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DEFICIENCIES IN THE POST PPSA PREFERENTIAL CREDITOR REGIME

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ABSTRACT

This research paper deals with the preferential creditor regime in a company's insolvency. The paper first gives an overview of different preferential creditor regimes and the changes which have taken place in New Zealand. It explains that the basic principle in insolvency law provides for the equal distribution of the assets among all unsecured creditors. Granting preferential entitlements to specific creditors is contrary to this principle. However, there are specific creditors who need additional protection for social, economic or political reasons.

The paper then examines the legal and technical issues of the current preferential creditor system after the introduction of the Personal Property Securities Act 1999. It points out its deficiencies, in particular the inconsistency between the preferential creditor regime and the Personal Property Securities Act. It is important that the statutory principles for distributing the assets are transparent, as clearly any preference will be at the expense of others.

The paper next reconsiders the preferential positions of employees and the Crown, the two largest classes of preferential creditors. While the preferential status of the Crown is predominantly supposed, there is consensus that employees need protection. However, the method and the extent of protection are arguable.

The paper finally discusses whether or not there are alternatives to the existing preferential creditor system. In particular, it will be discussed whether the best approach to solve the problems is to completely abolish the preferential entitlements of employees and the Crown. The complete abolition might kill two birds with one stone. Both the deficiencies caused by the enactment of the PPSA and the remaining difficulties to balance the employees' interests could be solved.

This research paper comprises 14,883 words exluding front page, table of contents, abstract, footnotes and bibliography.

I INTRODUCTION

The subject of priority creditors is controversial and varies across the jurisdictions. The decision as to which creditors are at the front of the queue in a debtor's insolvency is the determining factor if a creditor will get paid or miss out. Since the problem of insolvency has been increasing in almost all parts of the globe, the issue has been gaining global recognition. There are three broad groups of preferential creditor regimes into which countries fall. The first group follows a more traditional approach retaining wide preferential rights for certain creditors, examples of which are France, Spain, Ireland, Italy and South Africa. The next group has reduced the level of priority significantly, for example Australia, the United Kingdom and Canada. Finally, the last group including Germany and Austria has completely abolished preferential claims.[1]

The position of New Zealand will be discussed in this research paper. Changes have been made to New Zealand's preferential creditor system by the introduction of the Personal Property Securities Act 1999 (PPSA) and the Companies Amendment Acts 2004 and 2006. In 2002, the coming into effect of the PPSA led to corresponding amendments of the preferential creditor regime.[2] The particular structure adopted for New Zealand's preferential creditor system was anomalous and in particular created the potential for circular priorities. This led to further amendments but some inconsistencies still exist. While the PPSA adaptations govern the priority order between preferential creditors and secured creditors, the Companies Amendment Acts 2004 and 2006 concern the priority order among the different classes of preferential creditors. The amendments particularly changed the preferential claims of employees and enhanced their entitlements in the scope of application and in amount.[3]

A tension exists between the need to protect employees or other preferential creditors on the insolvency of the employer and the need to ensure that the protection or level of protection given does not cause undue detriment to

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[1] Andrew Keay, Andre Boraine, David Burdette "Preferential Debts in Corporate Insolvency: a Comparative Study" (2001) 10 Int. Insolv. Rev 167, 168.
[2] Personal Property Securities Amendment Act 2001, Receiverships Amendment Act 2001.
[3] Companies Amendment Act 2004 and Companies Amendment Act 2006.

other creditors or cause harm to the overall economy.[4] Therefore, preferential entitlements must be balanced against the rights of unsecured creditors in insolvency.

[4] Paul Heath "Preferential Payments on Bankruptcy and Liquidation in New Zealand: Are they Justifiable Exceptions to the Pari Passu Rule" (1996) 4 Waikato Law Review 25, 44.

II PREFERENTIAL STATUS

A Pari Passu Rule and Preferential Creditors

The pari passu rule of distribution is a fundamental principle of insolvency law.[5] In the case of a debtor's insolvency the pari passu rule states that the assets will be divided among the creditors in proportion to the amount of each creditor's claim.[6] All unsecured creditors are to be treated equally. This principle of equal sharing is expressed in section 313(2) of the Companies Act 1993 (the Act). As a debtor's insolvency requires that the debtor's liabilities exceed its assets, some of the creditors will not be completely satisfied.[7] The rationale underlying the pari passu rule is that no creditors should receive preference over the general body of creditors in the division of assets. The principle 'first in first served' gives way to that of the orderly realisation of assets.[8]

However, this objective of equal distribution is virtually impossible in practice. In the overwhelming majority of cases, it is substantially undermined by the existence of preferential debts.[9] Preferential creditors are unsecured creditors who are given a special priority to payment by statute.[10] Section 312(1) of the Act and section 30(2) of the Receiverships Act 1993 (Receiverships Act) require liquidators and receivers to pay out these unsecured creditors before other unsecured creditors. Also the rights of certain, but not all secured creditors may be subordinated to the debt of preferential creditors.[11] The group of preferential creditors represent a major exception to the pari passu rule, as the range of creditors upon whom statutory priority is conferred is extensive.[12]

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[5] *Attorney General v McMillan & Lockwood Ltd* [1991] 1 NZLR 53, 58 (CA).
[6] Ibid.
[7] Michael Gedye "The Structure of New Zealand's "New" Priority Debts Regime" (2003) 9 NZBLQ 220, 221.
[8] Royston Miles Goode *Principles of Corporate Insolvency Law* (3 ed, Sweet & Maxwell, London, 2005) 60.
[9] Australian Law Reform Commission (Chairman, Mr. Ronald Harmer) *General Insolvency Inquiry (Harmer Report)* Report No.45 1988, para 33.
[10] Brookers *Insolvency Law & Practice,* Commentary on Companies Act (vol 2, Loose leaf, Brookers, Wellington, 2007) CA 312.01.
[11] Trish Keeper *Preferential Creditors* in Rt Hon Justice Blanchard *Business Insolvency* (New Zealand Law Society, Wellington, 2007) 107, see below Chapter III A 3 (b).
[12] Australian Law Reform Commission, above n 9, para 33.

B Preferential Claims

Schedule 7 to the Act ranks claims within the class of preferential creditors, with each sub-class having priority over the subsequent sub-class. Schedule 7 to the Act sets out five basic classes of preferential debt; administration costs; employee related claims; miscellaneous debts; and Crown related debts. In cases of receiverships, section 30(2) of the Receiverships Act refers to Schedule 7 of the Act, but states that the reimbursement for expenses and remuneration of the receiver ranks ahead of all the preferential claims and replaces the administration costs of Schedule 7, clause 1(1) of the Act.

The first class in a liquidation, being the costs associated with the initiation and administration of the liquidation, is payable in the order of priority in which they are listed.[13] It includes the payment of the liquidator's costs and expenses incurred in administering the liquidation as well as the costs of the person who applied to liquidate the company. The Companies Amendment Act 2006 introduced two new categories of preferential claim within this class: the inclusion of voluntary administration costs,[14] and costs of creditors who protect or preserve the value of assets of the company.[15] Administration costs are not typical unsecured preferential debts, as these costs would not have occurred without the insolvency. Both the public and the creditors are interested in professional and competent administration to maximise the fund for distribution. Without preferential status it would be difficult to encourage qualified people to fulfil this task.[16]

As second priority, the liquidator is required to pay employee related claims for unpaid wages and salary, as well as for amounts of holiday pay and unpaid redundancy payments. Included also are payments for certain amounts deducted by the company from the wages of an employee to satisfy obligations of the employee toward the Crown.[17]

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[13] Schedule 7, cl 1(1)(a) of the Companies Act (the Act).
[14] Schedule 7, cl 1(1)(b) of the Act.
[15] Schedule 7, cl 1(1)(e)(ii) of the Act, introduced to provide an incentive for creditors to assist the company to recover or preserve its assets.
[16] Heath, above n 4, 39.
[17] See below Chapter IV C 1.

After payment of these classes, a liquidator is next charged to pay certain debts of layby sales under the Layby Sales Act 1971 and the costs of organising a meeting to vote on a compromise.[18]

Finally, at the lowest priority class rank the payment of certain outstanding taxes and duties owed to the Crown. The Crown debts are GST, PAYE, NRWT, RWT and Customs duty.[19]

Preferential treatment is also given to subrogated rights. Where any person provides funds for the payment of preferential entitlements, the funder is subrogated and replaces the preferential creditor to the extent of the latter's preferential debt.[20]

C Reasons for Exceptions

The amount which the preferential creditors are owed can often be so large that there is little, or nothing, left for general secured and unsecured creditors.[21] In each case it is therefore necessary to ask whether the exception to the pari passu rule is justified.[22] The granting of preferential status to the debt has to be consistent with efficient insolvency administration.[23] Preferential treatment has been justified by social, economic, and political reasons including the principles of fairness and equity, which promote and protect the public interest.[24] By far the largest category of preferential debts belongs to the wages and entitlements of employees and to Crown debts.[25]

There is a general consensus that employees require additional protection. Their preferential status can be justified for many reasons.[26] Employees are

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[18] Schedule 7, cl 1(3) and (4) of the Act.
[19] Schedule 7, cl 1(5) of the Act.
[20] Schedule7, cl 4 of the Act. The Companies Amendment Act 2006 extended preferential treatment to any part of funds advanced by a third party, while formerly preferential treatment was only given where the funds were provided for payment of employees' preferential claims.
[21] Keay, Boraine and Burdette, above n 1, 167.
[22] Heath, above n 4, 31.
[23] Australian Law Reform Commission, above n 9, para 33.
[24] Insolvency Law Review Committee (UK, Chairman Sir Kenneth Cork) *Insolvency Law and Practice* (Cork Report) 1982, 1398.
[25] Gedye, above n 7, 222.
[26] New Zealand Law Commission (Law Commission) *Priority Debts in the Distribution of Insolvent Estates: An Advisory Report to the Ministry of Commerce*, Study Paper 2, Wellington, 1999, paras 43-45.

usually dependent upon wages. Generally, there will be one employer and one source of income for any one employee. Employees are less able and not expected to evaluate the financial position of an employer and are often unable to take meaningful steps to protect themselves from their employer's insolvency.[27] Additionally, New Zealand is a member of the International Labour Organisation and should therefore comply with the Convention on the Protection of Worker's Claims (Employer Insolvency) 1992. This 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.[28] However, the concrete amount and method of protection is questionable.[29]

Though the justification of Crown preferential debt is controversial, preferential treatment continued in New Zealand.[30] The government and legislator justified the preferential status for several reasons. The most common one is that taxes are owed to the community rather than to the individual. Unlike the claims of private commercial creditors, tax claims are for the benefit of all.[31] The Crown's revenue must be protected.[32] Another argument is that the Inland Revenue Department (IRD) is an involuntary creditor. Additionally, most of the tax claims are indirect debts of a quasi-trust nature.[33]

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[27] *Re Lawsan Electric Co Inc 300 F 736* (SDNY) 1923.
[28] Law Commission, above n 26, para 45. New Zealand is not obliged to comply, as the Convention has not yet been ratified in New Zealand.
[29] See below Chapter IV B 2 and 3 and Chapter V C.
[30] There are a number of opposing arguments on this issue, see below Chapter IV C 2.
[31] Hon Laila Harre´, previous Minister of Commerce "Tier One Decisions and Where to From Here" Speech to the Business Law Forum on Insolvency Reform, Auckland, 22 November 2001 http://www.med.govt.nz (accessed 30 September 2008).
[32] Ibid.
[33] See Law Commission, above n 26, para 132, 146.

III POST PPSA PREFERENTIAL CREDITOR SYSTEM

A Changes through the Enactment of the PPSA

1 Interaction between preferential creditor regime and PPSA

Preferential claims have priority over certain, but not all secured creditors.[34] The PPSA defines the different forms and creation of security interests; details priority levels among secured creditors; and regulates to a large extent the enforcement of security interests over personal property.[35] It applies where personal property is used as collateral. The enactment of the PPSA 1999 changed the law relating to security interests significantly. As the previous preferential creditor regime had referred to the terminology of the old PPSA, corresponding amendments to the preferential creditor regime had to be made before the coming into force of the PPSA on 1 May 2002.[36] The new Schedule 7 of the Act refers to the security interests defined and created by the PPSA.

