or out of the rents, profits, or income.

<sup>104</sup> Cork Report, above n 13, para 1411.

<sup>105</sup> 1916 1 SLT 19.

<sup>106</sup> Harmer Report, above n 15, paras 734–735, pp 299–301.



- 104 The Cork Report also concluded that, generally, revenue debts should not receive priority, primarily because this is inconsistent with the *pari passu* principle.<sup>107</sup>
- 105 In a paper given to the INSOL Pacific 99 Conference in Auckland earlier this year by an Inland Revenue Department official, it was stated that while the Inland Revenue Department does not hold statistics on the amount of debt received as a preferential debt on bankruptcy or liquidation, the amount of tax currently outstanding by bankrupts and companies in liquidation is significant. Goods and Services Tax was said to make up approximately 50 per cent of the total debt owed by bankrupts or companies in liquidation. Revenue-related preferential claims were said to make up approximately 60 per cent of the total debt owing by bankrupts and companies in liquidation.<sup>108</sup> We reproduce as Appendix D a useful schedule supplied by the Inland Revenue Department which provides a breakdown of preferential and non-preferential debt in bankruptcy and liquidation as at 4 October 1998.<sup>109</sup>
- 106 In assessing where the balance should be struck between the competing public interest of preserving the revenue base of the country and issues of private law including fairness of treatment between creditors, the same approach is taken as is applied to employee-related claims. The public policy imperative of preserving, so far as possible, the existing revenue base is no different in nature from the social or humanitarian aim of protecting employees who are less able to negotiate terms of employment to protect their own interests. Just as it has been argued that the humanitarian aim of protecting employees can be accomplished through social welfare legislation rather than through priorities created in insolvency law, so too can it be argued that the public policy of preserving the revenue base can be protected through early enforcement measures available to the Commissioner of Inland Revenue.
- 107 We do not think that all revenue-related debts can properly be grouped together. Accordingly, we have decided to examine the debts in the groupings mentioned in paragraph 93. We address each grouping in turn to decide whether priority can be justified.

## EMPLOYEE DEDUCTION DEBTS

### *PAYE*

- 108 Under clause 5 of the Seventh Schedule to the Companies Act 1993, *PAYE* deductions made by a company under the Income Tax Act 1994 are preferential debts. The Tax Administration Act 1994 applies to payments required to be made under *PAYE*.
- 109 Section 104(1)(e)(i) of the Insolvency Act 1967 provides that amounts payable to the IRD under section 167(2) of the Tax Administration Act 1994 are

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<sup>107</sup> Cork Report, above n 13, paras 1409–1425. Note that the retention of certain quasi-trust debts was recommended: para 1418. But, while revenue debts were largely abolished in Australia they were not in the United Kingdom.

<sup>108</sup> Munt, *Compromises in New Zealand: Vices and Virtues* (paper presented at the INSOL Pacific 99 Conference, Auckland, February 1999), 6. We are unable to vouchsafe the accuracy of these statistics.

<sup>109</sup> Submission of Inland Revenue Department dated 27 November 1998, Appendix.

preferential debts. Section 167(2) provides that where a tax deduction has been made under the PAYE rules and the employer fails to deal with the deduction as required by the Act, the amount unpaid to the Commissioner is a preferential debt.

- 110 PAYE represents taxation deducted at source from the wages of an employee. We are told by the Inland Revenue Department that in the 1997/98 fiscal year, \$12.6 billion was collected from PAYE out of the total revenue of \$29.3 billion collected through the Inland Revenue Department.<sup>110</sup> This means that PAYE represented 43 per cent of the revenue collected by the Commissioner during the 1997/98 fiscal year. We are also told that the Inland Revenue Department is responsible for collecting approximately 80 per cent of the total Crown revenue.<sup>111</sup>
- 111 PAYE is a component of the wage cost of an employer. PAYE is only payable if tax is deductible at source in relation to an employee. Ideally, it would be better to account for PAYE at the same time as the payment of wages.<sup>112</sup>
- 112 If wages are to be regarded as a preferential debt, there is much to be said for the proposition that PAYE be treated in the same way, with the result that gross wages rather than net wages are given priority. If wages net of tax were preferential but PAYE was not, there would remain an ability for the Commissioner to pursue the employee in relation to the PAYE component which the employer had not paid. Under the PAYE rules, the Commissioner retains the right to claim unpaid PAYE from the employee as well as the employer.<sup>113</sup> This may be seen as unfair to a person who has, in good faith, ordered his or her affairs on the assumption that the tax was met by the employer.
- 113 PAYE is regarded as being held on trust for the Crown.<sup>114</sup> But the PAYE component is rarely set apart in the manner contemplated by section 167(1) of the Tax Administration Act 1994. A remedy in trust will not be available where monies have been mixed with other fungibles and the right to trace lost.<sup>115</sup> As the Cork Report points out,<sup>116</sup> it is commercially impracticable to treat PAYE as impressed with a trust.
- 114 In our view, it is appropriate to continue the priority for PAYE but in a modified form. It should continue because:
- if the wages of an employee are to be given priority, then the tax component of those wages should also have priority; and
  - it is unfair to an employee who has, in good faith, ordered his or her affairs on the assumption that the employer has paid the tax to then be put at risk of being pursued personally for the debt. While the risk remains, it is diminished by preferential status being afforded to the tax component of the wages.

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<sup>110</sup> Submission of Inland Revenue Department dated 27 November 1998, 3.

<sup>111</sup> Submission of Inland Revenue Department dated 27 November 1998, 3.

<sup>112</sup> We suggest that consideration is given to collecting PAYE deductions, by direct credit to the Inland Revenue Department, at the same time that wages are paid.

<sup>113</sup> Tax Administration Act 1994, s 168(2).

<sup>114</sup> Tax Administration Act, s 167(1).

<sup>115</sup> See para 98.

<sup>116</sup> Cork Report, above n 13, para 1418.

- 115 We recommend that the PAYE preference, as such, be abolished. Instead a gross priority for wages of \$6000 plus the PAYE component should be enacted. This change will not disadvantage employees, but will, in effect, limit the Commissioner's priority for PAYE to the PAYE payable on a sum of \$6000. This limitation should provide an incentive for the Commissioner to monitor returns of PAYE and exercise remedies to collect the tax (outside of a formal insolvency regime) at an earlier time. As a matter of convenience, we suggest that the Commissioner be entitled to prove (rather than the employee) for the unpaid tax component of the wages priority in the bankruptcy or liquidation.
- 116 We set out our recommendations in relation to PAYE in paragraphs 132–133 and 246–247.

### *Child support deductions*

- 117 Under section 104(1)(d)(iv) of the Insolvency Act 1967 and clause 2(e) of the Seventh Schedule to the Companies Act 1993, amounts payable to the Commissioner of Inland Revenue in accordance with section 163(1) of the Child Support Act 1991 are preferential debts. Section 163(1) of the Child Support Act provides that a person who has made any deduction from any money payable to a person who is liable to pay child support or spousal maintenance shall pay that money to the Commissioner of Inland Revenue. Under section 169 of the Child Support Act (where a person is liable to pay any sum to the Commissioner (including under section 163)), an amount equal to the amount unpaid (including any interest, penalty, or judgment) shall be a charge on all the real and personal property of the payer. A Family Court or a District Court may make an order for the sale of the property the subject of the charge or for the appointment of a receiver of the rents, profits, or income from the property, and for the payment of the amount of the charge and the costs of the Commissioner out of the proceeds of the sale or out of the rents, profits, or income (section 169(9)).<sup>117</sup>
- 118 Section 175 of the Child Support Act 1991 provides that:
- Subject to this Part of this Act, the provisions of this Act and the Tax Administration Act 1994 shall apply with respect to every amount that any person is liable to account for or pay to the Commissioner under this Part of this Act as if the amount were financial support payable by that person under this Act.
- 119 Section 134 provides that where a financial support debt remains unpaid, the person liable to pay the debt is liable to pay a penalty.
- 120 The provisions of the Tax Administration Act 1994 also apply to amounts which people are liable to pay under the Child Support Act.<sup>118</sup> Section 1(2) of the Child Support Act provides that the Act is an "Inland Revenue Act" within the meaning of the Tax Administration Act 1994.<sup>119</sup>
- 121 Our recommendations in respect of child support deductions are set out in paragraphs 132–133 and 246.

<sup>117</sup> Child Support Act 1991, s 169(9).

<sup>118</sup> Child Support Act 1991, s 175.

<sup>119</sup> See paras 95–97 for a discussion of the Tax Administration Act 1994.

### *Student loan deductions*

- 122 Under section 104(1)(e)(ii) of the Insolvency Act 1967, all amounts payable to the Commissioner "in accordance with section 167(2) of the Tax Administration Act 1994 (as applied by section 25 of the Student Loan Scheme Act 1992)" are preferential debts. Section 167(2) of the Tax Administration Act provides that where a tax deduction has been made under the PAYE rules and the employer fails to deal with the deduction as required by the Act, the amount unpaid to the Commissioner is a preferential debt. We note that section 167(1) of the Tax Administration Act is not applied, so the money is not regarded as having been held on trust.<sup>120</sup>
- 123 In addition, section 46(2) of the Student Loan Schemes Act applies section 157 of the Tax Administration Act 1994. Section 157 provides that where a person has made default in the payment of any tax, the Commissioner may require any person to deduct an amount from money the person owes the debtor and pay that sum to the Commissioner. Thus, there are two sources from which deductions could be required.
- 124 Strangely, no corresponding priority has been granted expressly to deductions made under the Student Loan Scheme in the Seventh Schedule to the Companies Act 1993. Nevertheless, we are of the opinion that priority exists under the Seventh Schedule by virtue of either the general priority for employee deductions set out in clause 2(d) or the application of clause 5(b) to the PAYE rules applied by section 25 of the Student Loan Scheme Act 1992.
- 125 Our recommendations in relation to student loan deductions are set out in paragraphs 132–133 and 246.

### *Accident compensation levies*

- 126 Existing priorities under the Companies Act 1993 and the Insolvency Act 1967 refer to the Accident Rehabilitation and Compensation Insurance Act 1992. As from 1 July 1999, that statute will, save for certain transitional provisions, have been repealed and replaced by the Accident Insurance Act 1998. We confine our comments to the new Act even though, from 1 July 1999, it would be wrong to characterise the debt as a revenue debt. Also, we note that our analysis applies with equal force to deductions made under section 115(17) of the Accident Rehabilitation and Compensation Insurance Act 1992.
- 127 Section 169 of the Accident Insurance Act 1998 provides that every employer is required to enter into and maintain an insurance contract with an insurer in respect of work-related personal injury suffered by employees. Employers are prohibited from requiring employees to contribute to the cost of premiums.<sup>121</sup>
- 128 The Accident Insurance Act 1998 amends section 104(1)(e)(iii) of the Insolvency Act 1967. Section 104(1)(e)(iii) of the Insolvency Act now provides:

All amounts payable to the Accident Compensation Corporation in accordance with section 115 (17) of the Accident Rehabilitation and Compensation Insurance Act 1992 or *clause 4 of Schedule 5 of the Accident Insurance Act 1998*.

<sup>120</sup> Section 167(1) is set out at para 97.

<sup>121</sup> Accident Insurance Act 1998, s 172.

- 129 Clause 4 of Schedule 5 to the Accident Insurance Act 1998 provides that if an employer makes a deduction under section 285 (1) of the Accident Insurance Act 1998 and fails to deal with the deduction (or any part of it) in the manner required by the Act, the deduction, to the extent to which the employer has not made payment of the deduction to the manager or an agent of the manager, in the application of the assets of the employer, ranks:
- (a) Equally with the amount of any tax deduction not paid by the employer, as provided for in section 167 (2) of the Tax Administration Act 1994; or
  - (b) If there are no such unpaid tax deductions, in accordance with section 167 (2) of the Tax Administration Act 1994, as if the deduction were a tax deduction not paid by the employer.<sup>122</sup>
- 130 Sections 283 and 285 of the Accident Insurance Act 1998 need to be considered together. Section 283 provides that every earner must pay premiums to fund the Earners' Account. Section 285 provides that for the purpose of collecting premiums payable under section 283:
- when an employer makes a payment to an employee that is included in the earnings of the person as an employee of the employer, the employer must, at the time of making that payment, make a deduction in accordance with this section from that amount on account of the premium payable.
- 131 There is no comparable provision granting priority in the Seventh Schedule to the Companies Act 1993. We are of the view, however, that priority probably exists by virtue of the general employee deduction preference granted by clause 2(d) of the Seventh Schedule.

### *Employee deduction debts – recommendations*

- 132 In our view, the various preferences to which we have referred can be justified on the grounds that:
- they are deductions from wages of third parties who are likely to have ordered their affairs on the basis that the payments have been met; and
  - the money has not been applied for the purpose of paying the third party's debt, so it would be unjust to allow those moneys to be used to swell the assets available to the general body of creditors when it would be commercially impracticable to impress the funds with a trust.<sup>123</sup>
- 133 We recommend abolishing the specific priorities and replacing them (in both the Insolvency Act 1967 and the Companies Act 1993) with a general provision in terms of the current clause 2(d) of the Seventh Schedule to the Companies Act 1993. This will:
- give the creditor a greater incentive to monitor payment of the debt on a regular basis and to take timely action to recover amounts in arrears. This incentive will flow on from the fact that the Commissioner's priority will be restricted to the maximum amount of PAYE payable on the net wage priority of \$6000 and to deductions made from wages which have not been paid in accordance with the authority given to the employer; and

<sup>122</sup> We note that although amounts payable under the Accident Compensation and Rehabilitation Insurance Act 1992 were also regarded as being held in trust (see the Tax Administration Act 1994, s 167(1), set out at para 97) that provision has not been applied to deductions under the Accident Insurance Act 1998.

<sup>123</sup> Cork Report, above n 13, para 1418.

- simplify the current preferential regime by enabling the priority to be stated in a succinct manner and to apply across the board to all relevant deductions authorised by the employee. This will avoid the need for piecemeal amendment to the priority provisions to gain priority for other deductions which do not yet exist.

## THE QUASI-TRUST REVENUE DEBTS<sup>124</sup>

- 134 We deal with GST, RWT and NRWT together. Strictly speaking, we do not regard GST as a quasi-trust revenue debt,<sup>125</sup> but deal with it in the same context as RWT and NRWT for convenience and because it is often said to have a quasi-trust character.
- 135 We set out below a brief description of each of these debts together with a summary of the alternative remedies available to the Commissioner of Inland Revenue in respect of each. We then go on to consider whether the claims should have preferential status. Our recommendations are set out in paragraphs 145 and 146.

### *GST*

- 136 Under section 42(2)(a) and 42(2)(b) of the Goods and Services Tax Act 1985, where a person has not paid the amount of tax payable under Part III of the Act, the amount of tax unpaid is a preferential debt. Part III of the Act sets out: when individuals must supply a tax return, an individual's taxable periods, the calculation of tax payable, and the times for payment of taxation. Section 43 provides that where a person has made default in the payment of any GST, the Commissioner may require any person to deduct an amount from money the person owes the debtor and pay that sum to the Commissioner.
- 137 While section 1(2) of the Goods and Services Tax Act provides that the Act is an "Inland Revenue Act" within the meaning of the Tax Administration Act 1994, GST is not a tax to which section 167(1) of the Tax Administration Act specifically applies. Consequently, it cannot be argued that the debt is a trust debt as a result of the provisions of the Tax Administration Act.<sup>126</sup>
- 138 It is often asserted that GST is neutral and that, therefore, a taxpayer is holding GST in trust for the Crown from the time of receipt until the time of return. However, that analysis is flawed. A simple example (omitting profit margins) will suffice. If goods are sold for \$90 it is necessary to return one-ninth of that amount (\$10) as GST. If, however, the cost of making those goods for sale is made up of raw materials purchased (say 50 per cent) and labour (say 50 per cent) a credit will only have been recovered in respect of the non-labour portion of the debt. Thus, GST paid on sale of the goods does not equate to GST claimed on purchase of the raw materials. For this reason, we do not believe it is appropriate to regard GST as a quasi-trust revenue debt when analysing whether it should be given priority on bankruptcy or liquidation.

<sup>124</sup> When using this term, we refer to those debts which are said to have a quasi-trust character other than those with which we have dealt in paras 108–133 under employee deductions.

<sup>125</sup> See paras 137–139.

<sup>126</sup> See s 167(1) of the Tax Administration Act 1994 set out at para 97.

- 139 In our view, there are no compelling reasons to treat GST in a manner analogous to trust property. Goods and Services Tax is collected by taxpayers who are registered under the Goods and Services Tax Act 1985 and returns are made to the Inland Revenue Department for GST on a regular basis.<sup>127</sup> There is no obligation to keep GST apart from other monies, and therefore, there is no basis to treat the person who is responsible to account to the Commissioner for GST as being in a position analogous to a trustee for a *cestui que trust*. In our view, the obligation to pay GST is no different from an obligation to pay income tax. The latter has no priority status; accordingly, no priority should be afforded to GST.
- 140 We reject any suggestion that general taxes should be given priority based upon a need to protect the revenue. It is clear from a number of provisions to which we have referred that the legislature has given the Commissioner of Inland Revenue extensive powers to collect tax and to impose penalties and interest. The protection of the country's revenue base is better achieved by those powers being exercised in a timely fashion by the Commissioner.
- 141 We are not persuaded by the argument that priority should be given because the Commissioner is an involuntary creditor. First, it is arguable whether or not the Commissioner is, in fact, a true involuntary creditor. An argument can be made that the Commissioner is not an involuntary creditor as the legislature has decided that the Commissioner will collect tax on its behalf. Second, even if the Commissioner is an involuntary creditor, there are many involuntary creditors who do not enjoy preferential status. A simple example is the victim of a tort. As a matter of consistency, priority should not be afforded on this ground.<sup>128</sup>

#### *RWT and NRWT*

- 142 Under clause 5 of the Seventh Schedule to the Companies Act, NRWT and RWT deductions made by a company under the Income Tax Act 1994 are preferential debts. The Tax Administration Act 1994<sup>129</sup> applies to payments required to be made under NRWT and RWT.<sup>130</sup> No priority is given for these debts under the Insolvency Act 1967.
- 143 Under section 120 of the Tax Administration Act, taxpayers are liable to pay interest on unpaid tax. Under section 139, taxpayers are liable to pay a late payment penalty if the taxpayer does not pay the assessed tax on time. Under sections 143A and 143B, a person commits an offence if he or she uses a tax deduction for any purpose other than paying it to the Commissioner, or does not make a tax deduction as required. If a person is convicted of such an offence, the Commissioner must publish the person's name in the *Gazette*. Section 157 provides that where a person has made default in the payment of any income

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<sup>127</sup> See Part 2 and 3 of the Goods and Services Tax Act 1985.

