



BELL GULLY

Insolvency Update

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Welcome to Bell Gully's *Insolvency Update*, a digest of the latest news from the courts and legislators.

In this issue we feature:

- Proposed changes to the Insolvency Act 2006
- Deduction notices by the IRD
- Test case on voidable transactions
- Defrauding creditors by transferring assets to trust

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Disclaimer: this publication is necessarily brief and general in nature. You should seek professional advice before taking any action in relation to the matters dealt with in this publication.

Proposed changes to the Insolvency Act 2006

On 28 May, the Commerce Committee recommended that the Insolvency Amendment Bill 2009 (the Bill) be passed with a few minor amendments. If enacted, the Bill will amend the Insolvency Act 2006 (the 2006 Act) for the first time since it came into force on 3 December 2007.

The principal changes proposed by the Bill concern:

- the cancellation of insolvent gifts by the Official Assignee;
- the status of fraudulent debts on discharge from the No Asset Procedure (the NAP); and
- the retention of information on the public register.

Cancellation of insolvent gifts

The Bill makes a number of changes to the insolvent gift provisions in the 2006 Act, largely returning to the position under the Insolvency Act 1967 (the 1967 Act).

Gifts within two years of adjudication

Under the 1967 Act, the Official Assignee could cancel a gift made by the bankrupt within two years prior to adjudication without needing to prove that the bankrupt was insolvent at the time of the gift.

The 2006 Act changed this by allowing the Official Assignee to cancel a gift only if the bankrupt was unable to pay his or her debts immediately after the gift was made. The Act does create a presumption that the bankrupt was unable to pay his or her debts during the two years prior to adjudication. However, if the recipient of the gift is able to rebut this presumption, the Official Assignee cannot cancel the gift.

Under the Bill the position will revert to that under the 1967 Act by allowing the Official Assignee to cancel any gift made by the bankrupt within two years prior to adjudication, irrespective of whether the bankrupt was insolvent at the time of the gift.

Gifts within two to five years of adjudication

Under the Bill the position relating to gifts made within two to five years of adjudication also moves back to the 1967 Act.

Currently, the burden of proof lies on the Official Assignee to establish that the bankrupt was insolvent. The Bill shifts the burden of proof back to the recipient of the gift, where it had stood under the 1967 Act, so that the recipient will need to prove the bankrupt satisfied the solvency test to avoid the Official Assignee cancelling the debt.

In addition, the Bill makes a change to the time at which the bankrupt must be proven to have satisfied the solvency test. Under the current law, the test will be satisfied only if the bankrupt was able to pay his or her debts *immediately* after the gift was made. The Bill changes this so that the bankrupt will satisfy the solvency test if, *at any time* after the gift but before adjudication, the bankrupt was able to pay his or her debts. This is also a return to the pre-2006 Act position.

Solvency test for insolvent gifts and transactions at undervalue

The Bill also modifies the solvency test for insolvent gifts so that it takes into account all debts owed by the bankrupt, not just those that were due. Contingent liabilities will consequently need to be taken into account in applying the test.

The same change applies where the Official Assignee seeks to make a recovery in respect of a transaction at undervalue. For all other irregular transactions (insolvent transactions and insolvent charges), the test takes into account only due debts.

Commencement of changes

The changes to the insolvent gifts rules will not be retrospective. They will apply only where adjudication has occurred after the amendments have come into force. If adjudication has occurred prior to this, the current provisions in the 2006 Act will continue to apply.

Status of fraudulent debts on discharge from NAP

Currently, when a debtor is discharged from the NAP, all of his or her debts that were unenforceable upon entry into the scheme are cancelled. The Bill amends this blanket cancellation to exclude two types of fraudulent debt:

- any debt or liability incurred by fraud or fraudulent breach of trust to which the debtor was a party; and
- any debt or liability for which the debtor has obtained forbearance through fraud to which the debtor was a party.

While these types of debt will be unenforceable during the debtor's participation in the NAP, they will become enforceable again once the debtor is discharged. This change brings the position of fraudulent debts under the NAP into line with the position of such debts in bankruptcy.

This change will have some retroactive effect: this part of the Bill is deemed to have come into force on 10 March 2009. Therefore all fraudulent debts cancelled on discharge from 10 March 2009 will be revived when the Bill receives the Royal Assent.