2 Policy of the PPSA

The PPSA is a wholly statutory system that for most purposes replaced the common law security interest (registration) system, namely the Chattels Transfer Act 1924, the Companies (Registration of Charges) Act 1993, the Motor Vehicle Securities Act 1989, and the Industrial and Provident Societies Amendment Act 1952. The PPSA prescribes the mechanism for the creation and prioritisation of charges, and establishes a uniform registration system for security interests in personal property.

One of the PPSA's objectives was to abolish formalistic distinctions and to equally treat transactions that in substance utilise personal property as collateral for the performance of an obligation.[37] The PPSA looks at the substance of a transaction and not at its form.[38] The PPSA priority rules apply to security interests over fixed or circulating, present or future assets. In contrast, under prior

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[34] Schedule 7, cl 2(1)(b) of the Act.
[35] Peter Eady *PPSA: Putting the Act into Practice* (New Zealand Law Society, Wellington, 2002) 40.
[36] Personal Property Securities Amendment Act 2001, Receiverships Amendment Act 2001.
[37] S 17(1) of the PPSA.
[38] Eady, above n 35, 40.

law circulating assets were subject only to a floating charge not to a fixed charge. Whatever from a security interest now takes, it is regulated by the same set of statutory rules.[39]

A consequence of the new priority rules is the quasi-abolition of the traditional floating charge.[40] The PPSA does not abolish the floating charge, it merely makes the prior law's distinction between fixed and floating charge irrelevant. A security interest attaches to collateral when the statutory requirements are met without depending on its form.[41]

3 *New concept of the post PPSA preferential creditor regime*

Section 312, Schedule 7 of the Act and section 30 of the Receiverships Act were amended,[42] to accommodate the new type of security arrangement and its terminology. The intention of the amendments was to preserve existing priorities in particular the subordination of certain secured creditors to preferential creditors.[43]

(a) Previous preferential creditor system

The prior preferential creditors system broadly provided that preferential creditors had priority over debts secured by a floating charge, but rank below debts secured by a fixed charge or by retention of title.[44] A charge is an interest in property created in favour of a creditor to secure the amount owing. The title is not transferred to the creditor, but it gives the chargee the right to have the charged assets realised in order to pay off the debt. A charge can either be fixed or floating.

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[39] Gedye, above n 7, 225.
[40] See s 17(1) and (3) of the PPSA 1999, David Brown and Thomas G. W. Telfer P*ersonal and Corporate Insolvency Legislation: Guide and Commentary to the 2006 Amendments* (LexisNexis NZ, Wellington, 2007) 97.
[41] S 40(1) of the PPSA.
[42] Personal Property Securities Amendment Act 2001, Receiverships Amendment Act 2001.
[43] Brown and Telfer, above n 40, 97.
[44] Schedule 7, para 9(b) of the Companies Act 1993, as applied until 2002.

(b) Current preferential creditor regime

As the form of the security interest is irrelevant under the PPSA,[45] the amendments to the preferential creditor regime were based largely on the assets taken as collateral rather than on the form of security interest. Schedule 7, clause 2(1)(b) of the Act and section 30(1) and (2) of the Receiverships Act now broadly provide that preferential creditors have priority over secured creditors with a security interest in the company's accounts receivable and inventory. This does not apply to secured creditors with a purchase money security interest (PMSI) or assignees of accounts receivable for which new value is provided,[46] such as occurs in factoring.

(c) Priority of preferential creditors over creditors with security interests over the company's accounts receivable or inventory

The concepts of security interests over accounts receivable and inventory are used to describe assets that would have been made the subject of a floating charge. A floating charge covers all or parts of the debtor's assets. It allows the debtor to use the charged assets freely until the event of insolvency. It was used in cases of circulating assets or assets with fluctuating value, like stocks and book debts. In place of these assets the preferential creditor system now uses the asset types of inventory and accounts receivable.[47] The priority of preferential creditors over assets which were formerly subject to a floating charge is therefore preserved.

(d) Exceptions for PMSI holders and assignees of accounts receivable for which new value is provided[48]

The reason for the exceptions in Schedule 7, clause 2(1)(b) of the Act and section 30(1) of the Receiverships Act is that PMSIs in the terminology of the new PPSA include retention of title clauses and other interests were in substance security is being taken in order to facilitate purchase of the assets. Prior to the PPSA these interests would have been fixed proprietary or possessory security

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[45] See above Chapter III A 2.
[46] Schedule 7, cl 2(1)(b)(i)(B)and(C) of the Act, s 30(1)(b)and(c) of the Receiverships Act.
[47] Gedye, above n 7, 227.
[48] Schedule 7, cl 2(1)(b)(i)(B)and(C) of the Act, s 30(1)(b)and(c) of the Receiverships Act.

interests which were enforced prior to all other classes of creditors.[49] The new exceptions therefore operate to preserve the position of retention of title and other fixed security interests.[50]

(e) Section 312(2) of the Act

Section 312(2) of the Act states that, assets which are subject to charges are not used to satisfy preferential creditors. However, by referring to Schedule 7 clause 2(1)(b) of the Act, section 312(2) of the Act stipulates that certain secured creditor interests are subordinate to preferential debts to the extent that there are insufficient other assets to meet all preferential claims. These are the holders of security interests over all or part of the company's accounts receivable or inventory, the formerly floating charge holders.[51]

4 Entitlements under the Companies Act and Receiverships Act

(a) Statutory duty

The priority given to preferential creditors is conferred indirectly by imposing an obligation on receivers and liquidators to distribute the debtor's assets in accordance with the statutory preferential creditor provisions. In cases of liquidation, section 312 of the Act requires a liquidator to apply the company's assets in accordance with Schedule 7 of the Act. For receiverships, section 30(2) of the Receiverships Act requires the receiver to comply with the provisions of Schedule 7 of the Act, as though the liquidation references in the schedule were references to receivership. Paying preferential creditors as set out in the Companies and Receiverships Act is a statutory duty. Receivers and liquidators are liable in damages in tort to preferential claimants for breaches of this duty.[52]

The preferential creditor has usually no direct proprietary rights against a third party, if it received assets that should have been distributed to the

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[49] Brown and Telfer, above n 40, 98.
[50] Brookers *Insolvency Law & Practice* Commentary on Receiverships Act (vol 2, loose leaf, Brookers, Wellington, 2007) RA30.02.
[51] Brookers, above n 10, CA 312.02.
[52] Section 312(1) of the Companies Act, Section 30(1) and (2) of the Receiverships Act, Peter Blanchard and Michael Gedye *The Law of Private Receivers of Companies in New Zealand* (LexisNexis, Wellington, 2008) 184.

preferential creditor. However in cases, where the recipient of misdirected assets has colluded in the breach, the preferential creditor can directly claim against the recipient.[53] A further exemption exists in section 184 of the Property Law Act 2007 (PPA).

(b) Avoidance of preferential claims

The appointment of receivers or liquidators triggers preferential creditor entitlements, while direct enforcement against personal property by a secured party under Part 9 of the PPSA usually does not. That means, if a direct sale can be affected without the use of a receivership or liquidation, the creditor does not have to concede priority to preferential creditors.[54] An exemption exists with regard to the taking of possession by a mortgagee under the Property Law Act.[55]

(c) Receivership and liquidation

Section 30 of the Receiverships Act applies to every company which goes into receivership and which is not at the date of commencement of receivership already in liquidation. The fact that a company which is in receivership later goes into liquidation does not render the section inapplicable; nor does the existence of an application at the time of commencement of receivership.[56]

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[53] Gedye, above n 7, 223.
[54] Blanchard and Gedye, above n 52, 188.
[55] Ss 185(5), 153 of the PPA.
[56] Blanchard and Gedye, above n 52, 168.

B Deficiencies

1 Difficulties with definitions

According to Schedule 7, clause 2(1)(b)(i) of the Act and section 30(1) and (2) of the Receiverships Act, liquidators and receivers must apply accounts receivable and inventory but no other asset types to pay preferential creditors.

(a) Accounts receivable[57]

Part 2, section 16(1) of the PPSA defines accounts receivable as a monetary obligation that is not evidenced by *chattel paper*, an *investment security*, or by a *negotiable instrument*, whether or not that obligation has been earned by performance.[58]

As only accounts receivable and inventory, but no other asset types are applied to pay preferential creditors, the breath of accounts receivable on the one hand and the breadth of chattel paper, investment security or negotiable instrument on the other hand is the decisive factor for who will get paid.

(i) Chattel paper

It can be difficult to distinguish between accounts receivable and chattel paper. A chattel paper means one or more writings that evidence both a monetary obligation and a security interest in, or lease of, specific goods or specific goods and accessions.[59] Therefore, when a security interest in specific goods has been created in writing a chattel paper and not an evidence of accounts receivable is constituted. Problems can arise with regard to the term "specific goods". For example, a security agreement can include goods that are to come from the seller's warehouse which cannot be identified at the time of sale.[60] The determination could depend on whether the actual goods were identified by the time the document was issued.

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[57] Schedule 7, cl 2(1)(b)(i)(A) of the Act, section 30(1)(a) of the Receiverships Act.
[58] Emphasis added.
[59] S 16(1) of the PPSA.
[60] Blanchard and Gedye, above n 52, 172.

(ii) Investment security

An investment security includes a writing that is recognised in the place in which it is issued as evidencing an obligation of the issuer and that, in the ordinary course of business, is transferred or withdrawn by an entry in the records maintained for that purpose by or on behalf of the nominee.[61] For example, shares are investment securities. With regard to investment securities, uncertainty exists whether a credit balance in a bank account should be classified as an account receivable or as an investment security. A bank credit would usually fulfil these criteria, too. However, if the bank account is a simple form of monetary obligation without investment elements, like without interest, it seems more naturally be regarded as an account receivable. The distinction could be drawn whether the evidence paper is a simple deposit record or whether the document requires to be surrendered in order for the customer to be paid.[62]

(iii) Negotiable instrument

A negotiable instrument includes a writing that evidences a right to payment of money that is transferred by delivery with any necessary endorsement or assignment and a letter of credit which must be presented on claiming payment.[63] Excluded are chattel paper, a document of title, or an investment security. Due to these exclusions there is no overlap between negotiable instrument and chattel paper or investment security. While there are overlaps between the latter two and accounts receivable, the definition of negotiable instrument does not lead to specific problems in the context of preferential claims.[64]

(b) Inventory[65]

The key factor for the determination whether goods are inventory is the purpose for which the goods are held at the time when the security interest in the goods attaches.[66] According to Part 2 section 16(1) of the PPSA inventory means

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[61] See s 16(1) of the PPSA.
[62] Blanchard and Gedye, above n 52, 174.
[63] See s 16(1) of the PPSA.
[64] Michael Gedye "Anomalies and Lacunae in the Treatment of Preferential Creditors" (2003) 9 NZBLQ 295, 296.
[65] Schedule 7, cl 2(1)(b)(i)(A) of the Act, section 30(1)(a) of the Receiverships Act.
[66] S 16(3) of the PPSA.

goods that are held by a person for sale or lease, or that have been leased by that person as lessor; goods that are to be provided or have been provided under a contract for services; raw materials or work in progress; or materials used or consumed in a business. Therefore, if the company's purpose is to sell, lease, or consume the goods, the goods are part of the company's inventory.[67]

(c) PMSI[68]

There are four types of PMSIs.[69] Namely, security interests taken in collateral by the seller to secure the obligation to pay the collateral's purchase price, so-called vendor finance; security interests taken in collateral by a person who has given value to enable the debtor to acquire rights in the collateral, a kind of acquisition finance; the interest of a lessor of goods under a lease of more than one year; and the interest of a consignor who delivers goods to a consignee under a commercial consignment. In the case of acquisition finance, it can be difficult to decide whether or not the payment given by the debtor was applied for the acquisition of rights in the collateral. The qualification as PMSI can be complicated with regard to all-assets-securities with present and after-acquired assets. Schedule 7 clause 2(1)(b) of the Act and section 30(1) of the Receiverships Act provide that preferential creditors are given priority, if the security interest "is not" a PMSI. The wording "is not" indicates that it is necessary that the purchase money security interest does not only exist at the commencement of the liquidation or receivership,[70] but does still exists at the time when the receiver applies the proceeds of the inventory.[71]

Schedule 7, clause 2 (1)(b)(i) of the Act stipulates that preferential claims have priority "to the extent" that the security interest is not a PMSI. However, section 30 of the Receiverships Act seems only to give priority to preferential creditors where the security agreement does not create a PMSI at all. Priority appears not to be given where a security interest agreement creates a PMSI in some collateral and a non-PMSI in other collateral.[72] That means preferential

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[67] Blanchard and Gedye, above n 52, 174.
[68] Schedule 7, clause 2(1)(b)(i)(B) of the Act, section 30(1)(b) of the Receiverships Act.
[69] Part 2, s 16(1) of the PPSA.
[70] Blanchard and Gedye, above n 52, 174.
[71] Gedye, above n 64, 301.
[72] Ibid.

creditors have only priority where none of the assets under the security agreement is subject of a PMSI. Security agreements that comprise PMSIs as well as non-PMSIs are not uncommon. It can arise in many all-assets-securities. For example, arrangements where a supplier takes security over supplied goods as well as over other goods not financed by the supplier. Or where a security interest in goods supplied is not discharged when the goods are paid for.[73]

2 Proceeds

(a) Proceeds of a PMSI

Regarding the extent of a PMSI, the issue arises as to whether the priority given to PMSI holders includes the proceeds of the inventory which was the subject of the PMSI. This issue arises if the inventory that was subject to the PMSI is sold by the company before the commencement of the receivership or liquidation. The inventory can thereby have been converted into accounts receivable.

