IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV-2011-404-005898
MNC [2012] NZHC 597

BETWEEN	L N & M J STANLEY Applicants
AND	D P MCDONALD First Respondent
AND	MCDONALD TEXTURES PROPERTIES LIMITED Second Respondent
AND	L MCDONALD Third Respondent

Hearing: 23 March 2012

Counsel: DJ Powell for Applicants
No appearance for First Respondent
RK Potter for Second and Third Respondents

Judgment: 30 March 2012

JUDGMENT OF RODNEY HANSEN J

This judgment was delivered by me on 30 March 2012 at 4.00 p.m., pursuant to Rule 11.5 of the High Court Rules.

Registrar/Deputy Registrar

Date: ……..

Solicitors: Grimshaw & Co, P O Box 6646, Auckland 1141 for Applicants
Martelli McKegg, P O Box 5745, Auckland 1141 for 2nd and 3rd Respondents

Introduction

[1] The applicants are the trustees of a family trust. They own a leaky home. They successfully brought a claim before the Weathertight Homes Tribunal against the first respondent who installed the cladding system in the house. They were awarded $332,897. An appeal to this Court failed.

[2] Before the appeal had been determined and while bankruptcy proceedings against him were outstanding, Mr McDonald sold to his wife, the third respondent, 49 of 50 shares he owned in the second respondent. He used the proceeds to pay other creditors. The applicants say the shares were sold at an undervalue and with intent to prejudice them. They apply under s 348 of the Property Law Act 2007 (the Act) to set aside the disposition.

Statutory provisions

[3] The application is governed by Part 6, subpart 6 of the Act.

[4] Section 346 defines the dispositions to which Subpart 6 applies, providing as follows:

> **346 Dispositions to which this subpart applies**
>
> (1) This subpart applies only to dispositions of property made after 31 December 2007—
>
> (a) by a debtor to whom subsection (2) applies; and
>
> (b) with intent to prejudice a creditor, or by way of gift, or without receiving reasonably equivalent value in exchange.
>
> (2) This subsection applies only to a debtor who—
>
> (a) was insolvent at the time, or became insolvent as a result, of making the disposition; or
>
> (b) was engaged, or was about to engage, in a business or transaction for which the remaining assets of the debtor were, given the nature of the business or transaction, unreasonably small; or

(c) intended to incur, or believed, or reasonably should have believed, that the debtor would incur, debts beyond the debtor's ability to pay.

[5] Section 347(1) specifies who may apply under s 348:

347 Application for order under section 348

(1) Only the following may apply for an order under section 348:

(a) a creditor who claims to be prejudiced by a disposition of property to which this subpart applies (whether the disposition was made before or after the debtor became indebted to the creditor);

(b) the liquidator, if the debtor is a company in liquidation or an overseas company being liquidated under section 342 of the Companies Act 1993.

[6] Section 348(1) states when an order may be made:

348 Court may set aside certain dispositions of property

(1) A court may make an order under this section—

(a) on an application for the purpose (made and served in accordance with section 347); and

(b) if satisfied that the applicant for the order has been prejudiced by a disposition of property to which this subpart applies.

[7] Section 349 limits the power to make orders under s 348, providing as follows:

349 Protection of persons receiving property under disposition

(1) A court must not make an order under section 348 against a person who acquired property in respect of which a court could otherwise make the order and who proves that—

(a) the person acquired the property for valuable consideration and in good faith without knowledge of the fact that it had been the subject of a disposition to which this subpart applies; or

(b) the person acquired the property through a person who acquired it in the circumstances specified in paragraph (a).

(2) A court may decline to make an order under section 348, or may make an order under section 348 with limited effect or

> subject to any conditions it thinks fit, against a person who received property in respect of which a court could otherwise make the order and who proves that—
>
> (a) the person received the property in good faith and without knowledge of the fact that it had been the subject of a disposition to which this subpart applies; and
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> (b) the person's circumstances have so changed since the receipt of the property that it is unjust to order that the property be restored, or reasonable compensation be paid, in either case in part or in full.

Issues

[8] The disposition was made after 31 December 2007. It is accepted that Mr McDonald was insolvent at the time so the first limb of s 346(1) is satisfied. It is not, however, accepted that subparagraph (b) is satisfied. The respondents do not accept that the disposition was made with intent to prejudice a creditor or without receiving reasonably equivalent value in exchange.