Retention of information on the public register

The public register contains information on people who are or have been bankrupt and who are in the NAP. Information must currently be removed four years after discharge for bankrupts and on discharge for those admitted to the NAP.

The Bill will change this so that information on persons admitted to the NAP will be retained for four years after discharge and information on bankrupts will be kept permanently if they have multiple insolvency events. A person is defined as having multiple insolvency events if they have been bankrupted more than once or have been bankrupted once and also discharged from the NAP.

While these changes will not be retroactive for persons admitted to the NAP, they will be for those who have multiple insolvency events. The Bill introduced into Parliament made it clear that this included bankruptcies under the Insolvency Act 1967 or the Bankruptcy Act 1908. The Commerce Committee recommended that this be changed not to include bankruptcies under the 1908 Act as records prior to the 1967 Act can be unreliable.

The public register provisions were the one feature of the Bill in which members of the Commerce Committee differed. The Labour members of the Committee considered that there had been insufficient consultation with stakeholders, such as the Privacy

Commissioner, on this part of the Bill. The Committee consequently recommended that this part of the Bill be separated from the rest.

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IRD deduction notices and priority issues

The IRD appears to be issuing “deduction notices” more frequently to recover overdue tax under the Income Tax Act and the Goods and Services Tax Act. When these notices are issued, priority issues may arise between the IRD and secured parties of the debtor.

The IRD may serve a deduction notice on the clients of a taxpayer who fails to pay GST or PAYE. Under the deduction notice, the client, usually a company, is required to pay any amounts which were otherwise due to the taxpayer direct to the IRD.

Deduction notices have the potential to place third parties in a difficult position as they may have conflicting demands for payment. The debtor taxpayer may have granted a security interest over accounts receivables and secured creditors could also be demanding payment of the amounts due to the taxpayer from third parties.

Unless the taxpayer is in liquidation, or the secured creditor has appointed a receiver to recover accounts receivables, the secured creditor will most likely have priority over the IRD on amounts due to be paid to the taxpayer. If that is the case, a deduction notice would be of no effect because the funds in question are due to the secured creditor, they are not “payable” to the debtor taxpayer.

The difficulty secured creditors may face in these circumstances is that deduction notices carry with them the threat of prosecution if the IRD’s demands are not complied with. Faced with this threat, clients of the taxpayer could well decide to pay the IRD, even though the secured creditor may have priority to the payment.

Where a company has been placed into liquidation, or where the secured creditor has appointed a receiver, it is likely that the IRD has priority to the amounts owed by clients to a debtor taxpayer. The concern for the IRD is that, despite the fact that it may have issued a deduction notice, the significance of the company having been placed into liquidation or receivership may not be appreciated by the taxpayer’s client. If the client pays the secured creditor as a result, the IRD may be forced to issue proceedings to recover the payment.

Given the potentially difficult priority issues which arise, we recommend legal advice be obtained whenever a deduction notice is issued.

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Test case on voidable transactions

The process for setting aside a preferential transaction was changed in 2008. *Blanchett & Anor v The Roofing Specialists Ltd* is the courts' first decision using the new process.

The process

A transaction that was entered into when a company was insolvent, and which had the effect of preferring one creditor over other creditors, may be set aside by a liquidator.

The process is commenced by the liquidator:

- filing a notice under s294(2) of the Companies Act in Court; and
- serving a copy of this on the creditor.

Previously, a creditor who received a notice was required to file an application with the court in order for the transaction not to be set aside. Failure to file a court application resulted in the transaction automatically being set aside. Now, the creditor need only send the liquidator a written notice of objection within 20 working days of being served with the notice to avoid the transaction being automatically set aside. If the creditor takes this step, it is the liquidator who must file an application with the court in order to set a transaction aside.

To combat the prospect that a creditor without genuine grounds for objection would simply send a pro-forma notice of objection to the liquidator, creditors are required to set out full particulars of their reasons for objecting and identify documents that evidence or substantiate these reasons. This requirement is also designed to ensure that:

- the information imbalance between a liquidator, who often has limited records, and the creditor is addressed; and
- liquidators are fully informed as to both the substance and detail of a creditor's objection before determining whether or not to pursue a challenge.