Schedule 7, clause 2(1)(b)(i) of the Act and section 30(1) of the Receiverships Act which regulate the priority of PMSI holders over preferential creditors do not mention proceeds. However, Schedule 7, clause 2(1)(b)(ii) and section 30(2) of the Receiverships Act mention proceeds of accounts receivable or inventory, which means that the entitlements of the preferential creditors include these proceeds. Under the PPSA a security interest that is dealt with or otherwise gives rise to proceeds automatically extends to these proceeds.[74] The PPSA priority rules accord the same priority to the PMSI holder's claim to the proceeds as to the claim to the inventory before it was sold by the company.[75] The priority of PMSI holders over inventory would include accounts receivable when the accounts receivable sprang from the sale of the inventory.[76] However, the definition of PMSI in section 16 of the PPSA does not include the proceeds of the original collateral in which a purchase money security was held. According to Schedule 7, clause 2(2) of the Act, a PMSI under the preferential creditor system has the same meaning as under the PPSA. It seems unlikely that the drafter

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[73] Ibid.
[74] S 45(1)(b) of the PPSA.
[75] Blanchard and Gedye, above n 52, 174.
[76] Brookers, above n 50, RA30.02.

intended to deny a PMSI holder a priority over preferential creditors where the inventory covered by the PMSI had been sold before the commencement of the receivership. On the other hand, this result could follow from the different terms of section 30(1) and (2) of the Receiverships Act and Schedule 7, clause 2(1)(b)(i) and (ii) of the Act.[77]

(b) Proceeds of inventory and accounts receivable

According to Schedule 7, clause 2(1)(b)(ii) of the Act and section 30(2) of the Receiverships Act liquidators and receivers must apply any accounts receivable and inventory that are subject to the security interest or their proceeds. This raises the question whether proceeds are restricted to proceeds of realisations during the receivership not extending to proceeds held before the commencement of the receivership.[78] If proceeds extend to proceeds held before the commencement of the receivership, receivers will be obliged to undertake extremely difficult tracing exercises to determine which assets on hand are proceeds of inventory or accounts receivable. Therefore, it is argued that "proceeds" in Schedule 7, clause 2(1)(b)(ii) of the Act and section 30(2) of the Receiverships Act only include post-receivership realisations.[79] This would eliminate the tracing analysis that liquidators or receivers would otherwise face. However, this interpretation would differ from the PPSA. Under the PPSA proceeds are applied in the same way as the inventory.[80] Additionally, if the time of commencement of liquidation or receivership is the decisive moment whether the assets are subject to preferential creditor claims, the available assets could be affected by pre-receivership or pre-liquidation realisations. Secured creditors might try to realise inventory and accounts receivable to convert such assets into collateral that is not inventory or accounts receivable.[81]

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[77] Blanchard and Gedye, above n 52, 174.
[78] See Brookers, above n 50, RA30.02.
[79] Gedye, above n 64, 305.
[80] See 45(1)(b) of the PPSA.
[81] Gedye, above n 64, 305.

3 Overlap of receivership and liquidation

According to Schedule 7, clause 2(1)(b) of the Act and section 30(1) of the Receiverships Act, preferential creditors have priority over certain, but not all secured creditors. Section 30 of the Receiverships Act applies to every company which goes into receivership and which is not at the date of commencement of the receivership already in liquidation.[82] If the company has already, before the commencement of the receivership, been put into liquidation, section 30 of the Receiverships Act has no application. A receiver will have no obligation to apply inventory and accounts receivable in payment of preferential creditors. The liquidator who has the obligation to pay those creditors under section 312(1) and Schedule 7, clause 2(1)(b) of the Act may have no access to the assets. There is no explicit obligation on the receiver to release assets to the liquidator to enable him to meet his obligation. However, it is very unlikely that this result is intended.[83] In contrast, the former section 308 of the Companies Act 1955 said that specific debts must be paid in priority in a winding up, without limiting to the liquidator alone the obligation of making payment. Schedule 7 clause 2(1)(b) of the Act and section 30(2) of the Receiverships Act make it clear that preferential creditors should be given priority. The receiver may be required either to pay preferential creditors on behalf of the liquidator from accounts receivable and inventory in priority to the secured creditor or to release to the liquidator sufficient of those assets to enable the liquidator to make the payment.[84]

4 Specific Receiverships Act issue

An issue arisen due to the differences between receivership and liquidation has now been fixed. According to Schedule 7, clause 1(2)(a) of the Act preferential status is given to unpaid wages or salary of any employee in respect of the four months before the commencement of the liquidation. Unlike liquidation, receivership or rather the appointment of a receiver does not automatically terminate employments contracts. The receiver has 14 days from the date of appointment to decide whether or not to terminate employment contracts. Therefore, the preferential status of any payment due to an employee

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[82] Blanchard and Gedye, above n 52, 168.
[83] Gedye, above n 64, 304.
[84] Blanchard and Gedye, above n 52, 168.

for wages earned or holiday pay or redundancy accrued during this 14 day period was unclear.[85] Accordingly, new subsections 30(3)(d) and (e) were introduced into the Receiverships Act 1993. The preferential entitlement includes unpaid wages, holiday pay and redundancy payments accrued in the 14 days period or any extended period authorised under the Receiverships Act. A consequence of these changes is that payments of wages or salary in this interval will now count towards the total sum per employee for which preferential priority is given.[86]

5 *Inconsistencies between the priority rules of the PPSA and the preferential creditor system*

(a) Preferential creditor system before the Companies Amendment Act 2006

Schedule 7, clause 2(1)(b)(i)(B) and (C) of the Act conceded priority to PMSI holders and security interest holders arising from the transfer of accounts receivable for new value. However, the priority provisions of the preferential creditor regime of Schedule 7 of the Act were partly inconsistent with the priority provisions of the PPSA.[87] Under Schedule 7, clause 2(1)(b)(i)(B) and (C) of the Act all holders of a PMSI or assignees of accounts receivable for new value had priority over preferential creditors without depending on whether the security interest has been perfected.

Identical problems existed under the Receiverships Act. There was a conflict between the receiver's duty to pay preferential creditors according to section 30(1)(b) and (c) of the Receiverships Act and the PPSA priority rules. The PPSA in some circumstances, will accord priority to do the holder of the general security interest.[88]

(b) PPSA priority rules and security interests over accounts receivable for which new value is provided

According to the PPSA, the holder of a security interest in accounts receivable for which new value is provided has not always priority over the holder

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[85] Keeper in Rt Hon Justice Blanchard, above n 11, 111.
[86] Blanchard and Gedye, above n 52, 178.
[87] See Gedye, above n 7, 229.
[88] See Brookers, above n 50, RA30.02.

of a general security interest over the company's accounts receivable. According to the general priority rule of the PPSA, priority between perfected security interests in the same collateral is to be determined by the order of the registration of a financing statement, or the taking into possession of the collateral or the temporary perfection of the security interest in accordance with the PPSA, depending on the nature of the collateral.[89] For example, concerning a factor and a general secured creditor, the first-to-register priority rule of the PPSA would apply. If the general secured creditor was the first to register his security interest, the general secured creditor then has priority under the PPSA.

(c) PPSA priority rules and PMSIs

Under the priority rules of the PPSA, the holder of a PMSA in inventory has priority over a general secured creditor, provided the PMSI holder has registered the PMSI in time and perfected it. An anomaly was therefore created where the holder of the PMSI did not register the PMSI in time.

(d) Circular priorities in relation to inventory and accounts receivable

In cases where a PMSI holder did not register and perfect his PMSI a stalemate situation was created. Regarding securities over accounts receivable, the problem arose where a general security interest holder perfected its security interest first. In these cases, the general secured creditor had priority over an assignee of accounts receivable or a PMSI holder,[90] who had priority over a preferential creditor,[91] who had priority over a general secured creditor.[92] To remedy this inconsistency, the consequential amendment specified a "perfection" requirement for the security interests in the manner provided by the PPSA in order to have priority over preferential debts.[93]

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[89] S 66(b) of the PPSA.
[90] According to s 66(b) of the PPSA.
[91] According to Schedule 7, cl 2(1)(b), section 30(1) of the Receiverships Act.
[92] According to Schedule7, cl 2(1)(b), section 30(1) of the Receiverships Act, see Brown, above n 40, 99.
[93] Companies Amendment Act 2006.

(e) New Schedule 7, clause 2(b) of the Act

The new Schedule 7, clause 2(1)(b)(i)(B) and (C) of the Act now provides that the PMSI or security interest over inventory or accounts receivable for new value must be perfected in accordance with the PPSA. The amendment reflects the policymakers' attempt to preserve the priority of preferential creditors out of assets which, normally, were the type of assets subject to a floating charge.[94]

(f) New section 30 of the Receiverships Act

To avoid the priority circularities two amendments were necessary. The "perfection" requirement was introduced into 30(1)(b) and (c) of the Receiverships Act. A further amendment was necessary due to the special features of receivership. Section 30(2) of the Receiverships Act was drafted in a way which made the priority over preferential claims relate only to the security interest pursuant to which the receiver had been appointed. It did not require other secured creditors to concede priority to preferential creditors. The receiver had to pay preferential creditors before "before paying any claim of the person entitled to the security interest." As recently worded, it could happen that if a receiver was appointed by a subsequent secured creditor and the first secured creditor elected not to appoint its own receiver, preferential creditors ranked behind the claim of the first ranking secured creditor.[95] The problem was that this applied in all cases, whether the first ranking secured creditor had a security interest which was a PMSI or a security interest over accounts receivable for which new value was provided or whether it was a general security interest.

The position has now been clarified by the direction in subsection 30(2A) of the Receiverships Act in the same language as Schedule 7, clause 2(1)(b)(i) of the Act. A receiver must apply the accounts receivable and inventory in paying the claimants under perfected PMSIs and perfected transfers of accounts receivable for new value and also in paying preferential claimants, before paying

[94] Keeper in Rt Hon Justice Blanchard, above n 11, 113.
[95] Blanchard and Gedye, above n 52, 169.

the claims of any person under a security interest, other than PMSIs or security interests over accounts receivable for new value.[96]

(g) Remaining circularity problem

While the inconsistencies between the PPSA and the preferential creditor regime with regard to PMSIs have been rectified by requiring the perfection of the security interest, circularity problems relating to security interests arising from the transfer of accounts receivable for which new value is provided remain. This problem existed already before the amendments with regard to Schedule 7, clause 2 of the Act, and can now also arise under the Receiverships Act due to the amendments to subsections 30(2) and (2A) of the Receiverships Act.