[9] If there is jurisdiction to make an order, it will then be necessary to consider whether, in terms of s 349, the shares were acquired for valuable consideration and in good faith without knowledge of the fact that they had been the subject of a qualifying disposition.

Prejudice

[10] In addressing the issue of prejudice, the following definitions in s 345(1) are relevant:

> **345 Interpretation**
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> (1) For the purposes of this subpart,—
>
> (a) a disposition of property prejudices a creditor if it hinders, delays, or defeats the creditor in the exercise of any right of recourse of the creditor in respect of the property; and
>
> (b) a disposition of property is not made with intent to prejudice a creditor if it is made with the intention only of preferring one creditor over another; ...

[11] Section 345(1)(a) is referable to the stipulation in s 347(1)(a) that only a creditor who claims to be prejudiced by a disposition may apply for an order under s 348. It is not in dispute that the applicants have been prejudiced. The disposition denies them any right of recourse to the property. The issue of prejudice which requires resolution is whether, for the purpose of s 346(1)(b), the disposition was made with intent to prejudice a creditor.

[12] Mr McDonald sold the shares to his wife for $54,130.30 on the basis of an accountant's valuation of the shares which was in turn based on a registered valuer's valuation of the property comprising five residential and commercial units owned by the company (I will put to one side at this stage whether the consideration was adequate). The sale took place on 27 August 2011, just 10 days before the appeal against the decision of the Weathertight Homes Tribunal was to be heard. Shortly beforehand, on 19 August, Mr McDonald had obtained a stay of enforcement of the judgment of the Weathertight Homes Tribunal.[1] Potter J found that, with a bankruptcy notice about to expire, the right of appeal could be rendered nugatory.[2] She was told that Mr McDonald did not have any other creditors.[3] Mr McDonald acknowledged in evidence before me that this must have been the advice he gave his counsel.

[13] This was incorrect. Mr McDonald had six credit card debts amounting together to more than $40,000, which he repaid with the proceeds of sale of the shares. In addition, he paid interest of $5,120.32 outstanding on loans of $20,000, and $4,000 off a debt of $10,000. Self-evidently there was a deliberate decision to benefit all creditors except the applicants who were, of course, by far the largest.

[14] In his affidavit in opposition to the application under s 348, Mr McDonald deposed that at the time he was confident his appeal to the High Court would be successful but, as the award was a "close shave", when his wife approached him to buy the shares in order to distance herself from his troubles, he agreed. What he did not say in his affidavit but disclosed in evidence was that the sale of the shares and disposition of the proceeds were undertaken on the advice of his accountant. For her

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1 *McDonald v Stanley* HC Auckland CIV-2011-404-2623, 19 August 2011.
2 At [9] and [10].
3 At [13].

part, Mrs McDonald said her objective throughout was to shield herself and her dependent children from her husband's financial woes. As the couple and their children lived in one of the units owned by the company, the disposition also had the effect of transferring the family home to Mrs McDonald.

[15] Mr Potter, for the second and third respondents, relied on s 345(1)(b) to counter an inference of attempt to prejudice from the preference given to creditors other than the applicants. He was critical of observations of Fogarty J in *Steve Mowat Building & Construction Ltd v Boat Harbour Holdings Ltd,*[4] who discussed s 345(1)(b) in the following passage:

> [26] ... Mr Moss relied on subs (1)(b) which says that it is not sufficient to intend only to prefer one creditor against the other. Note that this proposition can be read in the plural. It is also not sufficient to intend only to prefer one set of creditors against another set.
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> [27] The key qualifier is subs (1)(b) is "only". I think the proposition in subs (1)(b) is reflecting decisions frequently made by debtors, who are not insolvent, to prioritise payment of creditors when their cashflow and credit facilities are not sufficient to pay all debts as they fall due but when they have confidence that in the long run all debts will be paid. So it is often the case that the landlord, and suppliers of essential services such as telephone and power companies, will be paid whereas non essential suppliers will be left unpaid.
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> [28] Prejudicial preferences occur frequently when the disposer is insolvent, see s 346(2). Upon insolvency the consequence of paying one set of creditors against others entails the knowledge that that will be an enduring consequence of preference so that one set of unsecured creditors get a higher pay out in the dollar than the other. In that context an intent to prefer is also an intent to preclude recovery by the other creditors – so subs (1)(b) does not apply.