<sup>128</sup> See also Cork Report, above n 13, para 1414.

<sup>129</sup> Section 167(1) of the Tax Administration Act 1994 is set out at para 97.

<sup>130</sup> Income Tax Act 1994, s NC 20, NF 13 and NG 17.

tax, the Commissioner may require any person to deduct an amount from money the person owes the debtor and pay that sum to the Commissioner.<sup>131</sup>

- 144 Under sections 169 and 172, where a person fails to make the deduction or is liable to pay any sum to the Commissioner, an amount equal to the amount unpaid is a charge on all of the real and personal property of that person. A High Court may make an order for the sale of the property the subject of the charge or for the appointment of a receiver of the rents, profits, or income from the property, and for the payment of the amount of the charge and the costs of the Commissioner out of the proceeds of the sale or out of the rents, profits, or income.

### *Quasi-trust revenue debts – recommendations*

- 145 In our view, the priority for GST should be abolished because:
- it is not, in truth, a debt analogous to a trustee's obligation to account to a beneficiary for reasons given in paragraph 139; and
  - there are no compelling reasons for requiring tax debts to be given preferential status because of
    - the need to protect the revenue base (paragraph 140), or
    - the Commissioner's (possible) position as an involuntary creditor (paragraph 141).
- 146 However, we think that the priority for RWT and NRWT under the Companies Act 1993 should be retained and, in fact, extended to bankruptcies under the Insolvency Act 1967. We say this because:
- these payments are of a type analogous to accident compensation deductions which are made on behalf of a third party;
  - removal of the priority would cause injustice to taxpayers who order their affairs on the assumption that payments have been made; and
  - it would be unjust to allow the assets of an insolvent to be swollen through the use of monies which the debtor ought to have paid to the Commissioner on behalf of a third party.<sup>132</sup>

We can see no reason not to apply the priority consistently in both bankruptcy and liquidation. Nobody has suggested a satisfactory reason to us for not doing so and, indeed, the Commissioner sought an extension of these priorities to cases of bankruptcy.<sup>133</sup>

## DUTIES OR LEVIES PAYABLE TO CROWN

### *Customs duties*

- 147 Priority is given, on bankruptcy or liquidation, to all duties payable under the Customs and Excise Act 1996.<sup>134</sup>

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<sup>131</sup> "Income tax" is defined as including a tax deduction to which s NC 15 of the Income Tax Act 1994 applies (s 157(10) Tax Administration Act 1994). Section NC 15 concerns tax deductions made by employers under the PAYE rules.

<sup>132</sup> Cork Report, above n 13, para 1418.

<sup>133</sup> Submission of Inland Revenue Department dated 27 November 1998, 5.

<sup>134</sup> Insolvency Act 1967, s 104(1)(e)(iv); Companies Act 1993, Seventh Schedule, cl 5(e). Note that the duty must be payable within the meaning of s 2(1) of the Customs and Excise Act 1996.



- 148 The New Zealand Customs Service tells us that it is the second largest revenue collector in New Zealand after the Commissioner of Inland Revenue. In the financial year to 30 June 1998, it collected approximately \$5.8 billion worth of revenue.<sup>135</sup>
- 149 Reasons given for retention of the existing preference in favour of the New Zealand Customs Service are:
- protection of the revenue base;
  - public agencies such as Customs are not as able as commercial operators to “assess and take . . . the financial risks involved in any given transaction involving duty payment”. Preferential recovery provides a measure of equalisation to the public sector in preserving its position with that of the private sector;
  - it would be anomalous to retain preference provisions in some areas of Crown revenue collection without also retaining preference for customs duties; and
  - preferential recovery provides an incentive for customs duty debtors to pay such duties promptly.
- 150 Under section 87(1) of the Customs and Excise Act, additional fees are imposed where any duty remains unpaid at the due date. The duty on goods constitutes a charge on the goods until the duty is paid (section 97(1)). Where duty charged on any goods is due and unpaid, Customs may take possession of the goods and sell them (section 97(2)). Customs may also hold the goods until the duty is paid (section 102(1)). Under section 165, Customs may require and take securities for the payment of duty. The security may be required in relation to a particular transaction or in relation to transactions generally, and be for such a period and amount and on such conditions as the Chief Executive may direct (section 156(3)). The Chief Executive may also require a new security in place of, or in addition to, an existing security (section 157(1)).
- 151 There is one particular quirk with regard to the preferential status of customs duties which ought to be mentioned. It seems to us that the additional fees imposed under section 87(1) of the Customs and Excise Act 1996 are, in effect, penalties under a different guise. No other revenue claims enjoy preference for either interest or penalties. The use of the euphemism “additional fees” should not affect consistent application of the principle that penalties are not afforded preferential status.
- 152 In our view, having regard to the criteria recommended (see chapter 2), there are no compelling reasons to justify priority for customs debts. With regard to the particular reasons given by the New Zealand Customs Service to justify priority (see paragraph 149) we respond:
- We have rejected protection of the revenue base as a compelling reason in itself for granting priority, for the reasons set out in paragraph 140.
  - The second point suggests that Customs should be given priority because it is largely an involuntary creditor. We have rejected that reason on the basis outlined in paragraph 141. The ability for Customs to require security (see paragraph 150) also militates against that view.
  - None of the debts owing to the Crown which we have recommended retain preferential status are analogous to customs duties; other debts have special qualities which give rise to the need for priority. Thus, no anomalies will result.

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<sup>135</sup> Submission of New Zealand Customs Service dated 29 October 1998, 1.

- There is no evidence to suggest that preferential recovery *by a creditor* provides any incentive *for the debtor* to pay the duties promptly. A debtor may well seek to prefer creditors to ensure that the revenue is not paid first, but it is highly unlikely that it will pay revenue debts first to ensure that all preferential debts are cleared on insolvency.
- There are ample alternative remedies available to the New Zealand Customs Service to protect itself should the preference be abolished.

For these reasons we recommend that the customs duty preference be abolished.

### *Fishing levies*

- 153 Fishing levies are given priority by statutes which, currently, overlap in their operation. The Fisheries Act 1983 is being progressively repealed and replaced by the provisions of the Fisheries Act 1996. Under section 107K(3) of the Fisheries Act 1983, levies payable pursuant to section 107EA of the Fisheries Act are preferential debts. Section 107EA (along with other provisions to which reference will be made, including section 107, section 107EF and section 107L)<sup>136</sup> is to be repealed. Under section 274 of the Fisheries Act 1996, "every levy" payable under Part XIV of the Fisheries Act 1996 has preferential status. Section 274 was brought into effect by the Fisheries Act Commencement Order 1996 (No 2) on 1 October 1996.
- 154 Under section 107I of the Fisheries Act 1983, every amount that is payable under the Act is deemed to be a "statutory debt" under section 13A of the Ministry of Agriculture and Fisheries Act 1953 (since repealed). Section 13A provides that where any part of a statutory debt remains unpaid, the debt shall be deemed to have been increased by a penalty sum as set out in section 13A (section 13A(3)).
- 155 Under section 107J of the Fisheries Act 1983, the Director-General of Agriculture and Fisheries may register a caveat preventing a person who has not paid levies due under the Act from dealing with any quotas held by that person. Under section 107L, the Director-General may also suspend the person's fishing permits, fish receivers' licences, or controlled fishery licences.
- 156 Section 107EF provides that levies imposed under section 107EA are payable to the Director-General. Where a person fails to pay levies in accordance with section 107EF, the person will have committed an offence against the Act. Section 93 (which is to be repealed by section 314(1)(zb) of the Fisheries Act 1996) provides that it is an offence to fail to comply with any provision of the Act. Under section 80 of the Fisheries Act 1983, a Fishery Officer may seize property which "is being or has been used or is intended to be used in the commission of an offence" against the Act.
- 157 Where a person has failed to pay a levy, the person will be subject to a fine. Under section 107, every person who commits an offence against the Act (see sections 93 and 107EF above), for which no other penalty is prescribed, is liable to a fine not exceeding \$250 000. The person may also be liable to forfeiture of his or her quota to the Crown (section 107B(3)(b)).

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<sup>136</sup> Fisheries Act 1996, s 314(1)(zj). However, an Order in Council to implement repeal has not yet been made.

- 158 Section 262 of the Fisheries Act 1996 provides for the imposition of levies. Section 18 of the Ministry of Agriculture and Fisheries (Restructuring) Act 1995 provides that where a fee, charge, or levy required by any enactment to be paid to the Ministry is unpaid, the debt is deemed to have been increased by a penalty amount as set out in section 18(3). Under section 273 of the Fisheries Act 1996, the Chief Executive may register a caveat against a person's quota where that person has failed to pay levies. Under section 275, the Chief Executive may suspend a person's fish receiver's licence, fishing permit, or controlled fishery licence where a person has not paid levies under section 262. Under section 207, a Fishery Officer may seize property used in the commission of an offence. It is not an offence under the 1996 Act to not pay levies.
- 159 It has been submitted to us by Treasury that the priority afforded to levies under the Fisheries Act should be retained.<sup>137</sup> The argument advanced in support of this claim is that the arrears arise from illegal activity (fishing above quota) so the claim simply represents the recovery of stolen property. However, we have been informed by the Ministry of Fisheries that Treasury's submission is incorrect. The levies which are accorded priority under the Fisheries Act are not penalties in respect of illegal conduct but are, instead, levies which are imposed on all fishers. We agree with the Ministry of Fisheries' analysis. This disposes of Treasury's submission. However, in our view, even if the levies had represented fines for illegal activity, the levies should still not be accorded preferential status. There is an immediate difficulty with arguing that levies for illegal conduct should receive preference because no other claims for loss against thieves receive preferential treatment on bankruptcy or liquidation.
- 160 Whether a proprietary right in unpaid fishing levies which result from illegal conduct could be asserted by the Crown, turns on principles similar to those successfully advanced in *Attorney-General for Hong Kong v Reid* [1994] 1 NZLR 1 (PC). In that case, the Privy Council held that Mr Reid (a former Deputy Crown Prosecutor of the Government of Hong Kong) was liable as a constructive trustee to repay bribes received by him while discharging duties as a Crown servant. It was held that the proprietary interest in the bribes of the Hong Kong Government extended to enable it to recover the bribes from properties in New Zealand. A caveatable interest in the property in New Zealand was held to exist.
- 161 In our view, the principle in *Attorney-General for Hong Kong v Reid* would be distinguishable from the position with regard to fishing levies which resulted from illegal behaviour. A person who is granted a quota by the Crown does not stand in a fiduciary position to the Crown. Mr Reid, on the other hand, owed fiduciary obligations to the Crown as a result of the employer/employee relationship.<sup>138</sup>
- 162 No other reasons have been put to us which justify the retention of this priority.
- 163 For the reasons given in answer to the Treasury's submission (see paragraphs 159–161), we are of the view that the priority for fishing levies cannot be justified and should be abolished. Other more general reasons which support abolition can be found in paragraphs 140, 141, and 145.

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<sup>137</sup> Treasury submission dated 2 November 1998, 1.

<sup>138</sup> *Attorney-General for Hong Kong v Reid* [1994] 1 NZLR 1 (PC), 3.

### *Radiocommunications Act 1989*

- 164 Under section 183(4) of the Radiocommunications Act 1989, preference is accorded to debts owing under sections 149, 157, 164, 177(2)(c), and 178(2)(c). Section 183(1) provides that the Secretary of Commerce may recover in court any amount owing under the above sections. Section 183(2) provides that where a person owes money under the above sections (or under a judgment obtained under section 183(1)), the amount owing is a charge on the liable person's real and personal property. Section 183(3) provides that section 169 of the Tax Administration Act 1994 applies to the charge created. Section 169(7) of the Tax Administration Act provides that the High Court may make an order for the sale of the property the subject of the charge or for the appointment of a receiver of the rents, profits, or income of that property, and for the payment of the amount of the charge and the costs of the Secretary of Commerce out of the proceeds of the sale or out of the rents, profits, or income.
- 165 No arguments have been advanced to support the retention of this priority. We can see nothing to differentiate a levy under this Act from any general tax. In our view, there is no justification for continuing the priority under the Radiocommunications Act 1989 and we therefore recommend its abolition.
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## 6 Miscellaneous debts

### GENERAL

- 166 **T**HERE ARE A NUMBER OF MISCELLANEOUS DEBTS which have been accorded priority on bankruptcy or liquidation. These debts are:
- monies which the Motor Vehicle Dealers Institute Inc is entitled to recover from a defaulting licensee company under section 42 of the Motor Vehicle Dealers Act 1975;
  - sums to which a buyer is, or may become, entitled to receive from a seller under sections 9 and 11 of the Layby Sales Act 1971;
  - the costs incurred in organising and conducting a meeting of creditors for the purpose of voting on a proposed compromise under Part XIV of the Companies Act 1993: section 234(c) and clause 4 of the Seventh Schedule;
  - the priority given to holders of liens over books and papers of a bankrupt or a company, which operates in lieu of exercise of the right of lien: sections 73(2) and 104(1)(d)(iii) of the Insolvency Act 1967 and section 263(2) and clause 2(f) of the Seventh Schedule to the Companies Act 1993.

We deal with each in turn.

### SECTION 42 OF THE MOTOR VEHICLE DEALERS ACT 1975

- 167 Section 42 of the Motor Vehicle Dealers Act 1975 provides that where the Institute pays money out of the Motor Vehicle Dealers Fidelity Guarantee Fund to settle a claim against a motor vehicle dealer, the Institute is subrogated to all the rights and remedies of the person who received the money, as against the motor vehicle dealer in relation to whom the claim arose. Section 42(2) provides that a District Court Judge may declare that a person is personally responsible for repayment of the amount paid from the fund in settlement of the claim.
- 168 The Motor Vehicle Dealers Institute supports the retention of this preference.<sup>139</sup> The reasons given for priority status are:
- Not all creditors should have equal entitlement to participate in an insolvent estate, as some creditors lend money and give credit knowing full well that the entity is in a perilous state. These creditors normally build into their debt a premium for risk.
  - Unlike a commercial insurer, the Motor Vehicle Dealers Fidelity Guarantee Fund has no control over the risk which it undertakes. Licences are issued by the Motor Vehicle Dealers Licensing Board rather than by the Fund.

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<sup>139</sup> Submission of Motor Vehicle Dealers Institute Inc dated 30 October 1998.

- The Motor Vehicle Dealers Fidelity Guarantee Fund is the only fund which underwrites a *company's* fidelity as opposed to the fidelity of an *individual*.
- Reform of the Motor Vehicle Dealers Act is currently in train which will, if passed in its proposed form, abolish the Fund with the consequence that consumers will cease to be protected by the Fund and all claims arising will need to be lodged before a given date. It is suggested that the priority should not be withdrawn, given the difficulty of enforcing subrogation rights prior to the Fund's abolition. (The Motor Vehicle Dealers Bill was referred to the Commerce Select Committee on 17 June 1998 after its second reading. The Committee is due to report back on 31 August 1999.)

169 We have considered carefully the reasons advanced by the Motor Vehicle Dealers Institute in support of retaining the preference. However, we cannot discern any compelling reasons why the *pari passu* principle should not apply. In particular:

- Motor vehicle dealers contribute to the fidelity fund and it is, in effect, those dealers who stand to recover monies in preference to other creditors while the priority remains. A similar preference does not exist (and never has) in relation to fidelity funds operated by, for example, the New Zealand Law Society and the New Zealand Society of Accountants (prior to the formation of the Institute of Chartered Accountants of New Zealand). In our view, the distinction sought to be drawn between the guarantee of a company's obligation and the guarantee of an individual's obligation is not sufficiently compelling to justify the retention of this priority.
- We have already commented on the fundamental nature of the *pari passu* principle and on the plight of an involuntary creditor (see chapter 2 and paragraph 141). Those matters need no further attention.
- Reform of the Act seems to us to be a reason to abolish the preference rather than a reason to retain it. Reform of the Act suggests that the original policy considerations are spent.

170 We recommend abolition of this priority.

## LAYBY SALES

171 Section 11(1) of the Layby Sales Act 1971 provides:

If, on the liquidation or bankruptcy of any seller . . . there are no goods or not enough goods to enable the layby sale to be completed, or if any buyer is or becomes entitled under section 9 of this Act to recover any sum of money, then the buyer shall be a creditor in the liquidation, bankruptcy, or receivership to the extent of the payments that he has made to the seller on account of the purchase price of the goods or to the extent of the sum that he is entitled to recover, as the case may require, with priority . . . over all other unsecured creditors and over creditors secured by a floating charge.

172 Section 9 provides that where a layby sale is cancelled, if the total amount of money paid by the buyer exceeds the purchase price, the buyer shall be entitled to recover the excess from the seller as a debt due and payable by him to the buyer. Section 10(1) of the Layby Sales Act provides that if on the liquidation or bankruptcy of the seller the seller has goods of the kind which the seller has agreed to sell (whether those goods have been appropriated to the sale or not), the buyer can pay the balance of the purchase price and obtain those goods.

173 The Layby Sales Act 1971 was based on the report of the Contracts and Commercial Law Reform Committee of New Zealand.<sup>140</sup> The Committee noted that, while in general the layby system had been working well, there had been many cases of hardship. The Committee noted that where a company failed and the goods subject to the layby contract were not found in the liquidation, layby customers often sustained heavy losses. The Committee were of the opinion that the legislature should intervene. The Committee stated:

In our opinion the proper course is to recognise layby customers as a special class of creditors in the insolvency of the layby vendor. . . . We think that those who finance the vendor's business for gain and those who extend credit to the vendor to encourage the vendor to buy their goods should yield priority to the vendor's layby customers. They assist the vendor in order that he may sell and it seems to us proper that they should be bound within reason by the vendor's contracts in the ordinary course of the business they have made possible. . . . [T]he purchaser should be treated as if the property had passed and, if there are no goods available for him, should be advanced in priority over the general and secured creditors.

If such a preference is established, financiers and merchants will, in their own interest, exercise a degree of supervision over layby vendors. The unstable layby vendor will find it more difficult to raise finance or obtain credit.<sup>141</sup>

174 If there are goods available of the type paid for, no difficulty arises because the purchaser will be able to acquire the goods on payment of the balance of the purchase price (section 10 of the Layby Sales Act 1971). However, if such goods do not exist, there is little prospect of a remedy as the monies paid on account of the layby will have been mixed with fungibles and will, therefore, not be traceable.

