INSOLVENCY LAW REFORM:
PROMOTING TRUST AND CONFIDENCE

AN ADVISORY REPORT TO THE MINISTRY OF ECONOMIC DEVELOPMENT

Law Commission
Wellington
March 2001

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Preface

In 1999 the Law Commission issued two publications dealing with aspects of the (then) forthcoming insolvency law review.

The first publication was a report which considered whether New Zealand should adopt the UNCITRAL Model Law on Cross-Border Insolvency.[1] A recommendation was made that the Model Law, with certain adaptations, be adopted in New Zealand.

Second, we published an advisory report to the Ministry of Commerce (as the Ministry of Economic Development was then known) on the topic of priority debts in the distribution of insolvent estates.[2] In that advisory report we addressed questions of priority at two distinct levels: i.e. first, we considered the criteria which ought to be applied in determining whether any particular debt should be afforded preferential status[3]; second, we considered whether existing preferences to be found in s 104 of the Insolvency Act 1967 and the Seventh Schedule to the Companies Act 1993 could be justified on the criteria recommended.[4] The advisory report made a number of recommendations which were to be used by the Ministry to focus public consultation and debate.[5]

Subsequently, in August 2000, we were asked, as part of the insolvency law review, to provide further advisory reports to the Ministry of Economic Development. The topics which we were asked to consider were: (a) the role of the State in insolvency law; (b) whether additional provisions should be inserted into New Zealand law to deal with business

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1 New Zealand Law Commission *Should New Zealand Adopt the UNCITRAL Model Law on Cross-Border Insolvency?: R52* (Wellington, February 1999) ["*Cross Border Insolvency*"].

2 New Zealand Law Commission *Priority Debts in the Distribution of Insolvent Estates: An Advisory Report to the Ministry of Commerce: SP2* (Wellington, October 1999) ["*Priority Debts*"]. In the course of our report on Priority Debts we mentioned specific problems affecting construction contractors. We were asked to prepare a further advisory report on that topic New Zealand Law Commission *Protecting Construction Contractors: SP3* (Wellington, 1999) ["*Protecting Contractors*"]. Our recommendations are currently being developed into legislation by the Ministry.

3 *Priority Debts*, above n2, chapter 2.

4 *Priority Debts*, above n2, chapters 3 – 6.

rehabilitation or reorganisation; (c) whether statutory management under the Corporations (Investigation and Management) Act 1989 should be retained in its existing or some modified form; and (d) whether it was desirable for New Zealand to adopt a generic statute dealing with all insolvency law issues. In this advisory report we address all of these topics.

The theme which we have found to underlie the four topics which we have been asked to address is the need to instil trust and confidence in an insolvency law system so that insolvency law can act as a pillar for both fiscal and social policy decisions.

So, in addressing the fundamental questions concerning the role to be played by the Stated in insolvency law, the alternative remedies which ought to be available to deal with business entities in financial distress and the need to bring order in cases where no mainstream insolvency regime can be applied, we have considered how the law can be structured in order to promote trust and confidence on the part of the community in general and the business community in particular. Our recommendations for insolvency law to be established in a single statute addresses the same point from a different perspective: the fundamental issue underpinning our recommendation in that regard is to make the law both more accessible and comprehensible to those who will be called upon to use it.

The Commission has expertise in legal matters. Decisions about the form and content of insolvency law are affected by economic as well as legal considerations. It is important to get the economic incentives of insolvency law right . We have endeavoured to analyse the issues from both economic and legal perspectives but we have no doubt that, particularly in relation to economic issues, other views will be expressed which may, or may not, in the fullness of time, affect the recommendations which we have made. Whether our views on economic issues are accepted or not, those views should help to focus informed debate on important questions.

While the Commission has undertaken some consultation in completing this report, our conclusions are intended to be the first, rather than the last, word on the topics addressed. We have been told by the Ministry of Economic Development that our report will be used for consultation which the Ministry will, itself, carry out before final policy decisions are made on the form and content of insolvency law.

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[5] *Priority Debts*, above n2, chapter 10.