[16] Mr Potter argued that on Fogarty J's analysis of s 345(1)(b), any payment by an insolvent creditor to only some of his creditors would necessarily involve an intent to preclude recovery by other unpaid creditors. As subpart 6 applies only to insolvent debtors, such an interpretation would effectively render s 345(1)(b) otiose. Mr Potter suggested that some "ancillary or ulterior or hidden intention" in addition to the preference of one creditor over another is necessary to remove the availability of s 345(1)(b) as a "defence" to an application under s 348.

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[4] *Steve Mowat Building & Construction Ltd v Boat Harbour Holdings Ltd* HC Christchurch CIV-2010-409-2698, 17 February 2011.

[17] In my view, it is unhelpful to attempt to put any gloss on s 345(1)(b). It says, simply, that an intention to prefer will not by itself establish an intent to prejudice. Something more is required. All of the circumstances must be considered. The circumstances in this case, additional to Mr McDonald's insolvency (leaving aside any inadequacy of consideration) include the fact that the shares were Mr McDonald's sole asset and that blatant preference was given to particular classes of creditor.

[18] In *Regal Castings Ltd v Lightbody*,[5] which concerned the predecessor of s 348, s 60 of the Property Law Act 1952, Elias CJ said (*citations omitted*):

> [7] The financial position of the transferor at the time of the alienation is always a key consideration. It is not determinative against intent to defraud if the transferor is solvent at the time, particularly if he is contemplating entering into a risky venture. But where the transferor's financial position is precarious, it is objective evidence of intention to defraud if he acts to put property beyond the reach of creditors. Other indications of fraud commonly occurring are transfers to close relatives, particularly where the transfer is at an undervalue, alienations in which the transferor retains the use or benefit of the property, and secrecy in the transfer or a misleading explanation for it.

Many of the factors referred to by Elias CJ are present in this case: a precarious financial position; a transfer to a close relative; the retention by the transferor of the use and benefit of the property; and false and misleading explanations.

[19] In evidence before me, Mr McDonald said that his wife borrowed the money to pay for the shares from family and friends. That was another untruth (to add to his earlier failure to disclose to this Court that he had further debts). Mrs McDonald, who I found to be a truthful witness, said she borrowed $40,000 on her credit card and the balance from friends. It is significant, in my view, that Mr McDonald used the proceeds of sale to pay off more than $40,000 in credit card debts. Effectively the credit card debt was transferred from Mr McDonald to Mrs McDonald.

[20] I am bound to conclude that this was a carefully contrived scheme which had the intention of putting Mr McDonald's sole asset out of the reach of the applicants. The inference of an intent to prejudice them is unavoidable.

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5 *Regal Castings Ltd v Lightbody* [2008] NZSC 87; [2009] 2 NZLR 433.

Reasonably equivalent value

[21] The price for the shares was based on what has been described as a valuation by the parties' accountant. The basis of the valuation was recorded in a letter dated 26 August 2011 from Michael W Eiberg and Associates Limited, Chartered Accountants, which reads as follows:

Value of Land & Buildings as per Valuation dated 27/7/2011 in normal sale:		$1,520,000.00
Less ANZ mortgage owed as at 31 March 2011	1,224,800.00	
Real Estate Commissions at 4% of sale price:	60,800.00	
Advertising of property for sale:	10,400.00	
Legal Fees:	2,000.00	
Tax owed on depreciation recovered Of $337,971.00 @ 33%:	111,530.00	$1,409,530.00
		$ 110,470.00

> As Daryn McDonald owns 50 of the 100 shares his shares are worth $55,235.00.
>
> However for taxation Daryn needs to retain ownership of at least 1 share so that a portion (in the past 100%) of profit the company makes is allocated to him as Lily has other income which saves tax. Thus 49 shares would be worth $54,130.30.