175 We consider that there are compelling reasons why the priority afforded by the Layby Sales Act 1971 should be continued.<sup>142</sup> Our reasons are:

- Prudent budgeting should be encouraged rather than discouraged by the law. While consumer behaviour has changed significantly since the report of the Contracts and Commercial Law Reform Committee was prepared in 1969, anecdotal evidence suggests that layby is still a popular form of purchasing goods by those who do not wish to extend themselves financially. In other words, while there has been a growth in the use of credit cards,<sup>143</sup> prudent purchasers continue to use the layby system and should not be disadvantaged.
- Those who elect to use the layby system will largely have modest means. Accordingly, they can least afford to lose the money.
- The amounts at issue in relation to preferential claims based on layby sales will generally be modest and are unlikely to impact unduly on dividends received by other creditors.
- Appropriation of goods by the vendor is beyond the control of the customer.

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<sup>140</sup> The Contracts and Commercial Law Reform Committee of New Zealand (1969), *Layby Sales*.

<sup>141</sup> Contracts and Commercial Law Committee, n above 140, 9.

<sup>142</sup> We recognise a superficial similarity between the issues raised by layby sales and those by gift vouchers. Our reasons for drawing a distinction between them are set out in para 233.

<sup>143</sup> Credit cards were first introduced into New Zealand in 1981; for statistics showing the increase in credit card indebtedness between 1988 (\$2.575 billion) and 1997 (\$6.901 billion) see the *New Zealand Official Yearbook 1998* (Statistics NZ, Wellington 1998) 507.

176 We recommend retention of this priority.<sup>144</sup>

## COSTS OF COMPROMISE

- 177 The costs incurred in organising and conducting a meeting of creditors for the purpose of voting on a proposed compromise under Part XIV of the Companies Act 1993 are given priority, if incurred by a person other than the company, a receiver or liquidator, on liquidation: section 234(c) and clause 4, Seventh Schedule, of the Companies Act 1993.
- 178 The primary rule is that the costs must be met by the company (section 234(a)). If the costs are incurred by a receiver or a liquidator who promotes the compromise, then the costs become costs of the receivership or liquidation and are treated as administration costs (section 234(b)).
- 179 This provision provides an incentive for a company to face its creditors at the earliest possible time and, if possible, restructure its affairs without the need for liquidation. However, there may be an argument that the rule does not go far enough. For example, the wider powers given to the court to approve arrangements, amalgamations and compromises under Part XV of the Companies Act 1993 do not contain a provision equivalent to section 234 of the Act.<sup>145</sup>
- 180 There are obvious benefits in adopting such a priority. Such an approach would accord with the views expressed in the Report of the Task Force on Priority Claims and Insolvency Administration prepared by the Bankruptcy Legislation Sub-Committee of Committee J of the International Bar Association.<sup>146</sup> But, it seems to us necessary to consider the extent of the provision in the context of the question of whether New Zealand should adopt a voluntary administration procedure akin to that used in Australia or the United Kingdom. We recommend that the existing priority remain but that consideration be given to the wider question in terms of paragraphs 197–201.<sup>147</sup>

## LIENS OVER BOOKS AND PAPERS OF A BANKRUPT OR COMPANY

- 181 A priority is given to holders of liens over books and papers of a bankrupt or a company in liquidation. The right to seek preferential payment of a debt to a maximum amount of \$500 (with the balance being an unsecured debt) operates in lieu of the exercise of the right of lien. The rationale for the preference is that lien holders could disrupt the orderly administration of the bankruptcy or liquidation by refusing to provide the records without, in effect, being given preferential treatment for the whole of the debt to discharge the lien. The current

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<sup>144</sup> Compare with the Harmer Report, above n 15, paras 769–771 for a different approach to prepayments generally.

<sup>145</sup> Although it is possible that some form of priority might be given through Part XV of the Act, as ss 234 and 239 give the High Court power to adjust rights of creditors either in anticipation or in consequence of liquidation. However, there is no recognition of this possible *de facto* preference in the Seventh Schedule to the Act. This issue should be considered further in the context of paras 197–201.

<sup>146</sup> Presented to Committee J's meeting in New Orleans, USA on 11 October 1993 by the Task Force Co-Chairs Dr Ole Borch and Mr Timothy L'Estrange.

<sup>147</sup> See chapter 7.



priorities are set out in sections 73(2) and 104(1)(d)(iii) of the Insolvency Act 1967 and section 263(2) and clause 2(f), Seventh Schedule, of the Companies Act 1993.

- 182 The issue is whether the priority should remain or whether lien holders should have to prove on an unsecured basis for the whole of their debt. The position of a lien holder in respect of books and papers of a bankrupt or a company in liquidation is not dissimilar to the position of a supplier of essential services which is prohibited from requiring outstanding charges to be paid as a condition of supply or from requiring that the liquidator personally guarantee charges which would be incurred for the supply of the service: see section 275 of the Companies Act 1993.<sup>148</sup> The point of the distinction between the supplier of essential services (which has no preferential claim) and this type of lien holder (who does) is that the lien holder has a lawful possessory lien which is not allowed to prevail because it would create inefficiencies in the administration of an insolvent estate, whereas the supplier of an essential service is reliant on “commercial muscle” to achieve the de facto priority which section 275 of the Companies Act 1993 sought to end.
- 183 At present, someone who has done little work may get the whole of the debt back in priority to other creditors because of the limit of the preference. On the other hand, someone who has done a great deal of work is only entitled to a priority claim to the extent of \$500.
- 184 We recommend that the preferential claim be made 10 per cent of the amount of the total debt, up to a maximum level of \$2000. This will, in our view, remove the unfairness which currently operates in providing complete reimbursement to someone who has done very little work for a bankrupt or a company in liquidation but providing little compensation to those who have done work of far greater value. A maximum preferential entitlement of \$2000 will mean that someone who is owed \$20 000 or more will receive a preferential entitlement of \$2000 and rank unsecured for the balance, while those owed less than \$20 000 will receive 10 per cent of the amount actually owed and also rank unsecured for the balance.

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<sup>148</sup> For background to the prohibition contained in s 275 of the Companies Act 1993 see *Company Law Reform and Restatement* (NZLC R9, 1989) at paras 683 (p 160) and 784–785 (p 388).

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## 7 Additional priorities and other issues

### GENERAL

- 185 **I**N THIS CHAPTER we consider:
- whether any new priorities should be created; and
  - whether any other amendments to the preferential debts regime need to be made.
- 186 We approach the question of whether any additional priorities should be created by referring to the principles identified in chapter 2 of this report. There are five distinct issues which we think should be addressed:
- first, whether some form of incentive should be provided to creditors who wish to finance an action taken by an Official Assignee or a Liquidator to recover funds for the benefit of the general body of creditors;
  - second, whether there is a need to extend the priorities for reorganisation costs;
  - third, whether some additional protection should be given to sub-contractors whose ability to protect themselves against non-payment was diminished by the repeal of the Wages Protection and Contractors' Liens Act 1939;
  - fourth, whether subrogation rights in respect of priority claims should be expressly addressed in the Insolvency Act 1967 and the Companies Act 1993;
  - fifth, the possibility of a super-priority for the cost of remedying environmental damage done by a debtor.
- 187 We also consider:
- whether there is a need to synthesise the definitions of "secured creditor" in the Companies Act 1993 and the Insolvency Act 1967; and
  - what consequential changes to the ranking of priorities between creditors are required if our recommendations are accepted.

### INCENTIVES TO FINANCE PROCEEDINGS

- 188 Section 564 of the Corporations Law (Australia) states:
- Where in any winding up:
- (a) property has been recovered under an indemnity for costs of litigation given by certain creditors, or has been protected or preserved by the payment of moneys or the giving of indemnity by creditors; or
  - (b) expenses in relation to which a creditor has indemnified a liquidator have been recovered;
- the Court may make such orders, as it deems just with respect to the distribution of that property and the amount of those expenses so recovered with a view to giving

those creditors an advantage over others in consideration of the risk assumed by them.

- 189 A similar provision is found in the Australian bankruptcy legislation where section 109(10) of the Bankruptcy Act 1966 (Cth) provides that:

Where in any bankruptcy:

(a) property has been recovered, realized or preserved under an indemnity for costs of litigation given by a creditor or creditors; or

(b) expenses in relation to which a creditor has, or creditors have, indemnified a trustee have been recovered;

the Court may, upon the application of the trustee or a creditor, make such orders as it thinks just and equitable with respect to the distribution of that property and the amount of those expenses so recovered with a view to giving the indemnifying creditor or creditors, as the case may be, an advantage over others in consideration of the risk assumed by creditor or creditors.

- 190 Section 564 of the Australian Corporations Law gives the Court power to confer an advantage on certain creditors who have assisted the liquidator to recover or preserve assets of the company, by providing an indemnity to the liquidator against the costs of litigation. Section 450 of the Companies Act 1981 was in the same terms as section 564. The Harmer Report discussed section 450 of the Companies Act 1981 and recommended that the court should continue to have a discretion to distribute the proceeds of an action in favour of those creditors who took the risk of financing it.<sup>149</sup>

- 191 Under both statutes, the court has an unfettered discretion (although, undoubtedly, to be exercised judicially) and may award the indemnifying creditors a larger proportion of the property than the creditor would otherwise have received in the bankruptcy. In exercising its discretion, the court has regard to the fact that the indemnifying creditor or creditors took a risk in funding the action or enabled the trustee to recover or preserve assets which would otherwise have been unavailable to the creditors (see, for example, *Re Invermee; Ex p Official Receiver* (1974) 36 FLR 187 and *Re Goodall* (1978) Tas SR 218). In exercising the discretion, the Court takes into account:

the amount of risk run, the amount recovered, the proportion between the debts of indemnifying creditors, and those non-indemnifying creditors and all other matters. (*Re Bavistock* (1946) 14 ABC 30, 32 per Paine J)

- 192 The rationale for section 109(10) is "to encourage creditors to support a liquidator in taking legal proceedings against persons for the recovery of property or the defence of the property of the estate".<sup>150</sup> The indemnifying creditors will often receive an advantage over other creditors in consideration of the risk assumed by them. It has been held that the advantage should be more than something "nominal" (*Re Bavistock* (1946) 14 ABC 30, 33). It is not uncommon for trustees with no available funds to obtain an indemnity from creditors to permit the trustee to pursue litigation, on the basis that the trustee will apply to the court on behalf of the indemnifying creditors to have the creditors awarded a greater proportion of the property recovered.

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<sup>149</sup> Harmer Report, above n 15, para 140.

<sup>150</sup> *Laws of Australia*, Bankruptcy, para 125.

- 193 Anecdotal evidence from Australian practitioners suggests, however, that judges have not taken a uniform approach to fixing an appropriate priority under the discretion. Consequently, there has been some dilution of the benefits envisaged by the Australian provisions, because creditors would prefer not to wait until the proceedings have run their course to know how the proceeds will be shared. It seems to us that a clear rule based on expected results is to be preferred to the court determining the sharing of proceeds afterwards, as creditors can then better assess their risk.
- 194 The Law Commission received a submission recommending that New Zealand adopt a provision similar to section 564 of the (Australian) Corporations Law.<sup>151</sup> The submission noted that if a provision similar to section 564 was enacted in New Zealand, there would be an incentive for creditors to fund actions. Currently, creditors are loath to fund actions where priority creditors will get most of the money realised. Experience suggests that preferential creditors rarely finance actions of this type.
- 195 The Joint Insolvency Committee<sup>152</sup> expressed support for the proposition that it should be lawful for a creditor to obtain a preference either by funding actions to recover assets for distribution among creditors or by funding proceedings which defend claims which would diminish the value of the assets available for distribution. The Committee noted that even if priority was given to a financing creditor, the remaining creditors could only benefit from the action. They could not be worse off as a result of such an agreement.
- 196 We recommend an approach similar to that adopted in Australia, but without court discretion being exercised over the proportions in which proceeds should be shared. We recommend a mandatory priority in relation to litigation proceeds or over property preserved by the proceedings. If more than one creditor funds the action, then the proceeds should be shared ratably on the basis of admitted claims.<sup>153</sup>

## REORGANISATION COSTS

- 197 A survey of preferential debts conducted by Committee J of the International Bar Association in 1993<sup>154</sup> concluded that there was merit in including as a preferential debt the costs incurred in trying to put together a compromise for creditors when, ultimately, the compromise is unsuccessful. In a discussion paper circulated by the Co-Chairs of the Committee J Task Force entitled *Statement of Common Principles of Priority Claims and Insolvency Administration*, it was suggested that preferential status could be granted to:

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<sup>151</sup> Submission of A Agar, Phillips Fox, Auckland, 16 September 1998.

<sup>152</sup> See n above 67.

<sup>153</sup> We envisage the need to disclose the financing creditor so that it may be made liable to pay security for costs where appropriate.

<sup>154</sup> This survey was conducted by the Bankruptcy Legislation Sub-Committee of Committee J through its Task Force on Priority Claims in Insolvency Administration which was presented to Committee J's 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. The countries which responded to the survey were Australia, Bermuda, Bulgaria, Canada, Czech Republic, Denmark, England and Wales, Finland, Ireland, Italy, New Zealand, Norway, Poland, Romania, Spain, Sweden and USA.

Debts contracted by the debtor, during a preceding period of suspension of payments with some kind of official management or supervision, if the debt is contracted with the approval of the appointed management/supervision.<sup>155</sup>

- 198 The issue is whether such an approach should be adopted in New Zealand.
- 199 There is currently only a limited right to claim the cost of organising and conducting a meeting of creditors as a priority debt (section 234 of the Companies Act 1993). However, the scope of that provision is arguable. For instance, does the provision include only those costs which relate specifically to the meeting of creditors or does it also include the costs of putting together the reorganisation plan which is considered by the creditors? The difference in the amount claimable could be considerable. On the face of it, there appears to be a basis for creating an incentive for debtors to face their creditors at the earliest possible time, which would justify such a preference.
- 200 We are loathe to make a recommendation until the economic impact of the suggestion can be assessed. It would be wrong, for example, to create a priority which might encourage additional (but unwarranted) expenditure on reconstruction costs when it is likely that little or no benefit to creditors would ensue.
- 201 This type of priority might be more justifiable if abolition of the priorities recommended by us takes place and it is decided to enact a provision along similar lines to that contained in section 588FGA of the Corporations Law (Australia) in an endeavour both to provide the Crown with an alternative remedy against a director of a company and to provide an incentive for the director to commence restructuring proceedings. The issue is also allied to the possible introduction of voluntary administration provisions in New Zealand. Empirical research is required before a recommendation can be made on this issue.<sup>156</sup>

## SUB-CONTRACTORS

- 202 Under the Wages Protection and Contractors' Liens Act 1939, sub-contractors who carried out work on land were entitled, within prescribed time limits, to protect themselves for payment, either by registering a lien against the land on which the work was done or by seeking a charge over monies payable by the owner to the head contractor.<sup>157</sup> In the Harmer Report, reference was made to sub-contractors and the limited protection given to such persons in some Australian states.<sup>158</sup>
- 203 The Wages Protection Contractors' Liens Act 1939 was repealed by the Wages Protection and Contractors' Liens Act Repeal Act 1987. While there had been some concerns about the utility of the 1939 Act in practice, it seems clear enough that those representing the interests of sub-contractors preferred the retention

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<sup>155</sup> Page 3.

<sup>156</sup> See chapter 10.

<sup>157</sup> *Re Williams, Ex Parte Official Assignee* (1899) 17 NZLR 712 at 719 (CA) and *Farrier-Waimak Limited v Bank of New Zealand* [1965] NZLR 426 at 443 (PC) and J Wilson, *Contractors' Liens and Charges* (2 ed, Butterworths, Wellington, 1976) 2.

<sup>158</sup> Harmer Report, see above n 15, para 729, which referred to the Sub Contractors' Charges Act 1974 (Qld) and Workmen's Liens Act 1893 (SA).

of the Act to the prospect of its repeal. A review of the Act had been undertaken in 1965. The report which followed the review identified areas of concern.<sup>159</sup> The Act seems to have been repealed because consensus on modifications to the Act was not achieved.<sup>160</sup>

- 204 Since the repeal of the Wages Protection Contractors' Liens Act 1939, the use of "pay when paid" and "pay if paid" clauses appear to have become more prevalent. Such clauses provide that sub-contractors cannot collect money payable to them until their head contractor has been paid by the owner or employer ("pay when paid"), or that head contractors have no obligation to pay sub-contractors unless they are paid ("pay if paid").<sup>161</sup>
- 205 The underlying concern is that sub-contractors are effectively used to finance the head contractor's work through the use of "pay when paid" and "pay if paid" clauses and by delays in making payments. Consequently, if the employer becomes insolvent, the sub-contractor will ultimately carry the loss. This is precisely the concern which the contractors' lien and charge, introduced by the forerunners to the Wages Protection and Contractors Liens Act 1939, was intended to overcome.
- 206 In our view, the insolvency law review is the right time to consider whether Part II of the Wages Protection and Contractors' Liens Act 1939 should be re-enacted in some modified form. As the Dugdale Committee Report is not generally available, we reproduce it as Appendix E to assist consideration of this issue.

## SUBROGATION RIGHTS

- 207 If a third party finances the payment of a priority claim, the question arises as to whether that party is to be subrogated to the priority of the creditor who has been paid.<sup>162</sup> There is already specific provision for this in relation to wages.<sup>163</sup>
- 208 There is no statutory provision which makes it clear that other debts can be subrogated. If the intention is to create a schedule of all debts which have priority rights, then rights of subrogation should be included.
- 209 We recommend that subrogation rights be expressed clearly in both the Insolvency Act 1967 (section 104) and the Companies Act 1993 (Seventh Schedule). Such an approach is desirable because of the need to express existing preferences clearly and unambiguously. Such an approach would be consistent with:

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<sup>159</sup> New Zealand Property Law and Equity Reform Committee, Wages Protection and Contractors' Liens Act 1939 (1965, Chairman DF Dugdale) to which reference is made at (1987) 483 NZPD 503.

<sup>160</sup> 7 October 1987 (1987) 483 NZPD 503 per Rt Hon Geoffrey Palmer MP, Minister of Justice.

<sup>161</sup> The legality of such clauses was affirmed in *Smith & Smith Glass Limited v Winstone Architectural Cladding Systems Limited* [1992] 2 NZLR 473 and *R H Page Ltd v Hitex Plastering Ltd* (22 December 1997, High Court, Auckland, CP 429/97, Paterson J).

<sup>162</sup> P Wood *Law & Practice of International Finance: Principles of International Insolvency* (London, Sweet & Maxwell, 1980) p 25, paras 1–42.

<sup>163</sup> Insolvency Act 1967, s 104(2), and Companies Act 1993, Seventh Schedule, cl 7. See also *Waikato Savings Bank v Andrews Furniture Limited* [1982] 2 NZLR 520. For the English practice see also *Re E J Morel (1934) Limited* [1962] Ch 21.