The general priority rule under the PPSA is that a perfected security interest has priority over an unperfected security interest in the same collateral.[97] For most security interests the PPSA includes a first-to-register rule, which means that the person who registers his security interest first, has priority over later perfected security interests in the same collateral.[98] PMSIs are exceptions to this rule. Provided the PMSI holder has perfected the PMSI in inventory or its proceeds before the debtor obtains possession of the collateral, the PMSI holder has priority over the general secured creditor even if the general secured creditor perfected his security interest first.[99] However, the PPSA does not provide such an exception for the sale of accounts receivable. The priority rules of the PPSA do not concede priority for perfected security interests in accounts receivable for which new value is provided over earlier perfected general security interests in accounts receivable. If the general security interest was perfected first, the priority rules of the PPSA give priority to the perfected general security interest.

In contrast, Schedule 7, clause 2(1)(b)(i)(C) of the Act and section 30(1)(c) of the Receiverships Act direct liquidators and receivers to apply accounts receivable to pay assignees of accounts receivable for new value whether or not an earlier registered general security interest exists. This is contrary to the priority

[96] Ibid.
[97] S 66(a) of the PPSA.
[98] S 66(b) of the PPSA, John Steadman "Super priority under the PPSA" [2007] NZLJ 207, 208.
[99] S 74 of the PPSA.

rules of the PPSA and can lead to circular priorities. For example, the creditor with a security interest in the first rank is a creditor with a general security interest in accounts receivable. There is another creditor with a security interest arisen from the transfer of accounts receivable for which new value is provided, who perfected his security interest later, but before the commencement of the liquidation or the appointment of the receiver. Under the PPSA the general security interest holder has priority, while under the preferential creditors system the later perfected security interest over the accounts receivable has priority.

Under the old section 30 of the Receiverships Act this problem did not occur because the preferential creditor priority rules did not apply to the first ranking secured creditor if a subsequent secured creditor had appointed the receiver. In these cases, the first ranking secured creditor had priority over preferential creditors even though the creditor had only a general security interest. Section 30 of the Receiverships Act and the PPSA had led to the priority of the general secured creditor if he had registered first. However, section 30 of the Receiverships Act now always gives priority to the holder of a security interest over accounts receivable for new value, if it was perfected before the appointment of the receiver. The holder of a general security interests in accounts receivable has to concede priority, even if he perfected his security interest first.

However, the conflict between the direction of receivers and liquidators under the preferential creditor system to pay the assignee of the accounts receivable before the holder of a general security interest and the PPSA might not often arise in practice. Accounts receivable financiers can prevent this conflict if they obtain a contractual subordination from the holders of prior ranking general security interests.[100] The private reordering of priorities will prevent the conflict.[101] Without a priority agreement, the holder of a general security can avoid the loss of priority to an assignee of accounts receivable by personally collecting accounts receivable and excluding them from the assets in respect of which a receiver is appointed.[102]

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[100] Blanchard and Gedye, above n 52, 170.
[101] Ibid.
[102] Ibid.

C Analysis

The research reveals that the preferential priority system is complex and sometimes highly technical. Deciding which inventory and accounts receivable go to preferential creditors and which go to secured creditors, poses a difficult task. In some cases, receivers and liquidators will be obliged to undertake extremely difficult tracing exercises to determine which assets are subject to preferential creditor claims. Particularly with regard to section 30 of the Receiverships Act there are some remaining deficiencies which complicate the satisfaction of secured, unsecured and preferential creditors. These deficiencies are not so severe as they were before the amendments to Schedule 7 clause 2(1)(b) of the Act and to section 30 of the Receiverships Act. However, they still raise the question as to how the priority system could be made more simple or improved.

IV CRITICISM CONCERNING PREFERENTIAL POSITIONS

The Companies Amendment Acts 2004 and 2006 were the first substantive amendments to the classes of preferential creditors contained in Schedule 7 of the Act since its coming into force in 1993.[103] The origin of many of the amendments can be found in the recommendations of the New Zealand Law Commission (Law Commission) made to the Ministry of Commerce, now the Ministry of Economic Development (MED),[104] and the subsequent Discussion Document of the MED.[105] In 1998, the Law Commission was asked to investigate on whether existing classes of preferred creditors should continue to enjoy advantages over unsecured creditors when insolvency intervened.

A Changes to Employees' Preferential Entitlements

1 Companies Amendment Act 2004

The Companies Amendment Act 2004 came into force on 29 May 2004. It introduced a definition of employee into the preferential creditor regime.

Schedule 7, clause 3(4)(b) of the Act provides that

> Employee means any person of any age employed by an employer to do any work for hire or reward under a contract of service (including a homeworker as defined in section 5 of the Employment Relations Act 2000); but does not include a person who is, or was at any time during the 12 months before the commencement of the liquidation, a director of the company in liquidation, or a nominee or relative of, or a trustee for, a director of the company.

The 2004 amendments also extended the coverage of employees' preferential claims to encompass compensation for redundancy. After a technical change to the wording,[106] Schedule 7, clause 1(2)(c) of the Act now provides for redundancy payment owed to an employee that accrues before, or because of, the commencement of the liquidation. Additionally, employee priority was extended to awards made in personal grievances cases by the Employment Relations

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[103] Trish Keeper "New Zealand's Corporate Insolvency Preferential Creditor Regime: An Analysis of recent Changes to Employee Entitlements" (2005) 13 Insolv LJ 227, 228.
[104] Law Commission, above n 26.
[105] Ministry of Economic Development (MED) *Insolvency Law Review: Tier One Discussion Document* Wellington, 2001.
[106] Companies Amendment Act 2006.

Authority, Employment Court or Court of Appeal in respect of wages or other money or remuneration lost for the four-month period to liquidation. However, this does not include awards for humiliation, loss of dignity or injury to feelings, or loss of any benefit.[107]

Employees' entitlements other than any amount payable under the KiwiSaver Act 2006 or those specified under other enactments,[108] receive preferential status only for a limited amount. This cap was extended from $6,000 to $15,000. The Companies Amendment Act 2004 also introduced a mechanism to adjust the cap every three years in accordance with changes in average weekly earnings. The maximum sum per employee currently amounts to $16,420.[109]

The Companies Amendment Act 2004 removed the priority of compensation under the Volunteers Employment Protection Act 1973 as it related to compensation of dismissal and no similar claims were entitled to priority.[110]

2 *Companies Amendment Act 2006*

The Companies Amendment Act 2006 mainly affected other categories of preferential payments rather than employees' entitlements.[111]

The amendments extended the entitlements to amounts payable to the IRD to meet student loan repayment and child support obligations.[112] Student loan and child support deductions have been included into the general clause covering "amounts deducted by the company from the wages or salary of an employee in order to satisfy obligations of the employee". Additionally, a new government priority has been included into Schedule 7 of the Act in respect of deductions from wages or salary under the KiwiSaver Act 2006.[113]

The Companies Amendment Act 2006 removed preferential claims for compensation under the Workers Compensation Act 1956 and priorities applicable to apprentices. These priorities had become redundant because the

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[107] Schedule 7, cl 1(2)(e) of the Act, section 123(1)(c) of the Employment Relations Act 2000.
[108] Schedule 7, cl 1(2)(f) and (h) of the Act.
[109] Schedule 7, cl 3 of the Act, Companies (Maximum Priority Amount) Order2006 (SR 2006/284) came into force on 30 September 2006.
[110] See Law Commission, above n 26, paras 76 and 78.
[111] see above Chapter II B.
[112] Schedule 7, cl 1(2)(d) of the Act, see Brown and Telfer, above n 40, 94.
[113] Schedule 7, cl 1(2)(g) of the Act.

protected categories now fall under the general definition of employees under the Employment Relations Act 2000.[114]

3 Employee related preferential entitlements

Employee related preferential status now includes the following claims which rank equally between each other and abate in equal proportion, if there are insufficient funds to pay all of the claims of that class:[115]

Wages and salary owing for services provided in the four months prior to the commencement of liquidation or receivership;[116] Wages or salary of any employee is given preferential status whether or not earned wholly or in part by way of commission and whether payable for time or for piecework in respect of services;[117]

Any holiday pay accrued before or because of the commencement of liquidation[118] and any compensation for redundancy accrued before or because of the commencement of liquidation;[119]

Child support, student loan, and KiwiSaver deductions; these amounts are deducted by the employer from the wages of the employee in order to satisfy obligations towards the Crown;[120]

Certain reimbursement for lost remuneration provided for, or ordered by the Employment Relations Authority or court in respect of wages lost in the four month period prior to commencement of liquidation;[121]

Certain debts to lienors up to a maximum amount of $2,000 under section 263(2) of the Act and any sums that are required to be paid by any other enactment as second level priority debts; the last category is not related to employees' entitlements and will barely have any impact. Preferences under the Radiocommunications Act 1989 and under the Fisheries Act 1983 were removed.

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[114] Brown and Telfer, above n 40, 94.
[115] Schedule 7 cl 2(1)(a) of the Act.
[116] See above Chapter III B 4.
[117] Schedule 7, cl 1(2)(a) of the Act.
[118] Schedule 7, cl 1(2)(b) of the Act.
[119] Schedule 7, cl 1(2)(c) of the Act.
[120] Schedule 7, cl 1(2)(d) and (g) of the Act. KiwiSaver deductions are given equivalent priority, though they are not included within the general category of employee deductions.
[121] Schedule 7, cl 1(2)(e) of the Act.

The intention of the amendments was that new priorities will be incorporated in Schedule 7 of the Act.[122]

B Criticism concerning Employees' Entitlements

The two most difficult issues affecting preferential treatment for employees are how to distinguish an employee from an independent contractor who is reliant upon a particular customer for work and the extent to which any protection afforded should be given.[123]

1 Definition of employee

The first part of the new definition "being employed under a contract of service" is a codification of the existing law.[124] It emphasises the contractual form of the relationship. Uncertainty remains as to whether the real nature of the relationship is the key factor for deciding if the person is an employee and qualifies as a preferential creditor. In contrast to Schedule 7, clause 3(4) of the Act, the definition of "employee" in the Employment Relations Act 2000 explicitly includes the direction to decide on the real nature of the relationship rather than to treat any document or statement between the parties as definitive.[125] Therefore, it is uncertain whether the insolvency administrator has to consider all relevant matters, like the day-to-day control, the level of economic risk, the level of independence and the integrity of the work to the nature of the business. For example, this is relevant in cases where a person is described as self-employed, but worked exclusively for the insolvent company.[126]

The definition of employee now excludes persons who are or were directors of the company from qualifying as preferential creditors. The Law Commission explained that director-employees have access to financial information about the company on an ongoing basis, and will also be involved in the decision-making process of the company. The arguments for preferential status that employees are vulnerable and lack information or power in the

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[122] See Brown and Telfer, above n 40, 95.
[123] Heath, above n 4, 45.
[124] See Don Mackinnon "Employment entitlement in receivership" [2003] NZLJ 197, 197.
[125] S 6(2) of the Employment Relations Act 2000.
[126] Keeper, above n 103, 234.

bargaining relationship do not apply to director-employees.[127] The MED endorsed the exclusion of director-employees and added that this change would also provide an incentive for prudent director conduct.[128] One difficulty with this approach is that companies vary in nature. There are also small family businesses and medium entities, whose directors might be worthy of protection. Unjust result can especially occur for relatives of directors who are also excluded from preferential status. This approach discounts, in some cases, the extent to which directors are able to inform themselves concerning the insolvency risk and to influence financial risky situations.[129]

2 Compensation for redundancy

The extension of priority to compensation for redundancy was significant in principle, in that traditionally preferential status was only granted to pre-commencement debts.[130] Redundancy payments are compensation for the loss of a job and the opportunity to earn through its disestablishment as being superfluous. The basis of redundancy entitlements is compensation, not remuneration.[131] Redundancy pay is contractually agreed compensation from the employer, usually based on length of service to remove some of the employees' immediate financial disadvantages associated with losing their job.[132]