[22] The valuation of the land and buildings referred to was by a registered valuer employed by Telfer Young (Auckland) Limited. As the valuer had since left the firm, the valuation was reviewed by Mr David Perrow of the same firm. His valuation of the land and buildings, at $1,510,000, was $10,000 less than that of his former colleague. A valuation commissioned by the applicants, by Mr Robert Yarnton of Eyles McGough Limited, valued the block of units at $1,780,000.

[23] I find the evidence of value of the shares unsatisfactory and deficient in several respects.

[24] First, while the McDonalds were entitled to risk acting on the advice contained in the letter from their accountant, it is inadequate evidence of the value of the company shares. A properly researched and reasoned report should have been produced, as was provided to support the valuation of the land and buildings. It is not enough to simply take the value of the main asset of the company and deduct the mortgage, costs of realisation and contingent tax liability. Among other things, there

is no information given about the profitability of the company, other assets and liabilities or the current accounts of shareholders. There can be no shortcuts when the adequacy of the price paid is a key issue.

[25] Secondly, the basis on which the property was valued was not satisfactorily explained. It comprises a mixed residential/industrial development of five units. It was valued on the basis that all units would be sold to a single purchaser. The valuers said that a sale on that basis would reduce the price from what would be realised if the units were sold separately by between 10 and 12 per cent or approximately $200,000.

[26] I see no reason why the property should be valued on the basis of a combined sale. As Mr Yarnton acknowledged, it would not make commercial sense for an owner to sell the property on a basis that did not maximise its value.

[27] The third point is that generally I preferred the evidence of Mr Yarnton to that of Mr Perrow who was in the unenviable position of being asked to support a valuation done by someone else. He acknowledged that his valuation was some $75,000 less than one he had done in January 2010, although there had been no material changes in market conditions in the interim. Mr Yarnton showed, to my satisfaction, that the values per square metre used by Mr Perrow were on the high side and his valuation was not as well supported by comparative sales data.

[28] I readily acknowledge that valuation of real estate is not an exact science. There is an element of subjectivity which can lead to the sort of differences encountered here. Other things being equal, the valuation relied on might have provided a sufficient basis for a share valuation. But other things were not equal. The assumption of a sale of the property as a single unit was unjustified and artificially depressed the value used by the accountant in what was, in any event, a superficial and inadequate calculation of the share value. It follows that the disposition of the shares was made both with intent to prejudice a creditor and without receiving reasonably equivalent value in exchange. Accordingly, I may make an order under s 348 on either ground unless s 349 applies to protect the recipient of the property.

Protection of Mrs McDonald

[29] Section 349(1)[6] provides that the Court must not make an order under s 348 against a person otherwise entitled to an order who proves that they acquired the property for valuable consideration and "in good faith without knowledge of the fact that it had been the subject of a disposition to which this subpart applies".

[30] It is accepted that the shares were acquired for valuable consideration. It does not matter that the consideration did not equate with the value of the shares – see *Welch v Official Assignee*,[7] where it was held that under s 54(3) of the Insolvency Act 1967, "valuable consideration" means more than a nominal consideration but does not equate with the value of the property under consideration.[8]

[31] In considering the remainder of s 349(1)(a), it is noteworthy that the words "good faith" and "without knowledge ..." are not separated by the word "and" as they are in s 349(2)(a). That might suggest that, for the purpose of subsection (1), there is one rather than two separate enquiries with the issues of good faith and knowledge being considered together. That is the approach I intend to take, notwithstanding that good faith is a concept which has a specialised meaning in insolvency law[9] and, as s 349(2)(a) assumes, may be independently considered.

[32] As was said in *Welch*,[10] drawing on *Meo v Official Assignee*[11] and *Re Kerr (A Bankrupt)*,[12] good faith does not necessarily import any connotation of dishonesty or impropriety in motive or intention, but is a special and technical term for the purposes of bankruptcy law. Reference was made to a passage from the judgment of Skerrett CJ in *Re Kerr*, which explains further what acting in good faith requires in circumstances where one creditor is preferred to others:[13]

> A creditor does not act in good faith if he acts with knowledge of facts which show, or which ought to show, that the transaction was itself an act of

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6 Set out at [7] above.
7 *Welch v Official Assignee* [1998] 2 NZLR 8.
8 Ibid, at [12].
9 Ibid, at 13.
10 Ibid, at 13.
11 *Meo v Official Assignee* (1987) 3 NZCLC 100-280.
12 *Re Kerr (A Bankrupt)* [1927] NZLR 177.
13 At 186-187.