- section 104(2) of the Insolvency Act 1967 and clause 7 of the Seventh Schedule to the Companies Act 1993; and
- the notion that where a creditor is owed a partly preferential and partly unsecured debt but is liable to the bankrupt for a separate debt, the preferential and unsecured debts will abate proportionately in giving effect to set off (*Re Unit 2 Windows Limited* [1985] 1 WLR 1383); and
- the general right of subrogation available to a person who pays a secured debt. It would be illogical for the law to treat a preferential debt differently.

## ENVIRONMENTAL DAMAGE

- 210 The cost of remedying environmental damage has been given preferential status in some jurisdictions.<sup>164</sup> Despite this, we received no submissions suggesting that such reinstatement costs should have preferential status in New Zealand. We mention this issue in the interests of completeness.
- 211 We are of the view that in the absence of evidence suggesting a compelling need for such a priority, no priority should be established.

## SECURED CREDITORS

- 212 We have not questioned, and see no legitimate basis to question, the priority given to secured creditors. However, we think it proper to note our concern with the definitions of “secured creditor” in the Companies Act 1993 and the Insolvency Act 1967.<sup>165</sup>
- 213 The term “secured creditor” is defined at some length in the Insolvency Act 1967. “Secured creditor” is defined as meaning:
- a person holding a mortgage, charge, lien, or security on the property of the debtor, or any part thereof, as a security for a debt due to him from the debtor, whether given directly or indirectly through another person as security for a debt due to the creditor:
- 214 In contrast, section 2(1) of the Companies Act 1993 defines “secured creditor” in more stark terms by stating that it means:
- a person entitled to a charge on or over property owned by [the] company:
- The term “charge” is defined to include:
- a right or interest in relation to property owned by a company, by virtue of which a creditor . . . is entitled to claim payment in priority to creditors entitled to be paid under section 313 of this Act [which refers to preferential and other claims]; but does not include a charge under a charging order issued by a court in favour of a judgment creditor:
- 215 In our view, these definitions should be synthesised. The Insolvency Act 1967 definition casts a wide net. It is arguable whether all securities which fall under the Insolvency Act 1967 definition should be treated as securities for insolvency law purposes. In particular, we note that:

<sup>164</sup> For example, Canada. See above n 27 which refers to the Canadian legislation.

<sup>165</sup> The term “secured creditor” is defined in different terms in s 2(1) of the Companies Act 1993 and s 2(1) of the Insolvency Act 1967.

- the definition includes general liens, of the type discussed in *Re Papesch* [1992] 1 NZLR 751, and possessory liens (see, for example, *Re Boulton* [1926] GLR 329); and
- it has been suggested that a charging order should be regarded as a security rather than as a form of execution to which section 50 of the Insolvency Act 1967 should apply (see *Re Piercy, ex parte Baynes* (11 March 1988, High Court Invercargill M52/87, Tipping J)).<sup>166</sup> This is directly contrary to the Companies Act 1993 definition.

- 216 On the other hand, some classes of creditors who would fall within the definition of “secured creditor” have been denied priority. For example, section 73 of the Insolvency Act 1967 and section 263 of the Companies Act 1993 recognise that a person should not be entitled, as against an Official Assignee or Liquidator to claim or to enforce a lien over books, records or documents of the bankrupt or company in liquidation which would be needed by the Official Assignee or the Liquidator to perform his or her duty. A preference is created in favour of that person in lieu of the security which would otherwise be granted.<sup>167</sup>
- 217 The definition of “secured creditor” has an impact on the extent of assets available for both preferential and unsecured creditors.
- 218 We recommend that the definitions under both Acts be synthesised. We also recommend that the precise scope of the definition be considered by the Ministry in the course of the insolvency law review. The issue falls outside our current brief. We offer the suggestion that only perfected security interests under the proposed Personal Property Securities Act and registered mortgages over land should be considered as secured creditors for insolvency law purposes.

## RANKING OF PRIORITIES

- 219 We would rank the preferences which we have recommended be retained as follows:
- first, all administration costs;<sup>168</sup>
  - second, all other priorities to rank *pari passu* and to abate proportionally if necessary.
- 220 In our view, it is desirable that there be as little differentiation as possible between preferred creditors. We think this suggestion strikes the right balance.

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<sup>166</sup> This arises from the way in which R 548 High Court Rules 1985 is worded.

<sup>167</sup> See chapter 6, paras 181–184. See also the discussion of the lien in the context of a liquidator’s application to gain access to the documents, without prejudice to the lien, by examination order under s 262 of the Companies Act 1955 in *Re Stream Industries Limited* (21 November 1980, High Court, Auckland, M 1190/80, Holland J).

<sup>168</sup> However, the priority granted to a funding creditor in respect of its debt should apply only to the assets recovered or preserved: see paras 188–196.



## Phoenix companies

### BACKGROUND

221 THE PROBLEM OF THE "PHOENIX COMPANY" was put in the following way by the Law Reform Committee of the Parliament of Victoria:

A limited liability company fails, unable to pay its debts to creditors, employees and the State. At the same time, or soon afterwards, the same business rises from the ashes with the same directors, under the guise of a new limited liability company, but disclaiming any responsibility for the debts of the previous company.<sup>169</sup>

222 The problem has also surfaced in New Zealand. One particular example is New Zealand Stevedoring Company Limited, which reorganised its affairs in New Zealand last year, after over 300 wharf employees and staff had lost their jobs, in a manner which enabled redundancy payments of over \$14 000 000 to be avoided.<sup>170</sup> The company (and a number of its subsidiaries)<sup>171</sup> was placed in receivership on 10 March 1998 and in liquidation on 29 April 1998. Before receivership, their businesses were transferred to companies associated with the parent. An Australian example is *Patrick Stevedores Operations No 2 Pty Limited v Maritime Union of Australia* (1998) 72 ALJR 873.<sup>172</sup> In that case, the employer companies sold their businesses for a price of A\$314.9 million with the majority of this money being used to pay off intra-group loans and other debts and to effect a share buy-back scheme. As a result of the arrangements, by April 1998 shareholders' funds in the employer companies were reduced to A\$2.5 million which significantly diminished the amount of money available to pay preferential creditors.

<sup>169</sup> Law Reform Committee of the Parliament of Victoria *Curbing the Phoenix Company: First Report on the Law Relating to Directors and Managers of Insolvent Corporations* [1994] para 1.1. See also the Second and Third Reports of the Law Reform Committee of the Parliament of Victoria, dated May 1995 and November 1995 respectively.

<sup>170</sup> For press reports dealing with this issue see, in particular: *The Dominion* 16 September 1998, 11; *New Zealand Herald*, 17 August 1998; *The Christchurch Press* 27 June 1998, 7; *New Zealand Press Association* 26 June 1998; *New Zealand Press Association* 24 March 1998; *The Nelson Mail* 14 March 1998, 18; *New Zealand Herald* 12 March 1998; *New Zealand Press Association* 12 March 1998; *The Dominion* 12 March 1998, 2; *The Christchurch Press* 11 March 1998, 9; *New Zealand Press Association* 11 March 1998; *The Dominion* 11 March 1998, 1; *New Zealand Press Association* 10 March 1998; *New Zealand Press Association* 10 March 1998; *Lloyd's List* 10 March 1998; *New Zealand Herald* 27 February 1998; *The Daily News* 26 February 1998, 4; *The Christchurch Press* 25 February 1998, 3; and *Reuters News Service* 24 February 1998.

<sup>171</sup> Otago Stevedoring Company Limited, Waitemata Stevedoring Company Limited, Wellington Stevedoring Company Limited, Timaru Stevedoring Company Limited, Canterbury Stevedoring Company Limited, and Kaimai Stevedoring Company Limited.

<sup>172</sup> See also, R Hammond, *Voluntary Administrators: their role, powers and liability with respect to employee wages* (1999) 7 *Insolvent LJ* 40 for a commentary on this case.

- 223 We have been asked to consider whether any changes to the law relating to preferential payments are needed. In our view, the issues raised by phoenix companies are much wider than those we are considering in this report. The problems to be addressed include general questions of corporate governance, which have been reconsidered in New Zealand quite recently.
- 224 It is lawful for an insolvent company to sell its assets, at market value, to someone who is prepared to pay market price. The technique used is known as hive-down.<sup>173</sup> A hive-down is a well-established insolvency technique which has, if used properly, many virtues. It enables an administrator of an insolvent entity to sell the business as a going concern for a market value. In some cases, it may be sold to the existing management; in others, it may not. The difficulty is in distinguishing a decision to sell in good faith, and on proper terms, from a decision to sell to avoid liability.
- 225 The Third Report of the Law Reform Committee of the Parliament of Victoria sets out recommendations made to curb improper use of the phoenix company. The recommendations concentrate upon issues of corporate governance, including provisions relating to disqualification of directors. New Zealand law is generally adequate in this area, with disqualification provisions having improved significantly with the passing of the Companies Act 1993. We refer, in particular, to sections 382–386 of the Companies Act 1993. In addition, the laws in New Zealand relating to duties of directors<sup>174</sup> provide adequate remedies against directors when phoenix companies are used in bad faith to defeat the claims of creditors.
- 226 A fundamental issue in this context is the whole question of corporate personality and whether *Salomon*<sup>175</sup> is still the appropriate way to view that personality. Many companies operate not as distinct legal entities but as part of a larger economic grouping of companies which disclose accounting information not only individually but in a consolidated form.<sup>176</sup> A company may be set up within a group simply to employ staff; being entirely reliant on other members of the group to finance the payment of wages. That is the larger aspect of the phoenix company problem which must be addressed.

## A POSSIBLE SOLUTION

- 227 There is one potential solution to the problem of phoenix companies to which we wish to refer. By a Directive<sup>177</sup> dated 14 February 1977, the Council of Ministers of the European Community directed that upon the transfer of a

<sup>173</sup> See generally G Lightman and G Moss, *The Law of Receivers of Companies* (2 ed, Sweet & Maxwell, London, 1994) 147–156.

<sup>174</sup> Generally, see ss 131–138 and ss 300–301 of the Companies Act 1993. See also T Telfer, *Risk and Insolvent Trading* in Rickett and Grantham (eds) *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, 1998) 127–148.

<sup>175</sup> *Salomon v A Salomon & Co Limited* [1897] AC 22 (HL). See also *Company Law Reform and Restatement* (NZLC R9, 1989) at paras 127 and 352. See also Lord Cooke of Thorndon's Hamlyn Lecture, "A Real Thing: *Salomon v Salomon* [1897] AC 22, 33 per Lord Halsbury" in *Turning Points of the Common Law* (London, Sweet & Maxwell, 1997).

<sup>176</sup> For a discussion of this issue in an insolvency context see Wyatt and Mason, *Legal and Accounting Regulatory Framework for Corporate Groups: Implications for Insolvency in Group Operations* (1998) 16 C & SLJ 424.

<sup>177</sup> Council Directive 77/187 EEC.

business from one employer to another, the benefit and burden of a contract of employment between the transferor (“the old owner”) and a worker in the business should devolve on the transferee (“the new owner”). The Directive therefore imposed on the new owner liability for the workers in the business.<sup>178</sup>

228 The object of the Directive was expressed to be:

To provide for the protection of employees in the event of a change of employer, in particular, to ensure their rights are safeguarded; (*Litster v Forth Dry Dock Co Limited* [1990] 1 AC 546 (HL(Sc)) 555 per Lord Templeman).

229 The Directive was enacted in the United Kingdom through the Transfer of Undertakings (Protection of Employment) Regulations 1981.<sup>179</sup> In *Litster v Forth Dry Dock Co Limited*<sup>180</sup> the House of Lords outlawed a practice of dismissing employees a short time before hive-down in an attempt to avoid the operation of regulation 5 of the Regulations and thus to obtain a higher price for the sale of the subsidiary.<sup>181</sup>

230 We note that we have not had the opportunity to consult or to carry out empirical research on the implications of adopting such a scheme. The purpose of mentioning the potential solution is to enable the Ministry to consider whether it is something which could usefully be enacted in New Zealand. In considering the scheme, the Ministry will need to consider whether such a provision should apply in all circumstances where a transfer of undertaking takes place (that is, whether or not insolvency is a factor in the decision to transfer) or whether it should be limited to circumstances in which the transfer does not occur for true market value.<sup>182</sup> The Ministry would also need to consider carefully:

- how such a provision would interact with remedies available to employees under the Employment Contracts Act 1991; and
- whether adoption would give employees sufficient protection to justify either a reduction in the priority given to employees’ claims on insolvency or abolition of that priority; and
- the economic impact on acquisitions of businesses as a going concern.

We recommend that the Ministry address these issues in the insolvency law review together with the more fundamental issues raised in paragraph 226.

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<sup>178</sup> Member States were authorised by article 3 of the Directive to continue the liability of the old owner to the workers in the business in addition to the new owner.

<sup>179</sup> SI 1981 No 1794.

<sup>180</sup> The House of Lords followed decisions of the European Court of Justice, in particular, *P Bork International A/S v Foreningen af Arbejdsledere i Danmark* (Case 101/87) [1989] IRLR 41.

<sup>181</sup> See also Lightman and Moss, above n 173, 156.

<sup>182</sup> The regulations in force in the United Kingdom apply to all cases so that even a hive-down for market value cannot be effected outside the scope of the Regulations: see Lightman and Moss, above n 173, 156.

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## Gift vouchers

- 231 **W**E HAVE BEEN ASKED TO CONSIDER problems arising from the use of gift vouchers which arose as a result, in particular, of the receiverships of Levene & Co Limited and Palmers Garden Centres Limited.<sup>183</sup>
- 232 The problem can be expressed in the following way. A person goes into a retail outlet and buys a gift voucher with the intention of handing that voucher to a friend or relative as a gift. The money paid for the gift voucher is, in effect, a prepayment for unascertained goods. It gives the recipient of the gift voucher the ability to present the voucher to the named outlet and to acquire goods to the value stated on the voucher. There are no ascertained goods at the time at which the gift voucher is purchased. Consequently, no proprietary remedy will exist in favour of a purchaser who has received the voucher as a gift.<sup>184</sup>
- 233 It might be argued that prepayment for goods by purchasing a gift voucher is no different in principle from the prepayments made to a vendor when a layby sales transaction occurs.<sup>185</sup> But, we think there is an important distinction. In a layby transaction, the vendor ought to appropriate goods for the purchaser. When a gift voucher is bought, no goods are purchased and therefore no appropriation of goods can take place. The voucher is redeemed in due course to acquire goods to the value shown in the voucher, but the purchasing power of the voucher may decrease in the interim if prices increase. In those circumstances, we do not believe a case can be made to afford priority to holders of gift vouchers.
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<sup>183</sup> Reference is made in particular to the *Waikato Times*, 24 November 1997, 3; *The Dominion*, 23 January 1998, 1; *New Zealand Herald*, 23 January 1998; *Independent Business Weekly*, 25 February 1998; *Waikato Times*, 20 May 1998, 12; and *New Zealand Herald*, 20 May 1998.

<sup>184</sup> See *Re Goldcorp Exchange Limited (In Receivership)*, *Kensington v Liggett* [1994] 3 NZLR 385 (PC).

<sup>185</sup> See paras 171–176 as to layby sales.

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## 10 Recommendations

### GENERAL

- 234 **WE RECOMMEND THAT** the Ministry consider synthesising the definitions of “secured creditor” in the Insolvency Act 1967 and the Companies Act 1993 (see paragraphs 212–218).
- 235 **We recommend** that a provision in the form of clause 11 of the Seventh Schedule to the Companies Act 1993 be enacted in the Insolvency Act 1967. This is to ensure consistency of approach.
- 236 **We recommend that:**
- all preferential debts should be scheduled in a clear, definitive, and unambiguous fashion; and
  - all preferences be considered with the principles discussed in chapter 2 in mind.
- 237 **We recommend** that a provision akin to section 7 of the New Zealand Bill of Rights Act 1990 be enacted in the Insolvency Act 1967 and in the Companies Act 1993, providing that any Member of Parliament introducing a Bill into the House of Representatives must indicate whether there is anything in the Bill which would affect the order of priorities set out in the insolvency regime schedules. This should be supported by Standing Orders of the House of Representatives (see paragraphs 28 and 29).
- 238 **We recommend** that, so far as is practicable, the preferential debts for bankruptcy, receivership, and liquidation should be identical. It is possible that some debts which are justifiable in, for example, a liquidation, may not be debts into which an individual would enter. In those circumstances, we would regard the “so far as is practicable” qualification as being effective.

### ADMINISTRATION COSTS

- 239 **We recommend** that the existing administration costs be retained (see paragraph 35).
- 240 **We recommend** that the priority afforded to administration costs should include the reasonable solicitor/client costs of procuring an order of adjudication or liquidation by a creditor (see paragraphs 36 and 37).
- 241 **We recommend** that the legislation affecting individuals and companies should be synthesised, and that in both cases, a majority in number and 75 per cent in value of creditors have the right to approve remuneration for a committee, with that remuneration forming part of the administration costs. A right for a dissenting creditor to apply to the court, to challenge such a resolution, should be added (see paragraphs 38 and 39).

## EMPLOYEE-RELATED CLAIMS

- 242 **We recommend** that:
- a priority for wages or salary of an employee be retained (see paragraphs 50,<sup>186</sup> 67–69 and 79–82); and
  - there be a mechanism established for reviewing the limit of the preference (see paragraph 81).
- 243 **We recommend** that the preferential status afforded to apprentices and to persons whose employment is terminated by reason of involvement in protected voluntary training under the Volunteers Employment Protection Act 1993 be abolished (see paragraphs 70–78).
- 244 **We recommend** that all claims by directors of companies (as the term “director” is defined in section 126 of the Companies Act 1993) for remuneration should be barred from preferential status (see paragraphs 51–54).
- 245 **We recommend** that the provisions in relation to rights of subrogation for payment of wages or salary, set out in section 104 (2) of the Insolvency Act 1967 and clause 6 of the Seventh Schedule to the Companies Act 1993, be repealed and replaced with a general subrogation clause (see paragraphs 207–209).

## REVENUE-RELATED CLAIMS

- 246 **We recommend** that the specific priorities for PAYE deductions, child support, student loan payments and deductions for accident compensation payments be repealed on the grounds that they are payments which fall, in any event, under clause 2(d) of the Seventh Schedule to the Companies Act 1993 as “amounts deducted by the company from the wages or salary of an employee in order to satisfy obligations of the employee:” (see paragraphs 132–133). In effect, this will place a limit on PAYE entitlement to preferential status because it will be linked to unpaid wages.
- 247 **We recommend** that the PAYE portion of the wages claim be in addition to the \$6000 limit but that other deductions be treated as falling within the \$6000 maximum claim (see paragraph 115).
- 248 **We recommend** that the preferential entitlements for GST, customs duty, levies under the Fisheries Acts and the Radiocommunications Act be abolished (see paragraphs 145, 152, 160–163, and 165).
- 249 **We recommend** that preferential status of NRWT and RWT deductions should continue (see paragraph 146).