The legislator decided that the rights of employees to be compensated for loss of the opportunity to earn have priority over the rights of trade and other unsecured creditors. One of the stated reasons for this decision was that "frequently employee debts make up a relatively small percentage of the total debts owed by an insolvent entity."[133] However, no research on the likely impact

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[127] Law Commission, above n 26, para 52.
[128] MED, above n 105, para 83.
[129] See Vanessa Finch *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, Cambridge, 2002) 437.
[130] Brown and Telfer, above n 40, 93.
[131] *Re NZ Seafarers' Union Retirement and Welfare Plans* [1996] 1 ERNZ 259, McGechan J.
[132] Joint Insolvency Committee *Status of Redundancy Payment Bill - Submission to the Labour Select Committee* 1994, para 2. Joint Insolvency Committee was set up by the New Zealand Society of Accountants and the New Zealand Law Society to consider issues of the insolvency law reform.
[133] Harre´, above n 31.

in New Zealand or the effects after the inclusion of retrenchment payment in Australia was provided to justify this assertion.[134]

The issue of granting preferential entitlements to redundancy payments has been the subject of general community concern.[135] To determine which debt should be afforded preferential status, the Law commission reverted to the basic principles. The priority must be justified on principles of fairness and justice, which can be applied in any given case.[136] The MED further explained that the principle of equal sharing should prevail unless it can be shown that the public interest in providing greater protection to creditors outweighs the economic and social costs of any such entitlements.[137]

It is difficult to identify compelling reasons for a higher priority for redundancy payments than for other debts owing to unsecured creditors. In contrast to redundancy payments, claims for unpaid wages and salary relate to labour provided to the company. Redundancy payments are due even if the employee finds a new employment immediately.[138] Furthermore, redundancy payments are of discretionary and indeterminate nature. The Law Commission and MED were also concerned that trading and unsecured creditors could be disproportionately prejudiced by the redundancy claims of employees.[139] Priority for redundancy payments will leave less for unsecured creditors. This could challenge the economic efficiency of insolvency law.[140]

3 Need for additional protection

There is general consensus that employees need protection in the event of their employer's insolvency.[141] By enlarging the cap for employee preferential entitlements and including redundancy payments, the legislator tried to address this need. However, on the one hand it has been shown, that regarding redundancy payments do not properly fit into the preferential creditor system. On the other

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[134] Keeper, above n 103, 239.
[135] Ibid, 237.
[136] Law Commission, above n 26, para 19, Insolvency Law Review Committee (UK), above n 24, para 1398.
[137] MED, above n 105, 84.
[138] Joint Insolvency Committee, above n 132, para 2.
[139] MED, above n 105, 84.
[140] See below Chapter IV D.
[141] See above Chapter II C.

hand, the extension of protections does not help employees if there are no or insufficient assets left. Preferential entitlement cannot address the need to protect employees, where the assets are not sufficient to meet the claims of preferential creditors. Beyond the initial impact for employees losing their job and income source, they will often find that the owed money will not be easy to obtain.[142] After the payment of secured creditors there is likely to be little left, and the payment of preferential creditors might be a small proportion of the entitlement. There are no statistics provided for New Zealand, but for example in Canada and the United Kingdom employees typically recover only about 15 cents for each dollar owed in wages.[143]

[142] Michael Salter "A sting in the tail" (2008) 158 NLJ 320, 320.

[143] National Union of public and general employees "Bankruptcy protection fund for workers will be operating soon" (19 December 2007) http://www.nupge.ca (accessed 30 September 2008).

C Criticism concerning Crown Preferential Status

1 Crown preferential debts

There are two categories into which Crown debts fall for preferential purposes. First, the Crown has priority under the second highest class of preferential priority for three types of amounts deducted from wages or salary of an employee.[144] The employer is required to act as the collection agent for the Crown to satisfy obligations under the Child Support Act 1991, the Student Loan Scheme Act 1992 and the KiwiSaver Act 2006.

Second, the Crown has preferential entitlements to outstanding taxes and duties, namely GST, PAYE, RWT, NRWT and Customs duty.[145] These revenue debts rank after all other classes of preferential debt, but still before general secured and unsecured creditors and without any cap on these payments.

The preferential status of the Crown is strongly supposed. The issue has attracted considerable public attention and generated many submissions calling for removal.[146] The Law Commission had recommended that the preferential entitlements to GST, custom duties and levies payable to the Crown be abolished. However, the legislator abolished preferential status only for insubstantial revenue debts, namely the preferential entitlements to levies under the Fisheries Act 1996[147] and the Radiocommunications Act 1983.[148]

2 Criticism

The government has based the retention of preferential entitlement on several reasons.[149] In the following, these reasons will be analysed and counter-arguments will be considered.

(a) Need to protect the revenue of the Crown

The government argued that it is necessary to continue with the existing Crown preferential debts in order to maintain the government's revenue base so

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[144] Schedule 7, cl 1(2)(d) and (g) of the Act.
[145] Schedule 7, cl 1(5) of the Act.
[146] Keeper in Rt Hon Justice Blanchard, above n 11, 108.
[147] S 274 of the Fisheries Act 1996.
[148] S 183(4) of the Radiocommunications Act 1989.
[149] See above Chapter II C.

that it can further other social and economic objectives.[150] Unpaid tax undermines the integrity of the revenue base and is a loss to all members of society.[151] However, unlike ordinary unsecured creditors, the Crown has an array of enforcement powers to collect tax and to impose penalties and interest in order to protect the revenue. For example, the Commissioner of Inland Revenue (CIR) has significant powers to impose penalties for non-payment of tax under section 139 of the Tax Administration Act 1994. Concerning tax deductions made by the employer under the PAYE rules, the CIR has the power to require a third party to pay a debt from monies held on behalf of the taxpayer.[152] The CIR is also protected by the possibility to seek orders from the High Court for the recovery of PAYE or RWT even though no judgement may have been entered against the debtor.[153] This is due to the fact that unpaid tax deductions are made a charge on all real and personal property of the person.[154] The CIR is in the best position to determine when the debtor is getting into financial difficulties, if returns are made regularly.[155] If returns are not made, the CIR is also the first to notice it.

(b) Taxes are owed to the community rather than to the individual

Another common argument is that taxes are owed to the community rather than to the individual. However this argument can be outweighed by assuming that the priority of tax debts over other unsecured creditors can hinder a company's recovery.[156] If the recovery of a company fails, this will indirectly have an impact on other public fields, including the protection of employment. Business failure, recession and protection of employment can also be seen as being in the public interest.

(c) CIR is an involuntary creditor

The Law Commission was not persuaded by the argument that the CIR has a statutory relationship with the taxpayer and is an involuntary creditor. The

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[150] Harre´, above n 31.
[151] MED, above n 105, 75.
[152] S 157 of the Tax Administration Act 1994.
[153] Law Commission, above n 26, para 99.
[154] Ss 169 and 172 of the Tax Administration Act 1994.
[155] Heath, above n 4, 49.
[156] See below Chapter IV D.

legislator chose that the CIR will collect tax on its behalf. Even more importantly, even if the CIR is an involuntary creditor, there are many involuntary creditors that are not accorded preferential status, for example victims of a tort.[157]

(d) Quasi-trust nature

Some of the debts, notably PAYE, RWT, NRWT, and the employee's wage deductions represent monies payable by the debtor to the CIR on behalf of another person and are therefore of a quasi-trust nature. The Law commission emphasised that it would be unjust to allow those funds to be used for trade creditors. The assets of the insolvent would be swollen with monies which the debtor ought to have paid to the CIR on behalf of a third party. This money had never belonged to the debtor company, but was hold quasi on trust on behalf of the Crown. Additionally, taxpayers might have ordered their affairs on the assumption that payments to the revenue have been made.[158]

This applies to RWT and NRWT as they represent a class of "on behalf of" tax collections. PAYE deductions from the employees' wages are also regarded as being held on trust for the Crown. However, the Law Commission made clear that priority can only be justified to the extent to which claims for unpaid wages are given priority.[159] Priority should therefore be limited to PAYE payable on the sum of $16,420, which is the cap for employees' preferential entitlements.[160]

Regarding GST or customs duty, the Law Commission pointed out that the quasi-trust argumentation does not apply. GST is not of a quasi trust nature, as there is no necessary correlation between the GST paid on the sale of the goods and the GST claimed on the purchase of the raw materials used to make the goods. A company is not holding GST in trust for the Crown from the time of receipt until the time of return. If the cost of making goods for sale is made up of raw materials purchased and labour, a credit will only have been recovered in

[157] Law Commission, above n 26, para 141.
[158] Ibid, paras 132 and 146.
[159] The Law Commission recommended that the PAYE preference, as such, be abolished. Instead a gross priority for wages plus the PAYE component should be enacted. This change will not disadvantage employees, but will limit the Commissioner's priority for PAYE.
[160] Law Commission, above n 26, paras 114, 115 and 132.

respect of the non-labour portion. Additionally, there is no obligation under the Goods and Services Tax Act 1985 to keep GST money separate from other monies of the debtor company.[161] The Law Commission therefore recommended that the preferential entitlement for GST and customs duty be abolished.

(e) Pari passu rule

The pari passu rule is likely to be undermined by the granting of preferential status to Crown debts.[162] Statistics of the Inland Revenue Department in 1998 provide a breakdown of outstanding preferential and non-preferential debt in bankruptcy and liquidation. The statistics shows that the total amount of preferential tax claimed for bankruptcy and liquidations as at 4 October 1998 accounted for about $35 million, whereof goods and services tax claims were the largest part with about 80 percent and a total amount of $28 million.[163] The huge amount of tax debts leads in many cases to the fact, that there is very little of nothing left for unsecured creditors. Priority of Crown debts therefore provides a substantial disadvantage for unsecured creditors. This is contrary to the pari passu rule.[164]

According to a document of the IRD, only an amount of $5 million per annum is gathered by the IRD under their preferential status.[165] However, it can be argued that the tax debts of insolvent companies are insignificant to the Crown when set against the shortfall suffered by ordinary trade creditors and the decisive influence in several insolvencies.[166] Revenue-related preferential debts made up about 60 per cent of the total debt owed by companies in liquidation.[167]

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[161] Law Commission, above n 26, para 138.
[162] Australian Law Reform Commission, above n 9, para 33.
[163] Statistics provided by the Law Commission, above n 26, Appendix D Revenue statistics – claims in bankruptcy and liquidations as at 4 October 1998.
[164] Australian Law Reform Commission, above n 9, para 33.
[165] Hon Pansy Wong *Parliamentary Debates - Part 8 of the Insolvency Law Reform Bill* (24 October 2006) 29 New Zealand Parliamentary Debates, p 6051.
[166] See Chapter IV D.
[167] Munt, *Compromises in New Zealand: Vices and Virtues* (1999) INSOL Pacific 99 Conference (Auckland).

(f) Success of voluntary administration

A further concern arose with the introduction of the voluntary administration regime in Part 15 A of the Act. Voluntary administration was introduced to compensate business failures and to avoid liquidation. As the Crown is often the largest unsecured creditor, the IRD will be able to effectively vote against any Deeds of Company Arrangement (DOCA) unless it was accorded its statutory priority within the DOCA.[168] The IRD has no strong interest to negotiate a compromise where it is likely that all or part of the tax debts can be obtained as a preferential creditor in receivership or liquidation.

(g) Priority is a disincentive to collect debts more quickly

The primary reason which persuaded the Australian Law Commission to recommend the abolition of Crown preferential debts was that the priority assures payment. It consequently operates as a disincentive for the CIR to recover debts in a quickly commercial manner choosing to instigate insolvency proceedings before the level of indebtedness increases further.[169] If the CIR is allowed debts to aggregate the position of other unsecured creditors can be seriously disadvantaged. This may result in a situation where ordinary creditors are prepared to provide credit to a company that is in apparent financial health but is actually carrying a huge liability tax.[170]

The quasi-trust argument for preferential status of certain Crown debts has to be weighed up with the counterarguments and the pari passu principle. It is difficult to see why the Crown should be placed in any better position than other unsecured creditors. To the maximum extent as possible, the principle of equal distribution should be maintained. It would encourage the effective administration of insolvent estates.[171]

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[168] Brown and Telfer, above n 40, 88.
[169] Australian Law Reform Commission, above n 9, paras 734 and 735.
[170] Ibid.
[171] See below Chapter IV D.