There is one particular aspect of our report which we must emphasise. On the information available to us we have formed the view that a new regulatory framework may be required to meet particular problems of trust and confidence identified in paragraph 146. In paragraph 156 we said:

> We are not in a position to assess whether the steps taken by the New Zealand Insolvency and Trustee Service to establish a national enforcement unit in Auckland are likely to improve market confidence significantly.

While we have expressed doubts about whether those steps are likely to improve market confidence for the reasons set out in paragraph 156, further policy work on this particular aspect of our report will be necessary. It is conceivable that, as a result of that policy work, our provisional views on a new regulatory framework (including the possible creation of an independent office of Inspector-General in Insolvency) will need to be revisited. In particular we are conscious that our provisional views raise organisational and fiscal issues which have not yet been fully explored. We look forward to reviewing further work which may be done by the Ministry of Economic Development on this subject in the hope that all information will lead to the most suitable solution being found to address the problems of confidence identified in this report. We are not wedded to our suggestion of an Inspector-General if further policy work suggests a better option; but we are committed to ensuring that the problems of market confidence are solved.

We express our appreciation to officials within the Ministry of Economic Development with whom we have worked closely in developing our ideas. We also express our thanks to the Insolvency Law Advisory Committee which the Commission established in conjunction with the Ministry of Economic Development to act as peer reviewers. Members of that Committee are Mr David Brown[6], Senior Lecturer in Law at Victoria University of Wellington, Mr Trevor Laing, formerly the Official Assignee at Dunedin and now in practice as an insolvency practitioner, Mr Kim Powell, a business consultant based in Auckland who has previously worked both as an insolvency practitioner and a banker and Mr Michael Ross[7], Senior Lecturer in Commercial Law, University of Auckland. While we have taken account of everything the Advisory Committee said, the responsibility for this report rests with the

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6 Author of *Corporate Rescue: Insolvency Law in Practice* (John Wiley & Sons, 1996) which we have found to be of assistance to our work on both business rehabilitation and statutory management issues.

7 Author of *Corporate Reconstructions: Strategies for Directors* (CCH New Zealand Limited, 1999) which we have found to be assistance in our work on business rehabilitation issues.

Commission; it is fair to say that individual Advisory Committee members may not agree with all of our recommendations.

Others gave generously of their time to assist our deliberations. A list of those to whom we express our appreciation is set out under the heading "Acknowledgements" at pages 10-11.

The Commissioner responsible for preparation of this report is Paul Heath QC. The research for this report, and some of the writing, has been undertaken by Lucy McGrath, Michael Josling, Karen Belt and Ruth Wilson to whom the Commission expresses its appreciation. The Commission also recognises the significant contribution of Commissioner D F Dugdale to the preparation of this report.

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Executive summary

PART ONE - SETTING THE SCENE

ES1 The purpose of Part One is to provide background information against which we can address the four issues referred to the Law Commission. An overview of the current insolvency regime and the entities which it affects is provided in chapter 1, as well as a brief reference to international work in the area of insolvency law reform.

ES2 In chapter 2 we outline the development of insolvency legislation in New Zealand.

ES3 In chapter 3 we set out the principles approved by the Minister for the Insolvency Law Review, and compare those principles with objectives adopted in other jurisdictions.

ES4 In chapter 4 we discuss aspects of contemporary New Zealand society and the New Zealand economy which are relevant to the issues referred to the Law Commission.

ES5 In chapters 5 and 6 we outline the commercial law framework within which the insolvency regime operates, and provide details of the size and relative success rate of businesses in New Zealand. This information is relevant to Part Three of the paper where we asses whether a further rehabilitation regime should be enacted.

ES6 In chapter 7 we outline some of the empirical and anecdotal evidence regarding business failure, and the events that lead up to an individual or business entering an insolvency regime.

PART TWO – ROLE OF THE STATE

ES7 Part Two of the paper discusses the various roles played by the State in insolvency law, and makes recommendations for reform. Chapter 8 gives an overview of the regulatory framework, and queries which functions should be performed in the public sector to ensure the level of trust and confidence required to make an insolvency system work.