Blanchett & Anor v The Roofing Specialists

To some extent, the decision of the High Court in this case undermines the rationale around the requirement to provide full particulars of the reasons for objection.

The case shows that a creditor will not be prevented from relying on an argument that it has not set out in its notice of objection.

In *Blanchett & Anor v The Roofing Specialists*, the creditor opposed the liquidator's notice on the basis that the company was solvent at the time of the transactions and that the payment did not confer a preference on the creditor. At the hearing, however, the creditor pursued neither of these grounds and instead argued that the payments were made in the company's ordinary course of business.

Despite this, Justice Allan held that the interests of justice required that the creditor should be permitted to advance the new arguments. Justice Allan did find that, in certain cases, a liquidator would be prejudiced by a late argument to such an extent that the creditor should not be permitted to advance a new argument at all. However, in the present case, he considered that the creditor had filed a very detailed notice of opposition that set out its intention to raise the new argument and, accordingly, there had been sufficient compliance with s292(4) to justify leave being granted to advance the argument.

The decision's merits

While one of the policies behind s294 – ensuring that liquidators are able to make informed decisions about whether to commence proceedings – is eroded by allowing creditors to raise arguments that should have been identified when the notice objection was served on the liquidator, in our view the decision is a fair one.

The significance of a notice to set aside a transaction is not always fully appreciated by creditors. It will often be the case that creditors do not seek legal advice on a notice to set aside a transaction until proceedings are issued. At this point, the creditor's legal advisors may well identify legitimate reasons why a transaction should not be set aside which the creditor did not raise itself. Except in cases where a creditor raises new arguments at a stage so late in the proceedings that the liquidator has no opportunity to respond to them, the creditor should be allowed to raise additional grounds not specified in the notice of objection. However, in such situations it is appropriate that the liquidator be compensated in terms of costs if he or she would not otherwise have issued proceedings had the argument been raised in the notice of objection.

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Defrauding creditors by transferring assets to trusts

The Supreme Court has provided further guidance on when it will rule that the transfer of assets to a trust constitutes intent to defraud creditors.

In *Regal Castings v Lightbody* the Supreme Court considered a transfer of property by a debtor to his family trust which was said to have been made with intent to defraud creditors. The Court found that the transfer of property was void.

The facts of the case

Regal Castings loaned Lightbody a substantial sum to provide capital for Lightbody's business. Without telling Regal Castings, Lightbody transferred his house, which was his only substantial asset, to a family trust. When Lightbody subsequently defaulted on the loan, Regal Castings obtained judgment against him. The creditor then brought the present claim under section 60 of the Property Law Act 1952 (PLA 1952) to set aside the transfer of the property as having been made with an intent to defraud.

It was suggested during the hearing that a transfer of property for no consideration gave rise to a presumption of an intention to defraud. The majority of Court found it unnecessary to decide whether this was correct. They instead held that the question of intent remains one of fact, but accepted that an inference of fraudulent intent may be drawn from the facts.

Counsel for Regal Casting argued that Lightbody's financial circumstances were precarious, and the position of Regal Casting was inevitably prejudiced by transferring Lightbody's only substantial asset. In those circumstances an intention to defraud was established.

The Court agreed that the circumstances showed an intention by Lightbody to defraud his creditors. In reaching this conclusion, in our view the Court has lowered the bar for the conduct sufficient to trigger section 60 of the PLA 1952. Lightbody knew that one of the effects of the trust arrangement was to protect assets, but there was nothing untoward in the terms of the trust deed. The house had been transferred at value, and the gifting programme was normal. To find Lightbody had an intent to defraud the creditor ultimately required the Court to infer a level of calculation and sophistication on the part of Lightbody that arguably did not exist.

The effect of the decision

Since 1 January 2008, it is no longer necessary to prove that the debtor disposed of the relevant property with intent to defraud creditors. A transaction may be set aside if the relevant property was disposed of:

- a) as a gift; or
- b) without receiving reasonably equivalent value in exchange.

The case of *Regal Castings* is, however, still relevant because section 346 of the PLA 2007 provides that a disposition of property may be void if it is done with intent to defraud creditors. Also, transfers of property to trusts prior to 1 January 2008 are still governed by section 60 of the PLA 1952 and the decision in this case.

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