D Efficiency of Insolvency law

The granting and the extension of preferential status inevitably means that there are substantially fewer funds available to meet the claims of general trading and other unsecured creditors. The Law Commission and the MED explained that this could challenge the economic efficiency of insolvency law.

Fewer funds left for unsecured creditors reduce the ability of a company to make a proposal to its creditors in the corporate rescue context.[172] If the possibility that unsecured creditors get paid is small, the chance of restructuring the company by means of compromises or voluntary administration is also small. Unsecured creditors may often not take an active interest in the administration of the insolvency because all the proceedings of any recovery will go to preferential creditors.[173] The requirement to pay preferential creditors before general secured and unsecured creditors can therefore prevent the effective reorganisation and recovery of insolvent estates. This can affect the continuing employment prospects of employees.

Fewer funds available to meet the claims of general trading and other unsecured creditors could also have an impact on the cost and availability of credit, particularly for small companies. This can also reduce opportunities for some companies to expand and decrease income and employment opportunities.[174] The significance of the problem needs to be regarded against the background that insolvencies tend to increase when the economy weakens and the availability of credit is already reduced.[175]

There are no statistics available for the recovery rate of unsecured creditors in New Zealand. However, statistics published in Canada in 1995 reveal that on average only 16 percent of the assets were left for unsecured creditors, though their debts accounted for 62 percent of the total debts. This led to a

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[172] See Advisory Committee on Bankruptcy and Insolvency (Canada - Chairman Mr G F Colter) *Proposed Bankruptcy Act Amendments - Colter Report* 1986, 77, 78.
[173] Ibid.
[174] MED, above n 105, 84, Joint Insolvency Committee, above n 132, para 2.
[175] Margaret Smith – Law and Government Division Canada "Protecting Employee Wages in Bankruptcy" 2002 Parliamentary Research Branch (PRB) 01-34E, I.

recovery rate of five percent for unsecured creditors.[176] However, unsecured creditors, especially small trade creditors, in most cases cannot calculate this risk and are not able to provide for it.

Regarding the efficiency of insolvency law, a tension therefore exists between the granting of preferential status to Crown debts and the extent of the preferential entitlement of employees on the one hand and the need to ensure that preferential claims do not cause undue detriment to other creditors.

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[176] Jakob S Ziegel "Preferences and Priorities in Insolvency Law: Is there a solution?" (1995) 39 St. Louis University Law Journal, 792, 806.

V *PROPOSALS*

The research shows that there is a need to improve the current preferential creditor system. There is justifiably severe criticism with regard to the two largest groups of preferential creditors, employees and the Crown.[177] Additionally, the preferential creditor priority rules involve a complicated structure and are partly inconsistent with the PPSA.[178] The following proposals regard how other countries, especially those of the commonwealth deal with the preferential creditor issue and which approaches they have undertaken. While the first proposals will address the technical deficiencies in the preferential creditor system, the subsequent proposals will concentrate on a more general review that is whether changes to the existing preferences should be made.

A *Unified Preferential Creditor Regime*

One idea to correct obscurities of the current preferential creditor regime is to put the preferential creditor system for liquidations and receiverships together in one Act as an annex to the PPSA.[179] This would solve problems in cases in which receivership and liquidation overlap. Difficulties because of the different wording like "extent of the security interest" under section 30(1) of the Receiverships Act would not occur anymore. Additionally, clarifications should be made concerning whether and what kind of "proceeds" are covered by the preferential creditor system.

However, this would not solve the inconsistencies between the PPSA and the preferential creditor system with regard to the remaining circularity problem. This inconsistency can only be solved if the preferential creditor priority system is adapted to the priority rules of the PPSA which would include that preferences which existed prior to the PPSA would have to be changed.

B *Super-priority*

Currently, preferential creditors have priority over certain, but not all secured creditors. A similar system exists in Australia and the United Kingdom.

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[177] See above Chapter IV.
[178] See above Chapter III.
[179] See Gedye, above n 64, 313.

Preferential creditors, at least employees, traditionally have priority over debts secured by a floating charge, but rank below debts secured by a fixed charge.[180]

An idea to simplify the preferential creditor system could be to either give preferential creditors priority over all secured creditors or to position them after all secured creditors.[181]

The latter approach was undertaken in Canada until July 2008. Preferential creditors had to concede priority to all secured creditors. However, the preferential position would be undermined in cases where the debts are higher than the securities and not all secured creditors get paid. Being positioned after all secured interests including general security interests over inventory and accounts receivable would in cases of doubt mean that preferential creditors don't get paid at all or at least not in the amount of their preferential entitlement. This would be quite unjust with regard to the fees and expenses of liquidators and receivers. Secured creditors have as well an interest in liquidators and receivers doing their job properly and getting paid for it. Even more importantly, it would be contrary to the general opinion that employees are worthy of protection and the tendency that they need more protection than currently provided.[182] Canada changed its system so that employees now get satisfied from the "current assets" including cash, short-term investments, inventory and accounts receivable and therefore have priority over certain secured creditors.[183]

The other approach to give preferential creditors priority over all secured creditors would place employee entitlements ahead of all other claims. However, granting a super-priority to unpaid wages and employee entitlements would affect the priority position of all secured creditors and is likely to reduce the availability of credit. The reason for this is that bank lending policies would likely become more restrictive if they were to lose their priority status.[184] Additionally, a super-priority does not guarantee that employees will recover the wages owed to them, if the assets are insufficient to meet all outstanding wage claims.

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[180] See s 561 Corporations Act 2001(AUS).
[181] See Smith, above n 175, C 1 a.
[182] See Chapter IV B 3.
[183] Amendments to the Bankruptcy and Insolvency Act (BIA) which took effect on 7 July 2008.
[184] See Smith, above n 175, C 1 a.

C Alternatives for Employees

The first two proposals for how to deal with the preferential creditors system can sort out some of the deficiencies, but they do not take the criticism into account regarding the preferential status itself. To address this criticism, a more far-reaching and fundamental approach is necessary.

1 Protection fund for employees

The aim of protecting employees is in the public interest. Therefore, this aim might be better accomplished through social welfare legislation than through priorities created in insolvency law. This applies especially to redundancy payments whose preferential status barely fits the preferential creditor system.[185]

Countries which chose to protect employees through social welfare legislation usually created a wage earner protection fund. Wage earner protection schemes ensure that employees will receive unpaid wages and other entitlements on an employer's insolvency. The creation of such a fund would alleviate the immediate needs of the employees. The fund could be financed either by contributions from employers and employees or by government through tax revenue.[186]

Wage earner protection funds have, for example, been established in Australia, Canada, the European Community countries, Norway, Switzerland, Israel, Argentina, and partially in the United States of America.[187]

In New Zealand, there is no employee's protection fund or other insurance scheme which provides a separate pool of assets for employees. This might be due to the recommendation of the MED not to introduce such a fund. However, the Law Commission in its advisory report to the MED mentioned that there is widespread support for such funds.[188] The Law Commission did not specifically consider the introduction of a wage earner protection fund as it did not fall within its terms of reference, but the Law Commission stated that it has to be considered,

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[185] See above Chapter IV B 2.
[186] Australian Law Reform Commission, above n 9, paras 723 and 724.
[187] Christopher Symes " Workers' Entitlements: the Government's Options - A social safety net for workers in employer insolvency" [2000] AltLJ 3.
[188] Law Commission, above n 26, para 88.

whether the establishment of a fund would be a better means of securing the protection for the vulnerable employees at whom the priority is directed.[189]

2 Wage earner protection systems

The Australian Law Commission,[190] the British Committee on Insolvency Law and Practice,[191] and the Canadian Committee on Bankruptcy and Insolvency[192] recommended the introduction of a Wage Earner Protection Fund in their reports on preferential claims.

(a) Australia

In 2000, the Australian Government established the Employee Entitlement Support Scheme (EESS). In 2001, the government reviewed the scheme and created a new government-funded employee entitlement scheme by replacing the EESS with the General Employee Entitlement Redundancy Scheme (GEERS) in relation to insolvencies occurring on or after 12 September 2001.[193] The fund is financed by the taxpayers. The GEERS covers up to three months unpaid wages, all unpaid annual leave, all unpaid payment in lieu of notice, and unpaid redundancy entitlement up to a maximum of 16 weeks. In calculating entitlements a maximum annual wage is used. The Maximum Annual Wage for 2008-2009 is $106,400 or a weekly wage of $2039.62.[194] Eligible are employees rather than contractors, subcontractors or agents. It does not matter whether the employee was remunerated by salary, wages, commissions, or otherwise.[195] The Department of Employment and Workplace Relations forwards the GEERS advance to the insolvency practitioner. The insolvency practitioner deducts any tax or obligations

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[189] Law Commission, above n 26, 89.
[190] Australian Law Reform Commission, above n 9, para 727.
[191] Insolvency Law Review Committee (UK), above n 24, para 1398.
[192] Advisory Committee on Bankruptcy and Insolvency (Canada), above n 172, 31-34.
[193] Australian Department of Employment and Workplace Relations, General Employee Entitlement and Redundancy Scheme Operational Arrangements; GEERS does not operate under legislation. The rules of GEERS are outlined in the GEERS Operational Arrangements, available at www.workplace.gov.au/workplace/Programmes/EmployeeEntitlements (accessed 30 September 2008).
[194] Ibid.
[195] GEERS Operational Arrangements 6 and 7.

under the Higher Education Loan Program (HELP) and then pays the employee.[196]

(b) United Kingdom

The National Insurance Fund provides for the payment of outstanding employee entitlements as provided under the Employment Rights Act 1996 (ERA).[197] The fund is mainly funded by employers and employees through National Insurance Contribution. These provisions implement obligations under the European Community Insolvency Protection Directive 80/987/EEC amended by the Directive 2002/74/EC.[198] Under this directive member states have to set up and finance guarantee institutions to ensure a degree of State guaranteed financial protection for employees if their employer becomes insolvent.

The entitlements under Part 12 of the ERA include unpaid wages up to eight weeks, holiday pay for up to 6 weeks, payment for notice given, or for an employer's failure to give proper notice, a basic award of compensation for unfair dismissal made by an employment tribunal and reasonable repayment of any fee or premium paid by an apprentice or articled clerk.[199] All but the last of these debts are subject to a limit on the amount that can be paid in relation to any one week. The maximum payment for a week currently stands at £330 (£310 before 1 February 2008).[200] Employees may also be entitled to redundancy pay under the separate provisions of Part XI of the ERA.[201] Eligible are employees who work under a contract of employment and who are not agency workers, short term casual workers, freelancers or self-employed. The Secretary of State for Business, Enterprise and Regulatory Reform is responsible for making payments from the National Insurance Fund under the insolvency provisions of the 1996 Act. The Redundancy Payments Offices (RPOs) carry out this function on behalf of the Secretary of State. The RPOs will deduct from the arrears of wage payments and

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[196] Australian Department of Employment and Workplace Relations, above n 193.
[197] Part XII of the Employment Rights Act 1996 (ERA).
[198] Article 3 of the European Community Insolvency Protection Directive 80/987/EEC.
[199] S 184 of the ERA.
[200] S 186(1) of the ERA.
[201] Ss 135 - 181 of the ERA.

holiday payments an amount of income tax and the employee's share of Earnings Related National Insurance Contributions (ERNIC).[202]

(c) Canada

Recently, Canada introduced a Wage Earner Protection Program. The Wage Earner Protection Program Act (WEEPA) took effect on 7 July 2008. The governmental financed program[203] guarantees payment of unpaid wages and earned vacation pay up to $3,000 or the equivalent of four weeks' maximum insurable earnings under the Employment Insurance Act depending on which is of the greatest value.[204] Eligible are individuals who had an employment with the employer.[205] Excluded are individuals who had a controlling interest in the insolvent business during the period in which wages were earned in respect of those wages. Similarly, an individual who was an officer or director of the former employer or who has occupied a managerial position if the responsibilities included making binding financial decisions affecting the business of the former employer or decisions with respect to the payment or the non-payment of wages by the former employer.[206] The Wage Earner Protection Program will be administered by the Labour Program of Human Resources and Social Development Canada and delivered through Service Canada.[207] Payments made under the Program will be reduced by applicable income taxes and other deductions.[208]

(d) Analysis

All protection funds guarantee payment of wages and holiday pay. Redundancy payments are covered directly by the Australian Scheme, and in a separate scheme in the United Kingdom, while Canada does not provide a fund

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[202] Department for Business, Enterprise and Regulatory Reform *Redundancy and Insolvency – A Guide for Insolvency Practitioners to employees' rights on the insolvency of their employer* (8ed, 2005) http://www.insolvency.gov.uk/guidanceleaflets/redundancypayments/guideforips/guideforips.htm (accessed 30 September 2008).