> bankruptcy, or if the transaction itself gives him notice of facts and circumstances which show that it was intended to be a fraud on the bankruptcy laws, or which render it incumbent on the creditor to make further inquiry. If the transaction itself is of a very unusual character, if it consists in the withdrawal from bankruptcy of substantial assets in favour of a particular creditor to the exclusion of other possible creditors, or if the motive and object of the transaction is to protect the particular creditor at the expense of other possible creditors, then it cannot be said that the creditor acted in good faith, unless he made such reasonable inquiries as were proper to satisfy him that the bankrupt might properly enter into the transaction without infringing the rights and remedies of his other possible creditors.

[33] While the enquiry in *Kerr* was into the conduct and knowledge of a creditor, what is said has general application as to how the requirement for good faith may be satisfied by the recipient of a disposition under subpart 6.[14] It also shows how closely interlinked is good faith and knowledge of the circumstances of the disposition.

[34] As I have said earlier, Mrs McDonald's primary concern was to protect herself and her children from her husband's financial misfortunes. I accept also that she would not have known that the shares were being sold at an undervalue. However, she knew her husband faced imminent bankruptcy and that adjudication would be inevitable if the appeal failed. She must have known also that the proceeds of sale would be used to pay some creditors in full, and the largest by far would receive nothing at all. In my view, she would have had to have been aware that credit card debts would be repaid in order to give her the ability to raise the purchase money. While not acting dishonestly or with an improper motive, she did not act in good faith and must have known that the transaction would prejudice the applicants.

[35] Relying on the judgment of Blanchard and Wilson JJ in *Regal Castings v Lightbody*,[15] Mr Potter submitted that the issue of whether Mrs McDonald knew that the sale of the shares was intended to prejudice her husband's creditors depends on whether she knew that the sale was intended to deplete the fund against which creditors could prove their debts. However, what is said in the passage relied on is that if property is disposed of at full value, creditors will have "an undepleted fund" against which to prove their debts and the transaction could not be characterised as

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[14] *Welch* concerned proceedings by the Official Assignee to recover a half interest in a matrimonial home transferred by the bankrupt to his wife.

[15] *Regal Castings* at [57].

involving a dishonest intent. That is not the position here. The sale was at an undervalue but, more importantly and relevantly in considering Mrs McDonald's position, it was made as part of a scheme which would undoubtedly hinder, delay or defeat the applicants.

[36] Mrs McDonald cannot rely on s 349 to spare her from the consequences of an order under s 348.

Appropriate order

[37] By s 348(2) an order under subsection (1):

> The order must do 1, but not both, of the following:
>
> (a) vest the property that is the subject of the disposition in the person (for any applicable purpose) specified in section 350:
>
> (b) require a person who acquired or received property through the disposition to pay, in respect of that property, reasonable compensation to the person (for any applicable purpose) specified in section 350.

[38] Mr Potter says that if an order is made, it should be for Mrs McDonald to pay any difference in value by way of "reasonable compensation" under subparagraph (b). The difficulty is that I have no way of knowing what the fair market value of the shares was or is. I consider the only course reasonably open is to direct, pursuant to s 350(1) and (2), that the shares vest in Mr McDonald for the purpose only of enabling the carrying out of any execution or similar process against him or the administration of a future bankruptcy or arrangement with his creditors.

[39] I accept that this will leave Mrs McDonald with substantial debts without the corresponding assets. This is regrettable but is the inevitable consequence of a scheme by which she, in effect, accepted an assignment of her husband's debts at the same time as she acquired the shares.

Result

[40] I make an order vesting the 49 shares in McDonald Textures Properties Limited, that were transferred by Mr McDonald to Mrs McDonald in Mr McDonald for the purpose only of enabling the carrying out of any execution or similar process against him or the administration of a future bankruptcy of him or arrangement with his creditors. I reserve leave to the parties to apply for further orders.

[41] I reserve leave to the applicants to apply for costs by the filing of a memorandum within 14 days. Any memorandum in reply by the respondents to be filed within a further 14 days.