## MISCELLANEOUS PRIORITIES

- 250 **We recommend** that the priority given to the Motor Vehicle Dealers Institute Inc be abolished (see paragraphs 169 and 170).
- 251 **We recommend**:
- that the preferential claim in favour of a lien holder in respect of books and records of a company or bankrupt be retained; but
  - that the preference be modified so that it is limited to 10 per cent of the amount owing to the lien holder, with a maximum preferential sum of \$2000 in any given case (see paragraphs 181–184).

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<sup>186</sup> See also the PAYE recommendation at paras 115 and 247.

- 252 We recommend that the preference for layby sales be retained (see paragraphs 175 and 176).

## NEW PRIORITIES

- 253 We recommend that the Ministry of Commerce undertake empirical research to ascertain whether a new priority should be established to cover the actual costs of failed reconstruction or reorganisation arrangements under, for example, Part XV of the Insolvency Act 1967 or Parts XIV or XV of the Companies Act 1993 (see paragraphs 197–201).
- 254 We recommend that it be stated explicitly in the Seventh Schedule to the Companies Act 1993, that the entitlements set out in the Schedule are subject to a discretion which can be exercised by the High Court in the event of a compromise or arrangement approved under Part XIV or Part XV of the Companies Act 1993 failing (see sections 233 and 239 of the Companies Act 1993). The provisions contained in sections 233 and 239 of the Act give a wide discretion to a court to reorder priorities based upon agreements struck as part of the compromise process. Those matters should be expressed specifically in the Schedule to give effect to our recommendation that priorities should be stated clearly and unambiguously.
- 255 We recommend that consideration be given to the possibility of adopting similar provisions with regard to the costs of reorganisation and adjustments of rights as a result of a failed compromise in the Insolvency Act 1967, where a proposal is made under Part XV of that Act. We suggest that the question is whether business proposals under Part XV should be treated differently from consumer proposals.
- 256 No submissions have been made to us suggesting any need in New Zealand for a super-priority for the costs of remedying environmental damage of a type in force in Canada. We do not recommend adoption of such a priority.
- 257 We recommend that the Insolvency Act 1967 and the Companies Act 1993 be amended so that if a creditor or creditors decide to fund proceedings taken by an Official Assignee or a Liquidator (or to defend proceedings resulting in the preservation of assets), the fruits of those proceedings go first to pay the costs of the proceedings and then to meet the debt or debts of those who took the risk of funding the proceeding (see paragraphs 188–196).
- 258 We recommend that a specific provision be inserted in both section 104 of the Insolvency Act 1967 and the Seventh Schedule to the Companies Act 1993 stating that if a third party pays a debt which is afforded priority then the third party will be subrogated to the rights of the priority creditor (see paragraphs 207–209).
- 259 We recommend ranking of priorities in the order set out in paragraph 219.

## RESEARCH

- 260 We recommend that research be undertaken to see whether there are any grounds to consider re-enactment, in some modified form, of Part II of the Wages Protection and Contractors' Liens Act 1939 with a view to protection of sub-contractors. (See the discussion of this issue in chapter 7 at paragraphs 202–206.)
- 261 We recommend that empirical research be undertaken by the Ministry of Commerce to determine more precisely how much of the \$6000 priority for

wages is currently utilised, so that further consideration can be given, once that research is available, to the question of whether other employment contract benefits, such as employer contributions to superannuation schemes and redundancy, should be covered within the priority. The economic impact of an extension of the level of priority needs to be considered carefully. There is a potential for the extension of preferential claims of employees in one insolvency to adversely affect the claims of employees in other companies, if the company by which those other employees are employed is unable to receive a dividend due to preferential claims of employees in the first insolvency.<sup>187</sup> It may be more feasible to extend the employee priority if the claims of directors are excluded from preferential status. This is an issue which would also need to be addressed in any economic impact report. We would also suggest that the question of whether a Wage Earner Protection Fund may be a better solution be addressed at the same time. Research would be needed on the structure, funding, and operation of similar funds in other countries. Pending that research, **we do not recommend** extension of the wages priority.

#### FURTHER ADVISORY WORK?

- 262 We have identified two areas in which the Ministry may wish us to consider some of the issues further. These issues are:
- Whether New Zealand should consider using a Wage Earner Protection Fund of the type mentioned in chapter 4 (see paragraph 89).
  - Whether legislation of the type suggested in chapter 8 to deal with the issue of the “phoenix company” should be adopted in New Zealand (see paragraphs 227–230).
- 263 Should the Ministry wish us to assist further with any of these issues, or indeed any other issues, the Commission would be happy to do so.

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<sup>187</sup> See para 65.



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## APPENDIX A

### List of submitters

AA Agar, Phillips Fox, Auckland  
Christchurch Insolvencies Special Interest Group  
David Blanchett, Beattie Rickman, Chartered Accountants, Hamilton  
Department of Labour  
EA Gould, Wellington  
Financial Services Federation Inc  
Inland Revenue Department  
Insolvency and Trustee Service, Ministry of Commerce, Auckland  
Institute of Chartered Accountants of New Zealand  
John Vague & Associates, Insolvency Specialists, Auckland  
Motor Vehicle Dealers Institute Inc  
Mr David Brown, Senior Lecturer in Law, Victoria University of Wellington  
National Distribution Union  
New Zealand Bankers Association  
New Zealand Business Roundtable  
New Zealand Council of Trade Unions  
New Zealand Customs Service  
New Zealand Institute of Economic Research Inc  
Rt Hon Justice Blanchard  
Professor Richard Sutton, Dean of University of Otago Faculty of Law  
Royce Blockley, Napier  
The Treasury  
Trevor Laing, Dunedin

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## APPENDIX B

### Media release

#### **Law Commission reviews preferential debts**

The Law Commission has announced that it will be assisting the Ministry of Commerce in the current general review of personal and company insolvency law. The Commission is to advise the Ministry whether existing classes of preferred creditors should continue to enjoy advantages over unsecured creditors. Preferred creditors are those people or institutions who are not secured creditors, but who are entitled to have their debts paid from the assets of a bankrupt person or a company in insolvent liquidation before other unsecured creditors.

As part of its review, the Commission invites comments from interested organisations or members of the public. In particular, the Commission is interested in views as to whether it is fair or efficient for certain classes of creditor to be able to “jump the queue” in insolvency, to the detriment of other unsecured creditors who may be paid less as a consequence.

Interested people or organisations should send any comments to Paul Heath QC or Nicholas Russell at the Law Commission no later than 30 October 1998.

For comment, call Paul Heath OC or Nicholas Russell 04-473 3453, fax 04-471 0959, email [pheath@lawcom.govt.nz](mailto:pheath@lawcom.govt.nz) or [nrussell@lawcom.govt.nz](mailto:nrussell@lawcom.govt.nz)  
Level 10, 89 The Terrace, PO Box 2590, Wellington.

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## APPENDIX C

22 July 1998

[*Insert Addressee*]

Dear [*Insert*]

### Review of Preferential Claims in Insolvency

The Law Commission is about to embark upon a review of that part of the law of insolvency which enables certain classes of creditors to gain preferential treatment on the insolvency of a debtor. The Law Commission has been requested to carry out this research by the Ministry of Commerce. The Ministry of Commerce is presently undertaking a general review of insolvency law in New Zealand and has asked the Law Commission to conduct the review of preferential claims to assist the Ministry of Commerce. The Law Commission will be providing a report to the Ministry of Commerce in due course which may or may not be published in some form.

[*Name of Institution*] currently enjoys preferred creditor status for [*Indicate type of debt, eg unpaid taxes*] under [*Insert relevant statute*]. The Commission invites your comments as to whether, and if so, why, this preferred status should be preserved under any revised insolvency law. In making submissions to us on these issues we would ask that you address the priority given to this particular class of creditor in light of the following propositions:

- The underlying basis of insolvency law is to divide the proceeds of realisation of assets of an insolvent debtor among unsecured creditors on a proportionate basis. This is the *pari passu* principle;
- Preferential entitlement to some creditors reduces the pool of assets available for distribution to unsecured creditors;
- By reducing the pool of assets available for distribution to unsecured creditors it may be necessary for the cost of unsecured credit to be increased to reflect that risk;
- It may be unfair to individual creditors who are in substantially the same position as a preferred creditor but who do not enjoy the same status; an example is the comparison of an owner/driver who conducts all of his or her work for a particular company who does not enjoy the same preferential status as an employee.

The Commission expects to report to the Ministry of Commerce in March 1999. Please forward your comments to the Commission by Friday, 30 October 1998 to enable the Commission to consider your comments when preparing its report to the Ministry of Commerce. If you wish to meet to discuss matters further please contact me to arrange a meeting or, in my absence, Mr Nicholas Russell

who is the researcher at the Law Commission primarily responsible for assisting in this project. The email addresses for myself and Mr Russell are:

pheath@lawcom.govt.nz – and – nrussell@lawcom.govt.nz

I advise that the Commission will also be publishing a press release which will indicate the nature of the work that the Commission is undertaking so that persons with particular interests in this area of law can make submissions on questions of principle.

We look forward to receiving constructive comment from you on these difficult issues.

Yours faithfully

*Paul Heath* *cc*  
Consultant

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## APPENDIX D

### Revenue statistics – claims in bankruptcy and liquidations as at 4 October 1998

	Amount \$	Percentage %
Preferential revenues		
Goods and services tax	28,180,000	49.12
PAYE	7,243,000	12.62
Student loans – employer deductions	40,000	0.07
Resident withholding tax	37,000	0.06
Specified superannuation contribution withholding tax (PAYE)	13,000	0.02
Non-resident withholding tax	7,000	0.01
Child support – custodial parent repayments	0	
Child support – employer deductions	0	
Sub total:	<u>35,520,000</u>	<u>61.9</u>
Non-Preferential Revenues		
ACC (employer levy)	6,317,000	11.01
Dividend withholding payments	5,000	0.01
Repayments of family assistance	74,000	0.13
Fringe benefit tax	591,000	1.03
Imputation credit account debits	3,000	0.01
Income tax	13,519,000	23.56
Self employed acc premiums	1,185,000	2.07
Student loan – borrower repayments	159,000	0.28
Sub total:	<u>21,853,000</u>	<u>38.1</u>
TOTAL	<u><u>57,373,000</u></u>	<u><u>100.00</u></u>

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# APPENDIX E

Report of New Zealand Property Law and Equity Reform  
Committee: (Chairman: D F Dugdale)

on the

Wages Protection and Contractors Liens Act 1939  
(1965)

## REPORT

The Hon. Minister of Justice,  
WELLINGTON.

Sir,

### 1. CONSTITUTION AND TERMS OF REFERENCE -

By warrant under your hand dated 10 November 1964 (a copy of which is set out in Schedule A) you appointed the persons therein named to be a committee to enquire into and report on the subject therein set forth. On 24 March 1965 you appointed Mr D.S. Cox of Auckland to be an additional member of the committee. It is perhaps sensible to record the occupations of the various members of the committee. Mr Angus is a master builder and a director of firms merchanting builders' supplies. Mr Cox is a public accountant. Mr Skinner is President of the Federation of Labour and has had experience in carrying on business as a plumber. Messrs Barker, Dugdale and Stephens are solicitors, Mr Stephens being solicitor to the Ministry of Works.

### 2. SUBMISSIONS -

Before starting work we invited submissions from all professional and trade associations and trade unions whose members we thought would be concerned with the matters to be considered. In addition submissions were invited from the public by means of public notices in the press, and the setting up of the committee received some press publicity. In the result we received submissions from the persons, companies, firms and associations listed in Schedule B. In addition the Hon. Mr Justice Wilson who has an unrivalled practical experience in Liens Act litigation and is the author of the standard textbook on the subject took the trouble to prepare a lengthy memorandum for the committee, which was of the greatest assistance.

The Department of Justice made certain comparative and historical material available to us. We had before us in our deliberations the Queensland Contractors' and Workmens' Liens Act of 1906 and some of the Mechanics' Liens Acts of the Canadian Provinces.

### 3. HISTORY OF THE LEGISLATION -

The branch of the law now represented in New Zealand by Part II of the Wages Protection and Contractors' Liens Act 1939 has its origin in North America. Statutory provision



for liens for master builders was enacted in Maryland in 1791 and analogous legislation was by the end of the nineteenth century widespread in the United States of America and the Canadian provinces. There is no equivalent legislation in the United Kingdom or the Australian States (although a not dissimilar legislative intent can be discerned in such Australian statutes as the South Australian Workmen's Liens Act and the Contractors Debts Act of New South Wales). The Queensland Statute referred to above has been repealed as from 1 April 1964. The first New Zealand Statute was the Contractors' and Workmen's Liens Act of 1892. This Statute was drafted by a Queensland lawyer and based on the Ontario Statute and on several other Acts in force in different States of the United States of America. In the consolidation of 1908 the 1892 Statute was linked with certain industrial provisions under the name of the Wages Protection and Contractors' Liens Act 1908 and this somewhat unnatural conjunction was perpetuated in the 1939 Statute of the same name, the industrial provisions forming Part I of the Statute. Part I was repealed and reenacted in a separate statute (The Wages Protection Act) in 1964. Part II (which is the only part of the statute we are concerned with) was amended in 1940, 1951, 1952, 1958 and 1961.

#### 4. OPERATION OF THE EXISTING STATUTE -

The scheme of the Act (expressed very broadly) is that contractors, subcontractors, suppliers of material and workmen are entitled to secure payment to them of the monies due to them under their contracts by way of a charge over the monies due under his contract to the contractor by whom they are employed or whom they supply and to any superior contractor and also (as a security for performance of the obligations of the owner of the land or chattel) to a lien over the land or chattel. To provide a fund against which the charges can operate the Act requires certain percentages of the contract price to be retained for a certain period out of the monies that would otherwise be payable for the work. On the claimant's giving the notice of charge prescribed by the Act, the owner and superior contractor must retain both the percentages that must be retained in any event and the amount claimed in the notice. If the owner and superior contractor fulfil their obligations as to retention then the total amount recoverable against them by claimants of charges may not exceed the amount such owner or superior contractor would have had to pay under his contract in any event. In the event of a deficiency the amounts recoverable by those claiming charges abate. As well as giving notice of charge the claimant must within sixty days after completion or abandonment of the head contract commence court proceedings.

Thus if A the owner of land contracts with B a builder to erect a building on such land, B enters into a subcontract with C a painter and C employs in the work one D, then D is entitled to a charge on monies due from B to C and from A to B, and to a lien on A's land. C is entitled to a charge on monies due from A to B and to a lien on A's land and B is entitled to a lien on A's land. A must retain out of the monies he pays B and B must retain out of the monies he pays C (i) the set percentage and (ii) the amount claimed in any notice of charge or so much thereof as he has not already paid over.

Three points as to the way the Act works in practice should be made clear at this stage.

- (i) Although the Act applies to work done both on land and chattels, and although there are a few reported cases in respect of work done on chattels, claims in respect of this type of work must be extremely rare. Certainly none had ever been encountered by any member of the committee.
- (ii) Although the Act provides for claims by workmen, such claims are extremely rare.
- (iii) Although the Act protects both head-contractors against the defaults of owners, and subcontractors against the defaults of head-contractors, the former situation though by no means unknown is relatively uncommon. In Wilson J's estimate claims of subcontractors (including in this term suppliers of materials) comprise not less than 95% of the total under the present statute.

In considering the statute therefore we have borne in mind that its commonest application by far is to claims by subcontractors (including suppliers of materials) arising out of the financial failure of master builders.

#### 5. REPEAL OR RETENTION -

The first leg of the question posed to us was whether in the light of present day conditions Part II of the Act should be repealed. This question seemed to us having regard to the way the Act works in practice (described in the previous paragraph) to boil down to whether the law should continue to give subcontractors in the building trade a special protection of the sort given them by Part II of the Act.

The issue of repeal or retention was canvassed at length in the various submissions made to us. Various arguments advanced to us in support of a complete repeal seemed to us not in fact to warrant such a conclusion. It was said that the present statute in its practical working can on occasion lead to odd results. We agree that this is so, and in a

later part of this report detail many examples of such difficulties and our recommendations for resolving them. We think that the undesirable side-effects can be largely got rid of, so that the existence of anomalies in the present Act does not justify its complete repeal.

It was said that the present statute is fruitful of litigation, with consequent expense and delay in winding up of the estates of insolvent head contractors. We agree that this is so. Any body of law wholly statutory in origin and dealing with an insolvency situation is bound to give rise to litigation, for the English language is not such a perfect instrument that it is possible to devise a statute so precise that no-one can misunderstand or pretend to misunderstand it, and the knowledge that there is not enough money available to pay in full his client and all the other claimants clears a lawyer's mind wonderfully. Yet it is possible to devise a viable code of law dealing with insolvency and wholly statutory in origin - the law of bankruptcy and the provisions as to winding up in the Companies Act come within this category - so that while accepting that litigation is an inevitable part of the administration of the present Act or any successor, we do not regard this fact as a convincing argument for total repeal. We do regard this fact, however, as a reason for aiming at as lucid draftsmanship as possible and for trying to devise as speedy and simple a court procedure for determining questions arising under the Act as we are able.

It was suggested to us that the present statute does justice in allowing subcontractors on the financial failure of the head contractor to receive the benefit of their own work and materials. This may be just but there is no general rule of law giving creditors such a right; there are plenty of situations in which the proceeds of an asset supplied to an insolvent by creditor A are shared among both A and all the other creditors of the insolvent.

The crux of the matter lies in our opinion not in the matters already discussed but in two further issues. The first is most easily stated in the rhetorical question asked in more than one submission - "why should the law give subcontractors in the building trade a protection that others who give credit have to manage without?" The answer to this question supplies what to our minds are the principal reasons why the Act or something like it should be retained. First a subcontractor who supplies work and materials has in practice no alternative but to give credit. Whatever his theoretical freedom to enter into contracts only with those who will pay him in full in advance, in fact as conditions are and are likely to remain in the building industry a plumber say or painter has no alternative but to

enter into contracts which require him to do some or all of the work contracted for before he receives any payment.

Secondly while it is a truism that anyone who elects to give credit must choose his debtor with care or take the consequences, experience shows that the financial failures of master builders so often occur suddenly and unexpectedly that subcontractors in the building trade may reasonably claim on this ground a special protection. Thirdly in other branches of commerce those giving credit have available to fall back on various aids to debt collection such as possessory liens, hire purchase agreements, debentures given by retailers to wholesalers and the like which are unavailable to subcontractors in the building trade who may therefore be regarded as entitled to analogous security.