ES8 Chapter 9 identifies various problems within the current regulatory regime. The following chapters address these problems in relation to the State's different roles, and propose options for reform.

ES9 Chapter 10 discusses the State's role as legislator of insolvency law. It concludes that the law should be clearly articulated and capable of being applied in a predictable way, to avoid some of the problems identified in the chapter.

ES10 In chapter 11 we conclude that the State's role in enforcing insolvency law should be confined to issues which are truly public in nature and which cannot be performed by the creation of adequate incentives for private sector participants. We recommend:

- in relation to director disqualifications, that consideration be given to legislating for a senior barrister or small panel of senior barristers, appointed by the Solicitor-General, to hear applications for disqualifications, with appeals lying to the High Court;

- in relation to the identified problem that the relevant public officials are not taking adequate enforcement action, that consideration be given to the following options:

    - monitoring the activity of the National Enforcement Unit of the Insolvency and Trustee Service to see if enforcement action improves to an acceptable level;

    - designing a new regulatory framework (proposed in chapter 14);

    - combining the investigatory resources of other agencies such as the Serious Fraud Office, the Securities Commission, the Commerce Commission, and the Registrar of Companies into an independent enforcement unit;

- that the Ministry of Economic Development survey the private sector on the extent of the current lack of confidence in enforcement processes;

- in relation to the level of expertise in insolvency matters among the judiciary, that consideration be given to specialist judges and Masters, nominated by the Chief Justice, sitting in specific classes of insolvency cases.

ES11 In chapter 12 we discuss the State's role as regulator within an insolvency regime. We recommend that:

- There should be a right to examine directors publicly before a Master where there are concerns about irresponsible commercial behaviour;

- in the longer term, consideration should be given to some form of accreditation process for those acting as office holders in a collective insolvency regime.

ES12 In chapter 13 we discuss the State's role as office holder in collective insolvency regimes. We recommend:

- private practitioners should be able to act as trustee of a bankrupt estate, provided an adequate supervisory regime is in place;

- assetless bankruptcies and liquidations should be administered by the Official Assignee;

- where the Official Assignee has been appointed but it has been determined that there are assets, creditors should determine whether to appoint a different administrator;

- where a private practitioner is appointed, he or she should certify to the Court his or her experience in insolvency matters, and whether he or she has ever been prohibited from being a liquidator, receiver, or other office holder.

ES13 In chapter 14 we propose the establishment of a new regulatory figure, an Inspector-General in Insolvency. This figure would have responsibility for all investigations and prosecutions, including director disqualifications. The Inspector-General would also have responsibility for overseeing office-holders, including the Official Assignee. We emphasise, as we have already emphasised in the Preface to this report, that our views on the need for an Inspector-General in Insolvency are provisional in nature. Those views will need to be revisited if further policy work suggests better solutions to the problems we have identified. We are thinking, in particular, of organisational and fiscal issues which the Ministry of Economic Development will address when considering our proposals.

ES14 Finally in Part Two, chapter 15 discusses the State's role in educating its citizens about credit management and insolvency processes. We recommend:

- further consideration be given to the Ministry of Consumer Affairs' proposal for an enforcement agency, one of the functions of which would be to raise awareness of consumer credit legislation;
- the Inspector-General proposed in chapter 14 could carry out educational functions, along the lines of those of the Canadian Superintendent of Bankruptcy;
- the Ministry of Education consider whether any additional material regarding budgeting and money management should be inserted into the secondary school curriculum.

BUSINESS REHABILITATION

ES15 In chapter 16 we summarise the economic and legal considerations that are relevant in deciding whether to introduce a business rehabilitation regime, and in particular consider:

- Significant features of New Zealand's economy;
- Difficulties that commonly prevent debtors and creditors reaching agreement;
- Existing statutory procedures in New Zealand under which debtors and creditors can enter into agreements as alternatives to liquidation/bankruptcy;
- Rehabilitation regimes in other jurisdictions.

ES16 In chapter 17 we consider whether there is any need to introduce a general rehabilitation regime containing stays against secured and unsecured creditors into New Zealand. We conclude that there is no clear problem that needs to be remedied. However we also reach the view that the New Zealand's insolvency laws could be improved by the introduction of a targeted regime.