[203] Government of Canada "Wage Earner Protection Program Regulations – Regulatory Impact Analysis Statement" (7 June 2008) Vol. 142 Canada Gazette No 23.

[204] S 7 of the Wage Earner Protection Program Act 2008 (WEPPA)

[205] S 5 of the WEPPA.

[206] S 6 of the WEPPA.

[207] See Government of Canada, above n 203.

[208] Ibid.

for them. Neither option guarantees full payment of all entitlements but promises that a maximum level would be set to provide a 'fair and reasonable' level of protection.[209] In any case, neither of the schemes removes the right of employees to sue their employers for the full amount owed but not paid. Payments made under all of the schemes are reduced by applicable income taxes. Insofar the governments protect themselves as well as the employees. While the fund is financed by the government from general tax revenues in Australia and Canada, it is financed by employers and employees in the United Kingdom.

The main advantage of wage earner protection schemes is the guarantee that employees will receive unpaid wages and other entitlements on an employer's insolvency. It has been shown that the assets are often not sufficient to meet the employees' claims.[210] The Canadian Advisory Committee on Bankruptcy and Insolvency emphasised that no other solution ensures prompt and certain payment to employees.[211] The payment will be given much earlier than payments under the insolvency distribution process.[212] Delays in paying employees due to the time involved in realising the employer's assets can cause increased difficulty in an already financially disadvantaged position. This argument preponderates especially where the event of insolvency appeared surprisingly for the employee. The Australian Law Commission identified further advantages such as the reduction in the amount of litigation over priorities and the reduction in administration costs.[213]

3 *Concerns*

The main concern against the establishment of a wage earner protection fund is the problem of financing such a fund. It is argued that the creation of such a fund would be an undue imposition on successful businesses or would additionally burden the national budget and the taxpayers respectively. Costs will occur under three headings, namely benefit payments to eligible employees,

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[209] Minister of Employment, Workplace Relations and Small Business (Australia, Reith Peter) *Ministerial Discussion Paper - The Protection of Employee Entitlements in the Event of Employer Insolvency*, issued in August (1999).

[210] See above Chapter IV B 3.

[211] Advisory Committee on Bankruptcy and Insolvency (Canada), above n 172, 31-34.

[212] Margaret Smith, above n 175, C 2c.

[213] Australian Law Reform Commission, above n 9, para 723.

administrative expenses, and payments to insolvency professionals.[214] The costs are significant. The Australian Ministerial Discussion Paper suggested an overall cost to government in the order of $100 million a year by a calculation of 10 percent administrative costs, and some savings from the social security section of the national budget.[215] The Canadian Wage Earner Protection Program counts on costs of $35 million to the government.[216] These different amounts are due to the fact that the Canadian entitlements are limited to wages up to about 4 weeks and to a far smaller maximum weekly earning. For New Zealand the total amount would be much smaller given the difference in population. However, per capita the amount would be roughly the same depending on the limits to the entitlements. However, a fund would spread the burden of paying the claims of employees among all employers and employees or taxpayers. Due to the fact that the protection schemes limit the amount which employee can recover, the benefit payment costs will be manageable.[217] With regard to collection costs limited government resources would be required by using the taxation system to collect the contributions, given that the administrative structure exists already.[218] Payments to insolvency professionals are outweighed by the reduction in administration costs due to a limited amount of preferential creditors.[219]

Further critique postulates that fund contributions would be an undue imposition upon successful business, as the costs might fall on sectors with no employees or employees who would never benefit form the fund.[220] This would apply to employees of institutions such as municipalities and school boards. This argument can support the financing of the fund by contributions of employers and employees rather than by tax revenue, but it is not an argument against the establishment of a fund itself.

Another concern is the potential for abuse by employers who might avoid their legal obligations to employees because they know that a wage guarantee

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[214] Government of Canada, above n 203.
[215] See Minister of Employment, Workplace Relations and Small Business, above n 209.
[216] Government of Canada, above n 203.
[217] Australian Law Reform Commission, above n 9, paras 723-725.
[218] See Symes, above n 187.
[219] See above Chapter V C 2 d.
[220] See Australian Law Reform Commission, above n 9, para 723.

scheme is in place.[221] However, the fund guarantees only a specific amount of the entitlements and does not remove the right to sue the employer for the full amount. Additionally, this concern can be smoothed out by the implementation of fines and personal civil liability for directors. For example, in Canada directors of a company can be liable personally for employee related debts on the insolvency of the company.[222] Under the Canadian Business Corporations Act (CBCA), directors are jointly and severally liable to employees for up to six months unpaid wages, subject to a due diligence defence.[223]

4 *Preferential status for subrogated claims*

Under the wage earner protection systems of Australia, the United Kingdom and Canada, the fund assumes all the rights and remedies of the employee with respect to payments made from the fund.[224] Where an employee is paid from the fund, the fund automatically takes over the employee's rights to recover that amount or obliges the employee to transfer his rights. It is appropriate that subrogation is included in the schemes so that the fund can be recovered. Additionally, a waiver of subrogation would unjustly privilege defaulting employers.

The question arises as to whether preferential status should remain for these subrogation purposes. Under the protection funds of Australia, the United Kingdom and Canada, the subrogation rights include any right of priority conferred under insolvency legislation.[225] That means the fund has the same rights as the employee to be paid in priority to the employer’s other preferential and unsecured creditors. The retention of preferential status for subrogated claims might reduce the costs and contributions for providing the fund. However, the recovery rate seems to be relatively small. The United Kingdom recovery rate is suggested to be at 15 percent, while the recovery rate of most of the other European countries seems to be 10 percent and lower.[226]

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[221] See Margaret Smith, above n 175, C 2c.
[222] S 119 of the Canadian Business Corporations Act (CBCA).
[223] S 119(1) of the CBCA.
[224] S 89 ERA, GEERS Operational Arrangements and s 36(1) of the WEPPA.
[225] Ibid.
[226] See Minister of Employment, Workplace Relations and Small Business, above n 209.

This money could be used more efficiently for the distribution among general secured and unsecured creditors. Having more money left for these creditors, would make the insolvency system more efficient. Enlarging the assets of general secured and unsecured creditors would encourage pre-insolvency arrangements and raise the creditors' confidence in the insolvency laws by treating all unsecured creditors equally.[227] If the possibility that these creditors get paid is small, the chance of restructuring the company is also small.[228]

Additionally, the advantages, such as the decrease in the amount of litigations over priorities and in administration costs, would not occur. If the government stands in the employee's place as a preferred creditor, the problems arising with the current preferential creditor regime would be transferred and distorted. Both the technical issues and the problem regarding the efficiency of insolvency law would still occur.

The Australian Law Commission emphasised that the interests of other unsecured creditors should not be overlooked when determining how the fund should work. It therefore recommended that the fund should have a right to be subrogated to the claims of employees, but should rank equally with other creditors.[229] In the same way, the Committee on Insolvency Law and Practice of the United Kingdom had no doubt that an elaborate system of priorities is the cause of much public dissatisfaction, and that there is a widespread demand for a significant reduction or even a complete elimination of preferential debts.[230] There is a potential that extended preferential debts of employees will prevent the recovery of a company which might then have to be liquidated and terminate its employees.[231] A wage earner protection fund with a waiver of preferential status for subrogated claims would be a big step forward to prevent this adverse affect on employees and would take the interests of unsecured creditors into account.

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[227] Keeper, above n 103, 241.
[228] See above Chapter IV D.
[229] Australian Law Reform Commission, above n 9, paras 723 and 724.
[230] Cork, above n 24, para 1397.
[231] See above Chapter IV D.

5 *Compulsory insurance scheme*

Before the introduction of the GEERS, the Australian Minister of Employment, Workplace Relations and Small Business also considered another option, namely a compulsory insurance scheme.[232] A compulsory insurance scheme would involve the introduction of a national program covering all private-sector employees. Businesses with more than 20 employees would be required to take out compulsory insurance to protect their employees' entitlements. The government would fund direct payments to protect the entitlements of employees of small businesses, those with fewer than 20 employees. This option would include less government involvement. The costs would be shared by employers and employees with the government bearing only the risk of small businesses' insolvencies.

However, this option would lead to even higher administration costs, as both private insurances and government would be involved in the administrative process. Of even more importance is that a private insurance system would be too uncertain and unpredictable. With an insurance system the costs would vary according to the risk of companies becoming insolvent and failing to pay their employee entitlements. Insurance contributions might vary depending on the insolvency risk and the size of the workforce in certain industries.[233] Private insurers might be cautious and so the initial premium costs would be likely to be high. Additionally, there is the almost unmanageable risk of non-compliance. This risk does not occur with the same probability under a wage earner protection fund, because the government is the administrative body and will use an already existing collecting system. For all these reasons a wage earner protection fund administrated by government is to be preferred.

6 *Abolition of preferential creditor system in Germany*

Both Germany and Austria have completely abolished their preferential creditor regime. These countries introduced wage earner protection programs including payments for unpaid wages, holiday pay and redundancy payments.[234] The funds are based on the European Community Insolvency Protection Directive

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[232] See Minister of Employment, Workplace Relations and Small Business, above n 209.
[233] See Symes, above n 187.
[234] For Germany, see para 183 SGB III.

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80/987/EEC and are similar to that of the United Kingdom. In contrast to the United Kingdom, both countries abolished the preferential status for subrogated claims under the wage earner protection programs.[235] In the following, the reasons for and the effects of the abolition in Germany will be considered. Parliament abolished the preferential creditor system on several reasons; priority infringes the pari passu rule and prejudices unsecured creditors; employees would be placed in a better position than before the event of insolvency; every priority system chooses people at random.[236]

The rationale underlying the pari passu rule is that no creditors should receive preference over the general body of creditors in the division of assets. Exceptions to the rule require justification. The government had difficulties in identifying any social or economic policy grounds for giving subrogated claims of the fund priority over the claims of trading and other unsecured creditors.[237] The objective was to ensure employees were paid without impacting adversely on other creditors. Parliament emphasised that payments to unsecured creditors were usually only a small proportion of the entitlement. The abolition of preferential creditors will therefore lead to a direct enlargement of assets for unsecured creditors which could conquer the financial crisis at least in some cases.

Additionally, the improvement of anyone's financial situation because of the intervention of insolvency is unjust.[238] Prior to the winding up the "first come first served" principle applies. All creditors have the same right to enforce their interests. Preferential creditors do not exist. In the event of insolvency all creditors should therefore be treated equally. The "first come first served principle" should give way to that of the orderly realisation of assets for the benefit of all secured creditors.[239]

Finally, the Federal Constitutional Court questioned any priority order as being random.[240] The prior existing preferential creditor system did not give priority to all social groups which are worthy of protection. For example, there is

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[235] German Parliament *Printed Paper 012/2443* (1998), see previous para 61 KO.
[236] Ibid, p 90.
[237] Ibid.
[238] Ibid.
[239] Ibid.
[240] German Federal Institutional Court *BVerfGE 65, 182* (1983).

no priority for claims for the maintenance of another person. Other involuntary creditors, such as those by tort victims or by government agencies for the cost of repairing damage to the environment caused by a negligent debtor are not protected.