The other point is this. It seems clear that because of the existence of the Act merchants of builders' supplies give credit to builders to whom otherwise they would not. Presumably if the Act were repealed such merchants would be more sparing with credit so that many undercapitalised builders would have to curtail or cease business. Mr Angus was unable to agree with the next step in the reasoning of the other members of the committee. In his view the weeding out of financially weaker builders is entirely desirable, and for this reason in particular he favours a complete repeal of the Act. The rest of the committee see the matter less clearly. In the absence of any precise information as to how extensive a building industry the national interest requires or as to the proportion of master builders that might be forced out of business in the changed circumstances in the building resulting from a repeal of the Act they do not see how they can responsibly recommend in respect of such an important sector of the economy what would be very much a leap in the dark.

Before leaving this subject it is desirable to say a word about the Queensland situation, for it may be argued that the fact that the legislature of that state decided totally to repeal its statute, similar in scope and purpose to ours, is some ground for a like step being taken in this country. At the time of its repeal the Queensland Act was in any event in need of drastic overhaul. Stern v. J.A. Redpath and Sons Ltd [1950] N.Z.L.R. 50 was followed in Queensland but there had been no legislative change designed like our 1958 Amendment to do away with the difficulties resulting from this decision. Moreover in Sturoid v. Stadiums [1960] Q.S.R. 300 the High Court of Australia had adopted an interpretation of the expression "completion of the work" where it occurred in various places in the Queensland Act which overruled various Queensland Full Court

decisions of very long standing and cast doubt on a large part of the body of Queensland case law interpreting the statute. Faced then with the need completely to recast the statute the Queensland legislature chose the alternative of cutting the Gordian knot and repealing the act in toto. It is not for us to comment on whether or not so ruthless and easy a solution was a proper one in the Queensland situation. It is sufficient for our purposes to observe that the New Zealand situation is, because our Act is in nothing like such an unsatisfactory state as was the Queensland one, completely distinguishable.

The majority of the committee (Mr Angus dissenting) are of the opinion therefore that the law should continue to give subcontractors in the building trade a special protection of the sort given them by Part II of the Act. While dissenting on this point Mr Angus agrees with the rest of the committee that if such special protection is to remain the provisions of the present statute should be altered in the respects indicated in the balance of this report.

#### 6. THE SCHEME OF PROTECTION -

We gave careful thought to the question of whether the scheme of protection contained in the present statute (which scheme was described in one submission as "an ambulance at the bottom of the cliff rather than a fence at the top") could not be improved. Although various new schemes were suggested to us, and members of the committee themselves put forward schemes, none of the alternatives we considered seemed really workable in practice.

It was suggested to us that head contractors should be licensed and bonded in the same way as land agents and motor vehicle dealers. But we have no doubt that the objects of the statute can be achieved without adopting so manifestly inconvenient a course.

It was suggested to us that contractors should be required to hold contract monies received by them in trust accounts. A contractor is not as the law now stands a trustee for his subcontractors and his and their workmen of the contract monies he receives, and it seems to us that here again the objects of the statute can be achieved without doing such violence to the existing law of contract as the proposal under discussion envisages. In any event unless such trust accounts were audited the only practical result of such provision would be to enable the criminal prosecution in certain circumstances of bankrupt builders. It is true that provisions constituting the contract price a trust fund are contained in the Canadian statutes (see (1956) 34 C.B.R.

855) but those statutes have retention provisions substantially different from ours.

It was suggested to us that the consent of every subcontractor should be required to each progress payment made to the head contractor. But this would put too much power into the hands of disgruntled subcontractors.

It was suggested that the owner before making each progress payment after the first should be obliged to ensure that all subcontractors had received a proportionate part of the previous progress payment. But this would cast too great a burden on the owner.

We considered these and other schemes with care, but in the result concluded that the scheme of the present Act (amended as to details in the various respects we will suggest later in this report) was preferable to any suggested to us or which we ourselves could devise, comforting ourselves with the thought that the present scheme has the further advantage of being familiar to the tradesmen and professional men who are concerned with its operation.

#### 7. DRAFT STATUTE -

Because of the intractable nature of the subject matter of this report it seemed to us that the most satisfactory way of making clear precisely what we proposed was to annex to our report a rough draft with new or altered provisions italicized of a statute designed to replace the existing Part II, and this is to be found in Schedule C. The words "rough draft" are precise, not mock-modest; none of the members of the committee claims any particular expertise as a draftsman and if our recommendations are adopted our draft will require considerable polishing at the hands of the Parliamentary Draftsman.

We have in preparing this draft tried to avoid change for the sake of change for when a section in one form has been given a meaning by the Courts it seemed to us foolish to tinker with it merely to satisfy some nice notion of draftsmanship and thereby run the risk of it being contended or held that some change in substance was intended.

Referring then to this draft as we go along we proceed to explain in detail both the change we recommend and the changes that were urged upon us and which we felt obliged to reject.

#### 8. WHO MAY CLAIM -

Workers - It was suggested to us that as claims by workers are rare the provisions for claims by workers could be dropped. Workers it was suggested are sufficiently cared

for by the various industrial statutes and awards and have in addition certain priorities under the Bankruptcy Act 1908 and on the winding up or receivership of companies so that they do not need any further protection. We reject this suggestion. We think that although workmen are usually paid out without their having formally to make claims under the Act, this is probably because it is so clearly and generally understood that the Act is there for them to invoke if they have to. Moreover if one class of claimant is to have protection then so must the workers lest the protected class exhaust the monies that would otherwise be available to pay the workers. This last consideration answers we think the contention that workers are sufficiently protected by their bankruptcy and Companies Act priorities; also of course invocation of the Liens Act is not invariably accompanied by the bankruptcy winding up or receivership of the party in default. Finally it would be in our view perverse to exclude workers from the benefits of a statute originally enacted with a view to assisting labourers and small contractors.

Material men - In this paragraph we adopt a convenient term from the Canadian statutes and describe those who supply material only (as distinct from work and materials) as material men. It can we think be not unfairly observed that the various arguments we have advanced in favour of retaining the statute, while true of those who supply work or work and materials, are not all true of material men. From this premise it can be argued that the Act should cease to protect material men. The answer to this contention is we think not dissimilar to one of the arguments we have adopted in relation to workers. If subcontractors other than material men are to be protected then so must the material men for otherwise the protected class might exhaust the monies that would otherwise be available to pay the material men.

Commercial Bailors of Plant - It was urged upon us that no logical distinction can be drawn between the position of commercial bailors of plant (who at present have no claim under the Act - Baylis v. Wellington City Council [1957] N.Z.L.R. 836) and that of material men and other subcontractors so that such bailors should be given protection under the Act. While acknowledging the attractiveness as a matter of theory of this argument we prefer to approach the question pragmatically. In practice commercial bailors can and do require payments in advance, and their eggs are spread among many more baskets, and for these and other reasons the losses they suffer on the financial failure of any one head-contractor are small compared with those of material men and other subcontractors.

In these circumstances we decline to recommend the addition of such bailors to the classes of those entitled to claim under the Act.

In the result therefore we recommend no change to the classes of those entitled to claim under the Act. We do recommend a procedural change in that only subcontractors (described in our draft as "declared subcontractors") who have given a certain advance notice may claim, but this alteration is best discussed in conjunction with the scheme of procedure we advocate later in this report.

9. THE RIGHT TO A LIEN OR CHARGE -

At present the head contractor and every subcontractor and worker has a right to a lien on the employer's land and every subcontractor and worker has a right to a charge on the monies due to the head contractor and to every other contractor higher in the chain than the claimant. This leads to a multiplicity of liens and charges and to duplication, for the quantum of the head contractor's lien claim (for example) will include monies due from him to subcontractors who will probably also claim a lien in respect of such monies due to them from the head contractor, so that the total of lien claims will exceed the total in fact payable. For this reason it was suggested to us that only the head contractor should be entitled to a lien and that the right to a charge should exist only in respect of monies owing to the claimant's own employer. While we appreciate the force of this argument it seems to us (a) that insofar as the right to a lien is concerned the suggestion overlooks the fact that in most cases it is the head contractor who gets into financial difficulty and (b) that in any event the procedural changes we suggest will overcome most of the difficulties said to result from the present system. We do not therefore recommend change in this respect.

A very real difficulty is the situation where notice of lien or charge is given by a contractor or subcontractor not because he has any genuine doubt as to the ability to meet his commitments of the person with whom he has contracted to do the work, but because he is involved in a dispute with that person as to the amount due to him or the quality of his workmanship, and hopes to exert pressure by means of giving the notice of lien or charge. There is no complete answer to this problem, but it will we think to some extent be met by the procedural changes we recommend, and by two further suggested alterations. One is a provision that liens shall (like charging orders under the Code of Civil Procedure) lapse after six months unless extended by the Court [s. 24(1) of our draft]. The other is the



requirement that a statutory verifying declaration should be filed with the District Land Registrar on registration of every lien [s. 23(2) of our draft].

10. PROCEDURE FOR CONSENSUAL DISCHARGE OF LIENS -

The present procedure involves registration of a receipt (s. 42) "acknowledging payment of the amount claimed". Usually the claimant does not recover the full amount claimed, and while in practice a form of receipt has been devised to cover the situation that District Land Registrars will accept clearly a less devious procedure is desirable. We recommend a form analogous to a discharge of caveat [s. 23 of our draft].

11. THE RIGHT TO A LIEN ON CHATTELS -

This is so rarely invoked that we recommend the Act being altered to apply only to work done on land.

12. PROVISIONS AS TO CROP THRESHERS (s. 47) -

This is so rarely if ever invoked that it should be dropped.

13. THE RETENTION AMOUNTS AND PERIOD -

The retention percentages were reviewed as recently as 1961 and we do not recommend any alteration.

The present retention period is 31 days. Although for various obvious reasons prompt payment to contractors is desirable this period of 31 days seems to us insufficiently long. Commercial practice is for accounts to be paid on the 20th of the following month. If an account is sent in the first fortnight or so of the preceding month more than 31 days will elapse before the creditor is aware of a default in payment. The retention period should be 60 days.

14. PRIORITIES AMONG CLAIMANTS -

Section 26 provides for priorities roughly as follows -

- i) Workers wages up to £50.0.0. for a period not exceeding three months.
- ii) Other workers' wages.
- iii) Contractors who have given notice within 30 days of completion of their work.
- (iv) Other contractors.

So far as workers are concerned if £50.0.0. was a suitable figure in 1939 it cannot be a suitable figure now. We recommend replacement of (i) and (ii) above by a provision simply giving workers priority for wages up to £150.0.0.

The existing provisions granting priority to contractors who give notice within 30 days of completion are among the most unsatisfactory of the existing statute. The time limit is unduly short for the same reasons as the 31 days retention period. It encourages the premature giving of notice of lien and charge and favours not so much the vigilant as the nervous. It can work considerable injustice in practice and indeed in practice is often waived by claimants entitled to its benefit. There should be no priorities as among claimants based on the time within which they gave notice [s. 11 of our draft].

15. TIME FOR GIVING NOTICE OF LIEN OR CHARGE -

Because under the procedure we suggest later in this report notice of lien or charge will itself set Court proceedings in train, it is unnecessary to specify a time for commencing proceedings, but it is necessary to specify a time for giving notice of lien or charge.

What then should be the period for giving such notice, and in the case of subcontractors should it run from completion of the head contract or of the subcontract? Taking the second point first, we are clear that time should run from completion of the subcontract. Modern building contracts can extend over years. It is wrong that the subcontractor who does say structural steel work and may finish his work at the end of the first eighteen months of a head contract extending over three years should be able to commence proceedings at a time fixed in relation to completion of the head contract and conversely that part of his contract price should be retained until after completion of the head contract, to satisfy possible claims by his subcontractors or workmen.

The period for giving notice should be 60 days from completion of the work done by the claimant, the period of 60 days being recommended for the same reasons as indicated in recommending a similar period as the liens retention period.

16. SHOULD THE ACT BIND THE CROWN -

We see no reason why the Act should not bind the Crown but with Crown Land remaining exempt from any right to lien. That is the present position with local bodies [s. 30 of our draft].

17. SET OFF AGAINST RETENTION MONIES -

We think the law should be altered to provide that monies retained by an employer pursuant to his duty under the Act so to do should not be subject to any rights of counterclaim

or set off the employer may have against the head contractor. The matter is discussed by North and Cleary JJ in their joint judgment in J.J. Craig Ltd v Gillman Packaging Ltd [1962] N.Z.L.R. 210 at p. 217, 218. The addition to the Act we recommend is based on s.21 (6) of the British Columbian Statute. This change if adopted may mean that employers seek to retain larger amounts than those required by the Act and that architects cease as a matter of practice to treat the monies retained under the Act as a fund to ensure proper completion or maintenance by the builder. Be this as it may, the change we recommend seems to us essential for the proper fulfilment of the objects of the statute [s.17 (2) of our draft].

#### 18. IDENTIFICATION OF MATERIALS -

We have considered the type of situation that arose in Ngapuna Timber Co. Ltd v. Ryan [1961] N.Z.L.R. 377 in which the claim of a supplier of timber to a builder failed because he could not relate particular timber to a particular one of the builder's contracts. We do not think any change in the law is called for. The principle that materials must have been supplied to a contractor for the purpose of a particular contract as distinct from a general supply unrelated to any particular contract to give rise to a claim under the Act seems both reasonable and necessary for the practical working of the Act, and becomes even more necessary if the procedural changes we recommend are adopted.

#### 19. PROCEDURE -

[missing text] institute proceedings or to join himself to the proceedings already instituted. This leads to a multiplicity of actions, of which some may be in a Magistrate's Court some in the Supreme Court. It is usually necessary to consolidate the actions, and there is usually a lapse of time before anyone gets round to doing this. Delay for this and other reasons is a major problem in disposing of Court proceedings in the present working of the Act.

The alternative seems to us to be to designate one person to apply to the Court, with notice to interested parties, once notice of lien or charge is given. The only persons who are parties to all actions under the present procedure are the head contractor and the employer. In most cases it is the head contractor who is in difficulty so that it is unreal to designate him as the person to make the application. Therefore the application to the court must be made by the employer. So that he will know who to join in the action only subcontractors (called "declared subcontractors") who have given a certain advance notice of

the fact that they are subcontractors on the job [s.4 of our draft] should we recommend be entitled to rights under the Act. Under the scheme we recommend the employer on receiving notice of lien or charge is required to apply within a limited time to the Court with notice of the application to the head contractor and to all declared subcontractors. At this stage others served with notice of the application and wishing to claim may themselves give notice of their claims. There are provisions covering default by the owner and provisions making his costs on a solicitor-and-client basis a first charge on the fund. Because of the need for speed and to have all proceedings in one Court the Magistrates' Courts are given exclusive jurisdiction at first instance but subject to the usual rights of appeal to the Supreme Court and with power for Magistrates to state a case to the Supreme court on questions of law. On the matter coming before the Magistrate he may dispose of it then and there, or treat the initial hearing as something roughly analogous to American pre-trial procedure or summons for directions in the English Commercial Court. In the latter event at the initial hearing issues should be determined, any other affected parties (such as mortgagees) directed to be served, all other interlocutory matters such as discovery and orders for particulars disposed of and a firm date fixed for the final disposal of the matter. [s.19 of our draft].

This scheme by substituting one application for a number of separate actions and by its emphasis on speedy disposal seems to us preferable to existing procedures with the expense delay and injustice arising from delay that existing procedures result in. An expeditious procedure will solve a large proportion of the difficulties experienced in the working of the present statute. We do not say that the scheme we proposal will work. That will depend on the Magistrates and on the legal profession. We do say however that the scheme provides a machinery that can work if bench and bar make the effort to ensure that it does.

We would add one further word about the limitation of the benefits of the Act to "declared subcontractors". This is necessary for the working of the scheme we propose but has in addition other advantages. One of the great difficulties in practice in trying to sort out liens problems, for example to organize in a hurry the completion of a building where a head contractor has abandoned the job, is to know just who the potential lien claimants are. The provisions we suggest will solve this problem. We have no doubt that tradesmen will get into the habit as a matter of routine of giving the owner the notice required by our draft statute to constitute them "declared subcontractors".

20. THE PURCHASE OF NEW BUILDINGS -

There are we believe considerable differences of opinion among lawyers as to the application of the Liens Act to the situation (common where for example houses have been built as a speculation) where land is sold on which a new building has been or is in the course of being erected. We think that the statute should clarify the situation. We believe that rights of lien claimants should not be defeated by a sale of the land. We have included in our draft a section containing rules intended to govern the position. [s.9 of our draft].

21. THE DEFINITION OF COMPLETION -

It is important having regard to the way the Act operates that the date of completion should be able to be ascertained in practice with reasonable certainty. For this reason we were exhorted to try and devise a better definition of completion. The only precise suggestions made to us were as follows -

- (a) That the definition of completion be amended to make it clear that "substantial completion" is sufficient. This did not seem to us an answer to the problem, for in practice it would be as difficult to decide what is "substantial completion" as it is now to decide what is "completion".
- (b) That "substantial completion" be defined as some set percentage of the total work. This suggestion it seems to us might well necessitate involved quantity surveying to determine what was "substantial completion" in any given case and so create as many problems as it was designed to solve.
- (c) That the certificate of the architect or engineer as to completion be conclusive. The difficulty with this idea (apart from the fact that not all jobs have architects or engineers) is that architects and engineers might be tempted to withhold certificates of completion for such reasons unconnected with the purpose of the Act as ensuring maintenance or correction of alleged faulty work by the builder in the same way as they undoubtedly tend to use retention moneys for similar purposes at present.

None of the precise suggestions made to us, then, were acceptable. We do not know the complete answer to the problem and it may be that there is none.

We do however recommend additions to the definition of completion to provide that completion shall not be later than the date on which possession of the works is given or

the date as at which the architect or engineer certifies the work to be completed or substantially completed. This addition to the definition will in most cases provide in the ascertainment of completion a precise terminus ad quem while leaving it free to any party to establish an earlier date of completion if he is able to do so. It will do away with the odd type of case where the return to the work by a contractor to perform some relatively trivial item has been held to delay "completion" within the meaning of the Act. Stern v. Taylor [1960] N.Z.L.R. 669 is an example of this unsatisfactory type of situation which the amendments we propose will do away with. [s.4 (4) (ii) of our draft].

We have inserted a provision enabling a single contract for work to be completed in sections if the contract price is apportioned among such sections to be treated for the purpose of the act as if there were a separate contract in respect of each section. This may prove of practical utility in the case of certain large contracts. [s.4 of our draft].

## 22. MISCELLANEOUS CHANGES -

We suggest the following further miscellaneous changes -

Quantum meruit - We suggest certain alterations in the definition section to make it clear that a person making a claim on a quantum meruit basis is entitled to the benefits of the Act. [s.4 (2) of our draft].