ES17 We also recommend that consideration be given to removing the tax liability of debtors that enter into collective compromises. Finally, the chapter sets out guidelines for conducting informal workouts.

ES18 In chapter 18 we consider whether the rehabilitation regime should focus on a particular entity (usually a company), or businesses generally. We recommend that the regime should be directed to the activity of the businesses because:

- less legislation will be required;
- the risk of inconsistency is reduced and
- policy goals can be developed in a coherent fashion.

ES19 In chapter 19 we outline a proposed rehabilitation regime, together with other suggested amendments to the present law; in particular:

- We outline an approach by setting out how a debtor/creditor negotiation should properly be conducted;
- We suggest that Part XIV Companies Act 1993 does not require significant alteration, as it provides a procedure which is already as simple and inexpensive as can reasonably be expected. We suggest however, in light of our recommendation in chapter 18, that its provisions be synthesised with Part XV of the Insolvency Act 1967;
- We express the view that Part XV of the Companies Act 1993 should be repealed, since its operation is too uncertain, and it permits compromises to be imposed on creditors where a significant number do not agree;
- We propose that a new rehabilitation regime be introduced, but with strict entry criteria. The main features suggested are:

  (a) Entry into the regime would require a court order. The proponent would need to satisfy the court that the business' records will enable a prompt assessment of its future viability to be made, that there is a real prospect that creditors will accept the proposal, and that once the proposal is implemented, the business will be able to satisfy the solvency test.

  (b) Once an order is made, a 14-day stay on all creditors' claims (secured and unsecured) will come into effect. There is provision for a further 14 day extension;

(c) An impartial administrator would also be appointed to carry out an investigation, negotiate with creditors, protect the assets of the business, and oversee the existing management.

ES20 We conclude chapter 19 by setting out the advantages of such a regime.

STATUTORY MANAGEMENT UNDER THE CORPORATIONS (INVESTIGATION AND MANAGEMENT) ACT 1989

ES21 In chapter 20 we identify a number of criticisms that have been made of the Act.

ES22 In chapter 21 we detail other Acts that have imposed forms of statutory management.

ES23 In chapter 22 we outline the provisions of the Act.

ES24 In chapter 23 we consider the objectives of the Act, namely:

- to enable action to be taken earlier when a company is, or may be, operating fraudulently or recklessly; and
- to enable companies to be given a decent burial when ordinary remedies are inadequate.

ES25 Chapter 24 considers the review of the Act undertaken by the Securities Commission, which ultimately recommended the retention of statutory management. The Commission's recommendations are set out in full at Appendix G.

ES26 Chapter 25 considers whether statutory management has any potential benefits as an insolvency procedure. It identifies three potential benefits:

- it provides an extraordinary procedure for business rehabilitation,
- it enables insolvencies involving groups of companies to be dealt with as a whole, and
- it provides an emergency measure for ensuring the continuing supply of essential services if the companies which provide them are faced with collapse.

ES27 We consider these potential benefits, with reference to the Securities Commission's report, and conclude that most of the benefits will also be available from our proposed new rehabilitation regime. We note however that statutory management may still be useful where:

- issues involving the public interest are involved; and
- a process is needed to bring order to chaos and then determine how to deal with the core business.

ES28 The chapter concludes by identifying problems arising from statutory management; in particular lack of transparency and accountability, cross-border issues, and lack of confidence and trust from creditors and shareholders.

ES29 In chapter 26 we set out our recommendations. We start by noting that we agree with a number of amendments suggested by the Securities Commission. We go on:

- To agree that statutory management should be preserved as a remedy of last resort to be used if:

  (a) the affairs of a corporation cannot adequately be dealt with by any other formal and collective insolvency regime; or

  (b) the public interest requires it to be used.