Before the coming into force of the new Insolvency Act, 70 percent of all petitions in insolvency were rejected because the assets were insufficient.[241] The average recovery rate of unsecured creditors stood at three percent. The beginning of liquidation proceedings with distribution of the assets has now increased up to 60 percent.[242] That does not mean that unsecured creditors get paid to the amount of their full entitlement. However, in 60 percent of all insolvency cases unsecured creditors get some form of payment. Among other reasons, the new recovery possibilities can be put down to the abolition of preferential entitlements. The chances for business recovery have significantly improved. Insolvency practitioners are comfortable with the new law and confirm that the abolition of preferential creditors has proved to be valuable.[243]

7 *Balancing of interests*

Weighing up the advantages and disadvantages involves a complex balancing of interests. The protection of employees against the risk of their employer's insolvency is a matter of public interest and social order.

As evidenced by the recent changes in the employees' entitlement, the level of protection afforded to employees has been considered in need of improvement. The legislator tried to address this need by doubling the cap for the preferential entitlements of employees and by including redundancy payments. However, the preferential creditor system is a rules-based mechanism to allocate risk among creditors and to create priorities in insolvency law. Especially redundancy payments have proved to be not compatible with the system.

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[241] Oliver Liersch, "International Insolvency law - Sicherungsrechte im Internationalen Insolvenzrecht" Skript Insolvenzrecht (2001) http://www.amb-online.de/downloads/amb1.pdf (accessed 30 September 2008) 6.
[242] Committee on Legal Affairs *Expert Hearing* (2006) 7 Indat-Report, 9.
[243] Ibid.

Additionally, preferential status does not provide adequate protection, where the assets are insufficient to meet all preferential claims. Furthermore, the preferential creditor system does not cover all social groups which are worthy of protection.[244]

The aim of protecting employees is therefore better accomplished through social welfare legislation. A wage guarantee scheme offers employees the greatest certainty in terms of immediate payment. Redundancy payments would fit this system much better. A wage earner protection fund can account for social policies and the need to protect specific groups. The inclusion of redundancy payments would not have economic flow-on effects for other unsecured creditors. Additionally, it would have to be decided which employees should benefit from the fund. Australia has excluded director-employees from preferential payments, but included them within the GEERS. This shows that a protection fund can grant protection to a greater extent than the preferential creditor system as it does not affect the efficiency of insolvency law.

There is no doubt, that there will be additional and significant costs. However, the costs and risks would be widespread among all employers and employees or taxpayers and not only to the detriment of unsecured creditors. These additional costs are the consequence of providing necessary protection for employees.

The introduction of a wage earner protection fund without eliminating the preferential status of employees would bolster the position of employees, but the difficulties in applying the preferential creditor rules would remain as the employee's claim would be subrogated. Only the abolition of preferential status for employee's entitlements would enlarge the assets for unsecured creditors. With regard to the efficiency of insolvency law[245] a waiver of preferential status for subrogated claims of the fund is preferable.

It is difficult to foresee the New Zealand's legislator withdrawing preferential status for employees. Historically, employees have been in a preferred position on insolvency since 1867.[246] However, regarding the deficiencies the

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[244] See above Chapter V C 6.
[245] See above Chapter IV D.
[246] Heath, above n 4, 45.

actual preferential creditor system causes and the need to give employees further protection employees is the abolition the best alternative: Employees would be better protected and insolvency law would be made more efficient.

D Abolition of Crown Preferential Status

In recent years the trend in other jurisdictions has been towards restricting or abolishing Crown preferences. In contrast to New Zealand, Australia,[247] Canada,[248] and the United Kingdom completely abolished the preferential status of Crown debts.[249] Crown preferential debts can hardly be justified on social or economic reasons. In particular, the arguments that the Crown revenue needs to be protected and that the CIR is an involuntary creditor are not convincing. Particularly with regard to GST the quasi-trust nature argument does not apply.[250] New Zealand should therefore abolish Crown preferential entitlements.

The abolition of Crown preferences would leave millions of dollars for the equal distribution of the assets. Revenue-related preferential debts make up approximately 60 per cent of the total debt owed by companies in liquidation.[251] The benefits of the abolition would automatically flow to general secured and unsecured creditors, though the Crown would be able to share in this amount as a newly unsecured creditor. The huge amount of tax debt and especially GST tax shows the great impact the abolition of preferential status would have on the entitlements of general secured and unsecured creditors. Additionally, the abolition of crown preferences would quantitatively reduce difficulties in applying the preferential creditor priority rules. It would therefore make the insolvency system more efficient.

Furthermore, by introducing a wage earner protection fund the government could protect its interests with regard to employee deduction debts. Under the wage earner protection funds of Australia, the United Kingdom and Canada payments are reduced by applicable income taxes. The fund administrators deduct

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[247] S 556 of the Corporations Act 2001.
[248] S 86 Bankruptcy and Insolvency Act (1985).
[249] S 251of the Enterprise Act 2002.
[250] See above Chapter IV C 2 (d).
[251] Munt, above n 167, 6.

the amount which the employer would have had to deduct if he had paid the employee.[252]

As a flipside of the abolishment of Crown preferential status, directors have been made personal liable for un-remitted company taxes in Australia.[253] However, there is no natural link between the abolition of preferential Crown debt and the imposition of directors' liability.[254] For example, in the United Kingdom Crown priority was removed without imposing personal liability on directors. Director's liability has to be seen in the context of the already existing liabilities upon directors for unpaid taxes.[255]

E Miscellaneous

The research paper did not focus on the highest class of priority debts, namely the administration costs. [256] However, it explained the specific status that these costs are not typical preferential debts as they occur only because of the event of insolvency.[257] The preferential creditor system would still have to provide for these costs. To simplify the preferential creditor system, these claims could get a super priority status and rank even before all secured creditors. As the secured creditors also have an interest in "well paid and good" administrators, their first rank over all other creditors could be justified. The Law Commission also emphasised the special position of administration costs by recommending that these costs should rank before all other priorities, while all other priorities should have the same rank.[258]

Difficulties regarding claims under Schedule 7 clause 1(3) and (4) of the Act can be neglected as the value of these claims is usually small. The amounts at issue in relation to preferential claims based on layby sales or on compromise costs will generally be modest and are unlikely to impact unduly on dividends

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[252] See above Chapter V C 2.
[253] Income Tax Assessment Act 1936, ss 222 AOB, AGB, and AHA.
[254] Brown and Telfer, above n 40, 89.
[255] Income Tax Act 2004, s HK 11(3) and (5), Brown and Telfer, above n 40, 89.
[256] Schedule 7 clause 1(1) of the Act, section 30(2)(a) of the Receiverships Act.
[257] See above Chapter II B.
[258] Law Commission, above n 26, para 219.

received by other creditors.[259] On the other hand it could be reconsidered whether there is still a need to protect these claims.

[259] Ibid, para 47.

VI CONCLUSION

The distribution of an insolvent's assets among its creditors is an intractable issue of insolvency law. The preferential creditor priority rules involve a technical and complicated structure. There are still some deficiencies, in particular that the system is partly inconsistent with the PPSA. Improvements would especially be the introduction of a unified preferential creditor regime.

With regard to the efficiency of insolvency law, New Zealand might be better off if it changed some traditional attitudes. There is a need to change preferential entitlements and pay greater attention to the claims of unsecured creditors. Concerning the abolition of Crown preferential debts, there are barely any convincing arguments against it. Therefore, New Zealand should abolish Crown preferential status as Canada, the United Kingdom, Australia and most European countries did.

Regarding employees' preferential entitlements, employees are often the most exposed creditors and the least able to absorb a wage loss. In practice, the issue involves difficult policy choices. Affording greater protection to unpaid wages comes at the cost to either unsecured creditors or to employees, employers or the taxpayers. Paying greater attention to the claims of unsecured creditors as well as to employees can be reached by the creation of a wage earner protection fund. Other countries of the commonwealth as well as European countries have already done it. New Zealand should follow suit. The preferable way would be a fund without preferential status for subrogated claims.

The abolition of preferential status for the two most significant classes, namely Crown and employees would lead to a quasi abolition of the preferential creditor system, though at least the costs of administering the insolvency would still need to be provided for. The insolvency law of Germany has shown that this path pays off. The abolition may sound like an insane proposal as it would be a milestone in New Zealand's insolvency law. However, regarding recent developments in the other countries of the commonwealth, plenty of changes have taken place. The question which should always be kept in mind is whether the granting of preferential status is consistent with efficient insolvency administration.

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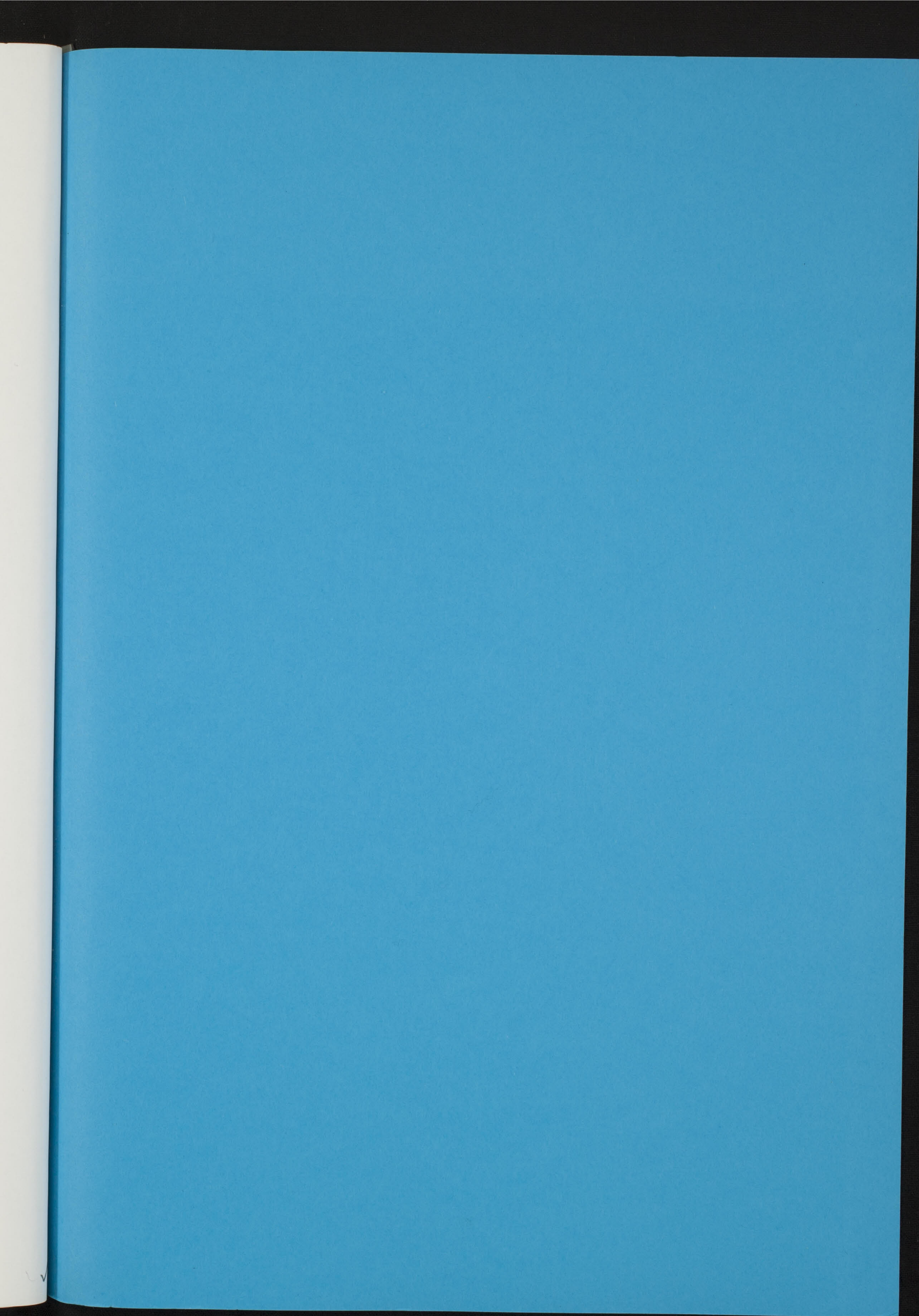

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