Definition of "worker" - Because of the decisions of Christie J. at first instance in Stern v. J.A. Redpath and Sons Ltd [1949] N.Z.L.R. 60, 65 in which case the learned judge held that a subcontractor was a "worker" it seems desirable to amend the definition of "worker" to put it beyond doubt that a worker is a person employed under a contract of service. [s.4 (1) of our draft].

Sale Procedure - We suggest a somewhat more streamlined procedure than that provided in the present s.43. If the Court holds a claimant entitled to a lien and the judgment remains unsatisfied for one calendar month the party entitled may without further order of the Court apply to the Sheriff to conduct a sale as if it were a sale under a writ of sale pursuant to a judgment of the Supreme Court. [s.25 of our draft].

Sections 25 and 41 - We have recast these sections in an endeavour to make quite clear the status of a lien registered under the Land Transfer Act and the competing priorities of lien claimants and mortgagees. The effect of what we have drafted is that a notice of lien claim shall be an "instrument" within the meaning of the Land Transfer Act 1952 and registered as such. Priority will therefore

by virtue of the Land Transfer Act 1952 s.37 depend on registration except in the two cases provided by the present s.25 (2) and (3). There is no provision for registration of liens affecting estates or interests not registered under the Land Transfer Act. They will be governed by the equitable rule *qui prior in tempore potior est jure*, and it is necessary in the statute only to specify the date when the lien is deemed to come into existence for the purpose of the rule. [ss.10 and 23 of our draft].

Removal of lien - We have included express provision for the Court to order the discharge of a lien registered against the interest in land of an employer who satisfies the Court that he is in a position to pay the amount due from him without the claimant's needing the security of a lien. [s.20 of our draft].

Priorities between competing head contractors - Where (as in the case of Williams v. Standard Insurance Co. Ltd [1962] N.Z.L.R. 969) there are two head contractors who do work on the same piece of land a fairer solution to the one adopted in Williams' case seems to us to be to provide that their claims shall abate inter se as if they were subcontractors and our draft provides accordingly. [s.11 (3) of our draft].

### 23. POSSESSORY LIEN ON CHATTELS -

Nothing we have said so far applies to s.46 of the Act, which really has nothing to do with the other matters dealt with in Part II of the Act and for which a home has been found in the Act presumably for want of anywhere better. The common law provides that those who do work on chattels are entitled to a possessory lien, i.e. to retain the chattels until they are paid, but the common law made no provision for the workman to pay himself out by selling the chattel. Section 46 gives the workman this necessary power. We recommend no alteration to this section. It has been suggested by those whose business it is to repair motor vehicles that one who does work on a chattel and returns it to the owner before he is paid should be entitled if he is not duly paid to seize possession of the chattel. Such a suggestion seems to us completely undesirable. The whole tendency of modern law reform is to curb the rights of self-help of creditors - the Property Law Act 1952, s.92, the limitation on a landlord's power to distrain in the Tenancy Act 1955 and the limitations on rights to repossess chattels subject to hire-purchase agreements contained in the relevant United Kingdom and Australian legislation are examples of this tendency. We are not prepared to recommend a reversal of this process in the case of workmen's liens.

24. DATE OF COMMENCEMENT -

If our recommendations are adopted care will be necessary in fixing the commencement date of the new Act, in particular because if the Crown is to be bound the Ministry of Works and other departments will have to devise new forms of contract. If an Act along the lines we suggest is passed in 1966 it should not come into force before 1st April, 1967.

25. CONCLUSION -

We recommend the repeal of the existing statute and the passage of a new Act along the lines of our draft. We are satisfied that our proposals while doubtless falling short of perfection nevertheless represent a substantial improvement to the present Act.

We wish to conclude by recording the very real assistance furnished us by the Secretary to the Committee Mrs M.A. Vennell, who is herself a solicitor. Her duties were not made easier by the fact that most of the Committee reside out of Wellington and all of the Committee have been heavily engaged with other commitments, and we are indebted to her for her help.

R. J. E. M.

D. S. G.



S C H E D U L E A

WARRANT OF APPOINTMENT

I hereby appoint -

Mr K.W. Angus of Wellington

Mr R.I. Barker of Auckland

Mr D.F. Dugdale of Auckland

Mr T.E. Skinner of Wellington

Mr K.O. Stephens of Wellington

to be a committee to inquire into and report on whether in the light of present day conditions Part II of the Wages Protection and Contractors Liens Act 1939 should be repealed, and if not, what changes in the law relating to contractors' and workmen's liens are necessary or desirable.

AND I further appoint Mr D.F. Dugdale to be Chairman of the committee.

Dated at Wellington this 10th day of November 1964.

(signed) J.R. Hanan

Minister of Justice

And on 24th day of March 1965 Mr Duncan S. Cox of Auckland was also appointed by the Minister of Justice to be a member of the committee.

S C H E D U L E B

The following is an alphabetically arranged list of the persons and bodies who in writing made submissions to the Committee. Those whose names are marked with an asterisk also appeared personally.

1. Air Hire Centre Ltd, Auckland
2. Auckland Builders Supply Merchants Group  
Auckland Steel Supply Merchants Group  
General and Drainage Contractors Supply Merchants Group
3. \*Auckland Guild of Master Painters Decorators and Signwriters (Inc.) -supported by  
Auckland Provincial Plasterers and Fibrous Plasterers Industrial Union of Employees, and the Auckland Building Trades Subcontractors Association (Mr R.A. Waite)
4. Auckland Master Builders' Association Inc.
5. Cain Steel Industries Ltd, Auckland
6. Canterbury Sub-Contractors' Association
7. Mrs Margaret Lawson, Auckland
8. Luke, Cunningham and Clere, Solicitors, Wellington
9. Metal Trades Employers' Association of Wellington (Inc.) and Industrial Union
10. New Zealand Associated General Contractors' Federation Inc.
11. New Zealand Electrical Contractors Federation Inc.
12. New Zealand Employers Federation (Inc.)
13. New Zealand Federated Master Painters, Decorators and Signwriters Industrial Association of Employers
14. \*New Zealand Institute of Architects (Messrs W.G. Smith and J.L. Mair)
15. New Zealand Institute of Engineers
16. New Zealand Joinery Manufacturers' Federation
17. New Zealand Law Society
18. New Zealand Master Builders' Federation Inc.
19. \*New Zealand National Creditmen's Association (Wellington) Ltd (Mr K.G. Sullivan)
20. New Zealand Reinforcing Steel Fabricators' Association Inc.
21. New Zealand Timber Merchants' Federation Inc.
22. Otago Sub-contractors' Association
23. Roberts Concrete Productions Ltd (In Receivership)
24. Wellington Industrial District Plasterers' and Fibrous Plasterers' Industrial Union of Employers

S C H E D U L E C

Draft Contractors' Liens Bill

An Act to consolidate and amend Part II of the Wages Protection and Contractors' Liens Act 1939

1. SHORT TITLE - This Act may be cited as the Contractors' Liens Act 1966.

2. COMMENCEMENT - This Act shall come into force on the first day of April 1967.

3. INTERPRETATION - (1) In this Act, unless the context otherwise requires, -

"Charge" means a charge under this Act.

"Contract price" means the amount of the consideration for the performance of any work under any contract or subcontract, express or implied, and whether the price is fixed by express agreement or not:

"Contractor", as regards an employer, means a person who contracts directly with the employer to perform any work; as regards a subcontractor it means a person with whom the subcontractor contracts to perform any work; and "subcontractor" means a person who contracts with a contractor, or with another subcontractor, to perform any work;

"Court" means a Magistrate's Court;

"Declared subcontractor" means in relation to the subcontract in respect of which he was given notice a subcontractor who has given the notice to an employer provided by Section 4 of this Act.

"Employer" means any person who contracts with another person for the performance of work by that other person, or at whose request, or on whose credit, or on whose behalf, with his privity or consent, work is done; and includes all persons claiming under him whose rights are acquired after the work is commenced; but a mortgagee who advances money to an employer shall not by reason thereof be deemed to be an employer:

"Lien" means a lien under this Act:

"Owner" means the person to whom the land upon or in respect of which any work is to be done belongs; and,

in the case of land, includes a person having a limited estate or interest in the land:

"Work" includes any work or labour, whether skilled or unskilled, done or commenced by any person of any occupation in connection with -

- (a) The contraction, decoration, alteration or repair of any building or other structure upon land; or
- (b) The development or working of any mine, quarry, sandpit, drain, embankment, or other excavation in or upon any land; or
- (c) The placing, fixing, or erection of any materials, or of any plant or machinery, used or intended to be used for any of the purposes aforesaid; or
- (d) Any clearing, excavating, digging, drilling, tunnelling, filling, roadmaking, grading or ditching in upon or under any land - and also includes the supply of material used or brought on the premises to be used in connection with the work:

"Worker" means a person employed pursuant to a contract of service in doing work, whether his remuneration is to be according to time or by piecework, or at a fixed price, or otherwise.

References to the amount payable under any contract or subcontract shall be deemed to include all amounts that under the contract or subcontract are to be credited or allowed in complete or partial satisfaction of the contract price otherwise than upon payment in money; and references to the payment of any moneys in reduction of the contract price shall be deemed to include the making of any such credit or allowance.

(2) The definition of "contract price" in the previous sub-section includes moneys recoverable on a quantum meruit basis and the definitions of "contractor" "subcontractor" and "employer" are hereby correspondingly extended.

(3) If a contract provides for the work to be completed in sections and apportions the contract price among such sections then the contract insofar as it applies to each section shall for the purposes of this Act be deemed to be a separate contract.

- (4) (i) For the purposes of this Act the work specified in any contract or subcontract shall be deemed to be completed when, with such variations, omissions, or deductions as have been duly authorised or agreed upon, it has been performed in accordance with the contract or subcontract, notwithstanding that the

contractor or subcontractor may then or subsequently be employed in doing additional or extra work which is connected with or related to the work but is not specified in the contract or subcontract, or that he may be liable to rectify defects in the work discovered since the performance thereof and during any period of maintenance provided for by the contract or subcontract.

(ii) The date of completion of a contract shall not in any event be deemed to be later than the following dates or the earlier of them should both occur namely;

(a) The date on which the employer or any person or persons claiming under him enters into possession of or utilises the whole or substantially the whole of the building or other improvements to the land created by the work, and

(b) If the contract provides for an Architect registered pursuant to the provisions of the Architects Act, 1963 or an Engineer registered pursuant to the provisions of the Engineers Registration Act, 1924 to certify for the purpose of defining the rights and obligations of the parties to the contract as to the completion or substantial completion of the work then the date as at which such architect or engineer so certifies such work to have been completed or substantially completed.

(iii) References to the completion of the work specified in any contract shall be deemed to include the completion of the work either -

(a) By the contractor; or

(b) By any person authorised by the contractor; or

(c) By any claimant who has given notice of a lien or charge in relation to the contract or to any subcontract under the contract:

References to the completion of the work specified in any subcontract let by a contractor shall be deemed to include the completion of the work either -

(a) By the contractor; or

(b) By the subcontractor; or

(c) By any person authorised by the contractor or authorised by the subcontractor; or

- (d) By any claimant who has given notice of a lien or charge in relation to the contract or to the subcontract or to any other subcontract under the contract.

Declared subcontractors

4. SUBCONTRACTORS MAY GIVE NOTICE - Any subcontractor may within seven days of commencing to perform any work give notice in writing to the employer setting out his name and address for service a short description of the work he has contracted to perform and the name of the person with whom the contract for the performance of such work by such subcontractor has been made by such subcontractor.

Rights of Lien and Charge

5. LIENS AND CHARGES IN FAVOUR OF CONTRACTORS, SUBCONTRACTORS AND WORKERS - (1) Where any employer contracts with or employs any person for the performance of any work upon or in respect of any land, the contractor and every declared subcontractor or worker employed to do any part of the work shall be entitled to a lien upon the estate or interest of the employer in the land, and every declared subcontractor or worker employed by the contractor or by any subcontractor to do any part of the work shall be entitled to a charge on the moneys payable to the contractor or subcontractor by whom he is employed, or to any superior contractor, under his contract or subcontract.

(2) The lien or charge of the contractor or of a declared subcontractor shall be deemed to secure the payment in accordance with his contract or subcontract of all moneys that are payable or are to become payable to him for his work.

(3) The total amount recoverable under the liens and charges of the contractor and of the declared subcontractors and workers employed by the contractor or by any subcontractor shall not, except in the case of fraud, exceed the amount payable to the contractor under his contract.

(4) The total amount recoverable under the liens and charges of all claimants who are employed as declared subcontractors or workers by any contractor or subcontractor shall not, except in the case of fraud, exceed the amount payable under his contract or subcontract to that contractor or subcontractor, as the case may be.

6. CERTAIN MONEYS DEEMED TO BE INCLUDED IN AMOUNT PAYABLE TO CONTRACTOR OR SUBCONTRACTOR - For the purposes of the lien and charge of any claimant who is employed as a declared

subcontractor or worker by the contractor or by any subcontractor, the amount of money payable to the contractor or subcontractor by whom the claimant is employed, or to any superior contractor, under his contract or subcontract shall be deemed to include all moneys paid in reduction of the contract price to any person other than the claimant, unless the payments are made in good faith, and not for the purpose of defeating or impairing a claim to a lien or charge existing or arising under this Act, and are not made in contravention of section sixteen or section seventeen of this Act.

7. LIABILITY OF OWNER WHO IS NOT THE EMPLOYER - (1) Where any owner is not the employer, the estate or interest of the owner in the land upon or in respect of which the work is to be done shall be subject to lien or liability as if he were the employer, to the extent to which the owner has consented in writing that he should be liable for the contract price or that his estate or interest in the land should be liable.

(2) References in this Act except in Sections four, thirteen, fourteen and nineteen to the employer shall be deemed to include references to an owner who has consented to be liable as provided in subsection (1) of this section, and references to the liability of the employer under his contract shall be deemed to include references to the liability of the owner under this section.

8. ASSIGNMENTS, ATTACHMENTS, ETC., TO BE VOID AS AGAINST SUBCONTRACTORS' OR WORKERS' CHARGES - (1) No assignment, disposition or charge (whether legal or equitable) that is made or given by any contractor or subcontractor (otherwise than to his workers for wages due to them in respect of his contract or subcontract) of or upon any money payable or to become payable to him under his contract or subcontract shall have any force or effect at law or in equity as against the lien or charge of any declared subcontractor or worker.

(2) No money that is payable or is to become payable to any contractor or subcontractor under his contract or subcontract shall be capable of being attached, or of passing or being charged by operation of law (otherwise than under this Act) so as to defeat or impair the lien or charge of any declared subcontractor or worker.

9. PROVISIONS WITH RESPECT TO PURCHASERS - (1) Where any person (in this section referred to as "the purchaser") contracts to acquire an estate or interest in land on which work has been or will pursuant to such contract be performed, and either the contract provides for title to such estate or interest to pass to the purchaser or his nominee or for

possession of the whole or part of the land to be given to the purchaser or his nominee prior to the expiration of sixty days from and after completion of the work or in fact title to such estate or interest does pass to the purchaser or his nominee or possession of the whole or part of the land is given to the purchaser or his nominee prior to the expiration of sixty days from and after completion of the work, then this Act except for section four shall apply to such contract as if the purchaser were and had been from the commencement of the work an employer and the person with whom he had contracted (in this section referred to as "the vendor") were and had been from the commencement of the work a contractor and the contract price were the total amount payable by the purchaser pursuant to his contract and the persons contracting with the vendor to perform the work or any part thereof were declared subcontractors.

(2) The vendor shall hand to the purchaser within seven days of the "settlement" of such contract -

(i) The notices that have been served on him pursuant to section four and

(ii) A list of those contractors who pursuant to the provisions of the previous subsection are to be treated as regards the purchaser as declared subcontractors and the purchaser shall forthwith give notice of his contract with the vendor to the persons who have so given notice pursuant to section four and to the contracts so listed.

10. PROVISIONS WITH RESPECT TO MORTGAGED LAND - (1) Notwithstanding anything to the contrary in the Land Transfer Act 1952 section thirty seven, a mortgage registered prior to a notice claiming a lien shall rank after the lien -

(a) if the mortgagee is a party to the contract in respect of which the lien arises and

(b) insofar as the mortgage secures money that is advanced after written notice of the lien claim or of the registration of the notice claiming the lien against the title to the land has been given to the mortgagee or to any solicitor for the time being acting for the mortgagee in respect of the mortgage.

(2) There shall be implied in every mortgage a power for the mortgagee to pay the moneys necessary to secure the discharge of a lien ranking in priority to the mortgage, such amounts so paid to be added to and form part of the principal money secured by the mortgage and bear interest accordingly.

(3) In determining priority between a lien and a mortgage in any case not governed by either the Land Transfer



Act 1952 section thirty seven or subsection (1) of this section, the lien shall be deemed to come into existence and attach to the estate or interest in land affected thereby on the date the notice claiming the same is served on the employer pursuant to the provisions of this Act.

11. PRIORITY OF LIENS AND CHARGES -

(1) Liens and charges shall have priority in the following order -

(a) The liens and charges of workers for wages, not exceeding one hundred and fifty pounds in the case of any worker:

(b) The liens and charges of workers for wages insofar as they are not included in the last preceding paragraph, and the liens and charges of declared subcontractors:

(c) The liens of contractors, -

so that the lien or charge of a declared subcontractor shall have priority over the lien or charge of the contractor with whom his contract is made.

(2) If the money available is insufficient to meet the claims of two or more claimants whose liens or charges have equal priority under this section, the claims shall rank equally between themselves and abate in equal proportions.

(3) If two or more contractors are entitled to a lien on the same price of land their claims and the claims of those claiming under them shall rank and abate in the same manner as if such contractors were declared subcontractors employed by the same contractor and in such case any party may apply to the Court to have consolidated the proceedings in respect of each contract.

12. TRANSMISSION AND ASSIGNMENT OF LIENS AND CHARGES -

(1) When upon the death or bankruptcy of the person entitled to a lien or charge, or otherwise by operation of law, the debt secured by a lien or charge passes to any other person, the right to the lien or charge shall pass therewith.

(2) A lien or charge may be assigned together with the debt secured thereby.

Notice of Lien or Charge

13. NOTICE OF LIEN - (1) Every person entitled to claim a lien on any land shall within sixty days of the completion of the work done by him give notice to the employer specifying the amount and particulars of his claim, and

stating that he requires the employer to take the necessary steps to see that it is paid or secured to the claimant.

(2) He shall also give notice of having made the claim to the owner (if the owner is not the employer), to the contractor or subcontractor (if any) by whom he is employed, to every superior contractor, and to every other person who to the knowledge of the claimant would, but for the claim, be entitled to receive any money payable to that contractor or subcontractor or to any superior contractor.