- To suggest that the maximum initial period of statutory management should be three months, but with power to extend for a further three months;
- To suggest that decisions to invoke statutory management should be made by the High Court, with provisions for notice of the hearing to be given, and reasons to be given;
- To suggest that a report be provided to creditors and shareholders within one month, with a meeting to be held in the second month to decide what action should be taken. We suggest that statutory management should be used as a filter to determine what insolvency procedure should ultimately be used, or whether the corporation can be returned in a solvent state to management.
- To consider the situation where groups are involved.

A SINGLE STATUTE?

ES30 In chapter 27 we list the advantages of enacting a single statute to deal with all insolvency regimes. We go on to list the disadvantages.

ES31 In chapter 28 we conclude that the advantages clearly outweigh the disadvantages, and recommend enacting a generic statute. We go on to suggest an outline for the statute.

PART 1
SETTING THE SCENE

1.

Introduction

32 In a market economy some businesses will succeed while others will fail. When businesses fail they are unable to pay their debts and creditors suffer a loss. The over-riding purpose of insolvency law is to fix default rules by which (subject to the right of a creditor to waive priority)[8] the order in which creditors will be paid on insolvency is determined. For that reason Philip Wood has argued cogently that insolvency law is the most crucial indicator of the attitudes of a legal system and, arguably, the most important of all legal disciplines. When there is not enough money to go around, the law chooses whom to pay.[9]

33 Insolvency regimes for individuals, both living and deceased, are set out in the Insolvency Act 1967. Under that statute, the following administrations may arise[10]:

(a) An individual may be adjudged bankrupt on the petition of either the debtor or a creditor;[11]

(b) A pre-adjudication receivership may be created in the circumstances prescribed by s 27 of the Act.;[12]

(c) A composition with creditors, after adjudication in bankruptcy, approved by the court entitles a debtor to an annulment of his or her bankruptcy;[13]

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8 *Stotter v Ararimu Holdings Limited* [1994] 2 NZLR 255 (CA) and Companies Act 1993, s 313(3).

9 Wood *Law & Practice of International Finance: Principles of International Insolvency* (Sweet & Maxwell, London, 1995), 1.

10 Generally, see *The Laws of New Zealand* (Butterworths, Wellington, 1992) vol 14, Insolvency, para 3 ["Laws NZ: Insolvency"].

11 Laws NZ: Insolvency, above n10, paras 18 – 138.

12 Laws NZ: Insolvency, above n10, paras 8 and 68 – 72.

13 Laws NZ: Insolvency, above n10, paras 9 and 433-448.

(d) A Proposal made by a debtor for the benefit of his or her creditors may be entered into and if approved by the High Court will enable a debtor to settle on a full and final basis with his or her creditors without a change in status to that of a bankrupt;[14]

(e) An insolvent deceased estate;[15]

(f) A summary instalment order which can address collective debts of not more than $12,000.[16]

34 The major trading entity in New Zealand is the limited liability company. All companies operating in New Zealand are registered under the Companies Act 1993 either as a result of incorporation or re-registration under that Act.[17] An insolvent company may, voluntarily through the action of its Board or shareholders, or, on the application of a creditor to the High Court, be placed in liquidation.[18] But, in addition,

(a) A company may enter into a compromise with its creditors (which may or may not require consent from the High Court);[19]

(b) On the application of the company, or any shareholder or creditor of the company, an arrangement, amalgamation or compromise which would be binding on all creditors and shareholders specified by the High Court can be instituted;[20]

(c) A creditor holding a debenture over the assets of a company may place the company in receivership;[21]

(d) The insolvency of a life insurance company can be met by the appointment of judicial managers;[22]

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14 Laws NZ: Insolvency, above n10, paras 10 and 449 – 475.

15 Laws NZ: Insolvency, above n10, paras 11 and 476 – 497.

16 Laws NZ: Insolvency, above n10, para 12; see also *The Laws of New Zealand* (Butterworths, Wellington, 1992) vol 8, Creditors' Remedies, paras 125 – 130.

17 Reregistration occurred under the Companies Reregistration Act 1993.

18 Companies Act 1993 s 241(2). The process of liquidation is dealt with in Part XVI of the Companies Act 1993.

19 Companies Act 1993 Part XIV, ss 227 – 234.

20 Companies Act 1993 Part XV, ss 235 – 239.

21 Because this form of insolvency regime is dictated by the secured creditor the powers of the receiver are generally fixed by the document creating the debenture; however, see also the Receiverships Act 1993.