14. NOTICE OF CHARGE - (1) Every subcontractor or worker entitled to claim a charge on any money payable to his contractor or to a superior contractor shall within sixty days of the completion of the work done by him give notice to the employer and to any superior contractor by whom the money is payable, specifying the amount and particulars of his claim, and stating that he requires the employer or superior contractor, as the case may be, to take the necessary steps to see that it is paid or secured to the claimant.

(2) He shall also give notice of having made the claim to the contractor to whom the money is payable and to every other person who to the knowledge of the complainant would, but for the claim, be entitled to receive any money payable to that contractor.

15. FORM OF AND TIME FOR GIVING NOTICE OF LIEN OR CHARGE -(1) A notice of lien or charge shall be in one of the forms in the Schedule to this Act or to the like effect, but its validity shall not be affected by any inaccuracy or want of form, if the property or money sought to be charged and the amount of the claim can be ascertained with reasonable certainty from the notice.

(2) A notice of lien or charge may be given although the work is not completed, or the time for payment of the money payable by the owner or of the money sought to be charged or of the money claimed has not arrived.

(3) A right to a lien or charge shall be deemed to be extinguished unless notice thereof is given within the time limited by sections thirteen, fourteen or nineteen of this Act.

#### Duties and Obligations of Employer or Superior Contractor

16. CONSEQUENCES OF NOTICE OF LIEN OR CHARGE - (1) When a notice of lien or charge is given to the employer or to a contractor by a claimant not employed by him it shall be the duty of the employer or contractor to retain in his

hands, until the claim is satisfied or otherwise disposed of, a sufficient part of the money payable or to become payable by him under his contract to satisfy the claim of the claimant.

(2) Subject to the provisions of this Act, the employer or contractor shall in every such case be personally liable to pay to the claimant the amount of his claim, not exceeding the amount that he is required by this section to retain, in the same manner and to the same extent as if the claimant had been employed by him personally.

#### Duty to retain part of contract price

17. (1) In addition to the amount (if any) that he is required by section sixteen of this Act to retain, every employer or contractor, whether or not he has received any notice of lien or charge, shall retain in his hands until the expiration of sixty days after the date of the completion or abandonment of the work specified in the contract or subcontract the following percentage of so much of the contract price as has become payable at any time since the making of the contract or subcontract, or would be so payable but for a provision inserted in the contract or subcontract to secure its retention in conformity with this Act, namely:

- (a) Ten per cent of the first hundred thousand pounds or part thereof:
- (b) Five per cent of the next four hundred thousand pounds or part thereof:
- (c) Two and one-half per cent of the next five hundred thousand pounds or part thereof:
- (d) One per cent of the next one million pounds or part thereof:
- (e) One quarter per cent of any amount in excess of two million pounds.

(2) Where a contractor or subcontractor is in breach of his obligations under his contract the amounts which employers and contractors are required by sections sixteen and seventeen (1) of this Act to retain shall not as against any claimant to a charge be applied by the employer or contractor to the completion of the contract or for the payment of damages for non-completion or in payment or satisfaction of any claims against the contractor or any subcontractor or for any other purpose and the entitlement of the claimant to charge to such moneys so retained shall not be defeated by any counterclaim set off or crossdemand by or on the part of the employer or subcontractor against

the person from whom the moneys have been so retained.

Procedure to determine claims

18. JURISDICTION - (1) Only a Magistrate's Court presided over by a Magistrate shall have jurisdiction in respect of actions matters questions and disputes arising under this Act, but subject to the rights of appeal given by Part V of the Magistrate's Courts Act 1947.

(2) A Magistrate may state any question of law arising in the course of any proceedings under this Act in the form of a special case for the decision of the Supreme Court, and a decision of the Supreme Court or any special case so stated shall be deemed to be a judgment of that Court within the meaning of the Judicature Act 1908 section thirty six.

19. (1) Within ten days of service on him of any notice of lien or charge the employer shall file in the Magistrate's Court exercising civil jurisdiction nearest to the land on which the work is being or has been done and shall service on the owner if he is not the employer the contractor and all declared subcontractors copies of an application in the form prescribed in the schedule hereto.

(2) The date of hearing of such application shall be not less than fourteen clear days after service of copies of the application and affidavit on all persons entitled by virtue of subsection (1) so to be served.

(3) Any party so served who claims to be entitled in such proceedings to a lien or charge under this Act or to any judgment pursuant to subsection (8) of this section shall not less than five clear days before the date of hearing serve a notice setting out particulars of his claim and the facts on which he relies to support it on the employer and all persons entitled by virtue of subsection (1) to be served with copies of the application and affidavit.

(4) Any person claiming to be interested in the land in respect of which a lien is claimed or in the money in respect of which a charge is claimed may intervene in any action to enforce the lien or charge. Every such person may intervene by filing in the Court and serving on all the other parties an affidavit stating the nature of his interest.

(5) The Court after hearing all persons required as aforesaid to be served and any worker who may enter an appearance and any person who may intervene pursuant to subsection (4) of this section shall determine the entitlement to a lien or charge or to judgment pursuant to subsection (8) of this section of any party and any other

question that may arise either forthwith in a summary way on the initial date of hearing or on such adjourned date as it may fix.

- (6) The Court if the proceedings are adjourned -
  - (a) may direct the trial of any issue;
  - (b) may direct the payment of moneys into Court;
  - (c) if it appears that questions call for determination affecting any worker mortgagee or other person who is not required to be served and who has not entered an appearance shall direct service of proceedings on such person:
  - (d) may order discovery;
  - (e) may order the provision of further particulars of any claim or defence;
  - (f) may make such interim order for the custody or preservation of any property concerned as the Court shall think necessary or desirable, but the Court shall not except in special circumstances make any such interlocutory order at any time other than the initial date of hearing.

(7) It shall be the duty of parties to proceedings under this Act and their solicitors and counsel to give to the Court and to other parties all such information and to take all such other steps as shall ensure the expeditious settling of issues and determination of proceedings under this Act.

(8) The court may in proceedings under this Act give judgment in favour of any party against any other party for the amount due under any contract.

(9) Should the employer default in carrying out the obligations imposed on him by subsection (1) of this section the contractor or any declared subcontractor may institute proceedings in the same manner mutatis mutandis as is provided by subsection (1) in the case of an employer.

(10) Should the employer without reasonable cause default in carrying out the obligations imposed on him by subsections (1) and (7) of this section then notwithstanding the provisions of section five subsection (4) of this Act the Court shall if the money available is insufficient to satisfy the charges of all those entitled to a charge on moneys payable by the employer require the employer to pay in addition to the amount limited by that section an amount as damages arising out of such default on the employer's part which shall in any event be not less than one per cent of the amount so limited by section five subsection (4) for

each week or part thereof that such default subsists.

(11) A declaration by the Court that a claimant is entitled to a lien or charge shall entitle the claimant to apply without further order of the Court for sale of the land pursuant to section twenty five directing a sale of the land.

(12) Notwithstanding any provision of the Companies Act 1955 or the Bankruptcy Act 1908 to the contrary it shall not be necessary to obtain the leave of any Court before joining a company in liquidation or a bankrupt as a party to any proceedings under this section.

(13) The costs of the employer on a solicitor and client basis shall except where subsection (10) of this section applies or the Court otherwise orders be a first charge on the moneys held by him and subject to any charge under this Act.

20. COURT MAY DISCHARGE LIEN OR CHARGE ON TERMS - The Court may at any time discharge a lien upon any land or a charge upon any moneys if it is satisfied:

- (a) That the party primarily liable to the claimant is willing and able to fulfil his obligations to the claimant under his contract with the claimant or under this Act without resort to the land subject to the lien or the moneys subject to the charge; or
- (b) That the party entitled to the land or moneys is willing and able to fulfil his obligations under his contract with the person under whom the claimant claims and his obligations to the claimant under this Act without resort to the land subject to the lien or the moneys subject to the charge; or
- (c) That the applicant for the order of discharge is prejudicially affected by the lien or charge

or on any other ground, and may make such order subject to payment into Court of the amount claimed or on such other terms as it deems just.

21. VEXATIOUS NOTICE OF LIEN OR CHARGE - If any person vexatiously or without any reasonable grounds gives a notice of lien or charge, or registers any lien, he shall be liable to pay to any person prejudicially affected thereby such reasonable damages as he sustains in consequence thereof.

22. EFFECT OF PAYMENT UNDER ORDER OF COURT - All payments made by an employer, contractor, or subcontractor to any person pursuant to an order of the Court made under this Act shall be a sufficient discharge to the person making

the payment of his liability to pay the money to the person who, but for the order, would have been entitled to receive the money from him.

23. REGISTRATION OF LIENS - (1) No estate or interest in land of which the owner is registered as proprietor pursuant to the provisions of the Land Transfer Act 1952 shall be affected by a lien unless the notice claiming the lien is registered as provided by this section.

(2) A copy of the notice claiming the lien verified by a declaration in the form in the Second Schedule hereto, shall be an "instrument" within the meaning of the Land Transfer Act 1952 and shall be registered in the same manner as is provided by that Act for the registration of instruments. Notice of the registration shall be given by the District Land Registrar by registered letter to the registered proprietor of the estate or interest in land affected by the lien claim and to every person entitled to a mortgage or encumbrance over the said estate or interest.

(3) A notice claiming a lien shall not be subject to stamp duty and no fee shall be charged for the registration thereof.

24. DISCHARGE OF LIEN - (1) A lien registered pursuant to the provisions of section twenty three of this Act shall be deemed to have lapsed six months from and after the date of registration thereof unless within such time the Court has on such terms as it may think fit ordered to the contrary.

(2) A lien may be discharged by the claimant thereof either as to the whole or any part of the land affected, or the consent of such claimant may be given to the registration of any particular dealing expressed to be made subject to the rights of the leinor.

(3) Such discharge in the form in the Schedule to this Act or an order of the Court discharging a lien may be registered in the same manner as a notice claiming a lien.

25. SALE TO ENFORCE LIEN AFTER JUDGMENT - (1) If the Court holds any claimant entitled to a lien then if the owner of the land subject to the lien fails within one calendar month from and after the date of such judgment to pay the claimant the amount which he has been held to be obliged to pay such successful claimant may without further order of the Court apply to the Sheriff in the district in which the land is situated for a sale of such land.

(2) The Sheriff shall make such sale on delivery to him of a copy of the decision, certified by the Registrar of the Magistrate's Court, which shall be a sufficient warrant and authority to the Sheriff to effect and complete the

sale in the same manner and with the same powers and authorities (including those relating to the execution of transfers and other instruments) as if it were a sale under a writ of sale pursuant to a judgment of the Supreme Court.

#### Lien on Personal chattels

26. SPECIAL PROVISION FOR ENFORCING LIEN ON PERSONAL CHATTELS - (1) Where a worker has done work upon a chattel in his possession so as thereby to be entitled to a lien on the chattel for any amount, and the amount to which he is entitled remains unpaid for not less than two months after it ought to have been paid, he may in addition to all other remedies provided by law, cause the chattel to be sold by auction.

(2) Not less than three weeks' notice of the sale shall be given to the owner of the chattel as provided in section twenty-seven of this Act if his address is known to the worker, and also (whether his address is known or not) by advertisement in a newspaper published in the locality in which the work was done, or if there is no newspaper published in that locality, in a newspaper circulating in the neighbourhood, stating in each case the name of the worker, the amount of the debt, a description of the chattel, the time and place of sale, and the name of the auctioneer. The advertisement need not specify the name of the owner.

(3) The proceeds of the sale shall be applied, firstly, in payment of the costs of advertising and sale and, secondly, in payment of the amount due under the lien, and any surplus shall, as soon as may be after the completion of the sale, be paid to the Registrar of the Magistrate's Court nearest to the place of sale, to be held by him for the benefit of the person entitled to it.

#### General Provisions

27. SERVICE OF NOTICES - (1) Except where otherwise specially provided, any notice required to be given to any person for the purposes of this Act (including any application or other document provided for by section nineteen) may be given by causing it to be delivered to that person, or to be left at his usual or last known place of abode or business or at any address specified by him for that purpose, or to be posted in a letter addressed to him at that place of abode or business or address.

(2) If any such notice application or other document is sent to any person by registered letter it shall be deemed to have been delivered to him when it would have been



delivered in the ordinary course of post, and in proving the delivery it shall be sufficient to prove that the letter was properly addressed and posted.

(3) Documents to be served on the Crown shall be served

(a) by serving a copy on the Solicitor-General and

(b) by serving a copy on the officer in charge of the departmental office (if any) named or designated in the contract as the address at which documents under this Act shall be served.

28. SAVINGS OF OTHER REMEDIES - Except as otherwise expressly provided, nothing in this Act shall be construed to affect the right of any person to whom a debt is due for work done or materials supplied to maintain a personal action to recover the debt against any person liable for it; and the judgment (if any) obtained by the plaintiff in any such action shall not affect any lien or charge or other right to which he is entitled under this Act.

29. CERTAIN LANDS NOT AFFECTED - Nothing in this Act shall be deemed to create or give to any person any right or remedy against any land vested in the Crown or in any local authority or public body.

30. This Act shall apply to Maori land as defined in the Maori Affairs Act 1953 notwithstanding anything in that Act or any other Act expressed or implied to the contrary.

31. ACT TO BIND CROWN - Subject to the provisions of section twenty-nine of this Act this Act shall bind the Crown.

32. REPEALS AND SAVINGS - (1) The Wages Protection and Contractors' Liens Act 1939 and its amendments are hereby repealed.

(2) Subject to subsection four of this section all liens, charges, notices, orders, registers, registrations, records, instruments, and generally all acts of authority that originated under any enactment hereby repealed, and are subsisting or in force on the commencement of this Act, shall enure for the purposes of this Act as fully and effectually as if they had originated under the corresponding provisions of this Act, and accordingly shall, where necessary, be deemed to have so originated.

(3) All matters and proceedings commenced under any such enactment and pending or in progress on the commencement of this Act may be continued, completed, and enforced under this Act.

(4) All liens registered against any land pursuant to the provisions of the Wages Protection and Contractors Liens

Act 1939 shall lapse at the expiry of six months from the coming into force of this Act unless within such time a Magistrate's Court orders to the contrary.

(5) Notwithstanding the provisions of subsection (1) the Wages Protection and Contractors Liens Act 1939 and its amendments shall continue to apply and this Act shall not apply to contracts entered into before the commencement date and to subcontracts and contracts of employment for the performance of the work specified in such contracts.

S C H E D U L E

FORMS

Section 4

(1) Notice by subcontractor

To C.D. of

Take notice that I have entered into a contract with E.F.  
to carry out on (your) property at                                 the following  
work [Here give a short description of the nature of the  
work].

My address for service is:

Dated this                                 day of                                 19

(For and on behalf of)

.....

(Signature of subcontractor)

Section 18(1)

(2) Notice of Lien [and Charge]

To Mr C.D. of

I, A.B., of [Address and occupation] hereby give you notice that I claim under the Contractors' Liens Act 1966 a lien on your land at [here describe the interest in land in such a manner that it can be identified] in respect of the following work upon or in connection with the land [or as the case may be], that is to say:

[Here give a short description of the nature of the work for which the lien is claimed], which work was [or is to be] done by me while in the employment of [or under contract with] you [or E.F. or G.H. (as the case may be) of (address and occupation)]

between the                      day of                      19                      and the  
day of                      19                      .

[If a charge is also claimed against the owner, add the following]:

And I give you further notice that I claim under the said Act a charge on the money which is now or will be payable by you to E.F. [Here state address and occupation of contractor if not given above] in respect of the same work [or by G.H. to I.J. (as the case may be)]

The amount which I claim as due [or to become due] is £                      ; and I require you to make the necessary application to the Court to determine my claim.

Dated at                      this                      day of                      19                      .

[Signature of Claimant]

[Important - The Contractors' Liens Act 1966 casts on you a duty to make an application to a Magistrate's Court within 10 days of the service of this notice on you, and makes you liable to a monetary penalty if you fail in this duty. If in doubt you should consult a solicitor immediately.]

(3) Notice of Charge

To Mr C.D., of

I, A.B., of [Address and occupation], hereby give you notice that I claim under the Contractors' Liens Act 1966 a charge on the money which is now or will be payable by you to E.F. of [Address and occupation], [or by E.F. to G.H. (as the case may be)] in respect of the following work in connection with your contract with the said E.F., that is to say:

[Here give a short description of the nature of the work for which the charge is claimed], which work was [or is to be] done by me while in the employment of [or under a subcontract with] the said E.F. [or G.H. of (address and occupation), a subcontractor under the said E.F.], between the                      day of                      19                      and the                      day of                      19                      .

The amount which I claim as due [or to become due] is £                      ; and I require you to make the necessary application to the Court to determine my claim.

Dated at                      this                      day of                      19                      .

[Signature of Claimant]

Section 19

(4) Application to Magistrate's Court

In the Magistrate's Court

Held at

In the matter of the  
Contractors' Liens Act 1966

I, C.D. of hereby apply to the Magistrate's Court at pursuant to section 19 of the above Act for an order determining the entitlement to the relief he seeks of E.F. and any other claimant who may give the appropriate notice under that section. A copy of the notice given by the said E.F. is annexed hereto. The date and time of hearing are day the day of 19 at o'clock in the noon.

The following information is given pursuant to my duty under the said Act.

1. The land in question is
2. I am the owner of the following estate or interest in the land (or the owner of the land is G.H. and I am the employer within the meaning of the said Act in the following circumstances).
3. The name and address of the head contractor are
4. The names and addresses for service of the declared subcontractors are
5. The contract is (not completed, was completed on [date], was abandoned on [date]).
6. The head contract price is £ of which £ has been paid.
7. My interest in the said land is subject to a mortgage securing a principal sum of £ to H.I. of The whole (or £ ) of the principal sum has been paid and the last payment to me on account of the principal sum was on (date).
8. I bring the following additional relevant matters to the attention of the Court -
9. I will serve this application on
10. My solicitor and address for service is

Dated this day of 19

.....

[Signature of employee or his solicitor]

TO: The Registrar of the Magistrate's Court at

Section 23(3)

(5) Declaration on Registration of Lien

I, A.B. of do solemnly and sincerely declare that I believe that I [or C.D. by whom I am employed] am justly entitled to the amount claimed in the (annexed) (foregoing) notice of claim of lien and that such of the matters referred to in the said notice as are within my own knowledge are true and the rest I believe to be true.

And I make etc.

-----

Section 24

(6) Discharge of Lien

In the matter of the Contractors' Liens Act 1966

AND

In the Matter of the notice claiming lien registered in the Land Registry Office at under No.

I E.F. of the claimant named in the above-mentioned notice, hereby discharge the same [(where part only of the land is to be discharged) as to the following land, namely:]

Dated this day of 19

.....  
(Claimant)

Witness:

Occupation:

Address:

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