(e) A company which is a registered bank may be placed in statutory management under the powers conferred by the Reserve Bank of New Zealand Act 1989.[23]

(f) A "corporation" (widely defined to mean any trading entity or individual[24]) may be placed in statutory management under the Corporations (Investigation and Management) Act 1989.[25] The goals identified by the Minister of Justice on the introduction of the Bill into Parliament were:

(i) To enable action to be taken earlier when a company, or may be, operating fraudulently or recklessly;

(ii) To enable companies to be given a "decent burial" when ordinary insolvency law remedies are inadequate.[26]

Only the second of these objectives is related specifically to insolvency law reform issues. In any event, the Act is clear that statutory management should not be used as an insolvency regime unless the interests of creditors or members of the company or the public interest could not be adequately protected under other lawful regimes.[27]

35 Other statutes provide for insolvency administrations affecting other entities. Many of those provisions apply, *mutatis mutandis* to the liquidation provisions of the Companies Act 1993 without expressly stating how the provisions should be adapted.[28] The entities which are governed in that way include charitable trusts[29], Industrial and Provident

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22 Life Insurance Act 1908, ss 40A – 40Q; see also *Re ACL Insurance Limited* [1991] 1 NZLR 211.

23 The powers provided to the Reserve Bank to recommend appointment of a statutory manager are exercised for the broad systemic purpose of protecting the interests of the financial system in New Zealand as a whole. A recommendation is made by the Reserve Bank to the Minister of Finance in order to place a bank into statutory management. The Minister of Finance will then give advice to the Governor-General who will, if the advice is accepted, appoint a statutory manager by Order-in-Council. More generally, see the discussion of this topic in our earlier report, *Cross-Border Insolvency* (above n1, ch 5, in particular paras 199 – 212). Note that the only financial institutional to have been placed in statutory management under the Reserve Bank of New Zealand Act 1989 was DFC New Zealand Limited: see SR 1990/69 and SR 1990/70.

24 Corporations (Investigation and Management) Act 1989, s 2(1), definition of "corporation".

25 See our discussion of this form of statutory management in Part 4.

26 See further para 330.

27 Corporations (Investigation and Management) Act 1989, s 39.

28 Examples are Incorporated Societies Act 1908, ss 23A – 27 and Friendly Societies and Credit Unions Act 1982, ss 90, 138 and 141.

29 Charitable Trusts Act 1957, s 25; e.g. *Misa v.Congregational Christian Church of Samoa (Wainuiomata) Trust Board* [1984] 2 NZLR 461 (CA).

Societies[30], Incorporated Societies[31], Maori incorporations[32], Friendly Societies and Credit Unions[33] and Building Societies.[34]

36 A number of recent international reports have stressed the need for strong insolvency systems to act as important pillars of support for the financial system as a whole and the efficient flow of international capital in particular. For example, in a report by the Legal Department of the International Monetary Fund (IMF), it was said:

> Over the years, the IMF has become increasingly involved in the promotion of orderly and effective insolvency systems among its members. Experience has demonstrated that reform in this area can play a major role in strengthening a country's economic and financial system.…Insolvency reform can be particularly relevant for economies in transition, where it can play a critical role in addressing the problems of insolvent State-owned enterprises. In the context of financial crises, an orderly and effective insolvency system can provide an important means of ensuring adequate private sector contribution to the resolution of such crises. Finally, although insolvency procedures are implemented through the courts, the very existence of an orderly and effective insolvency system establishes incentives for negotiations between debtors and their creditors, which may lead to out of court agreement being reached "in the shadow" of the law.[35]

37 Similarly the World Bank, in a consultation draft, *Effective Insolvency Systems: Principles and Guidelines* says:

> When credit markets tighten, however, enterprises are pushed to the brink of survival. In developing countries, a larger portion of enterprises routinely operate on the fringes of profitability and efficiency. Increasing competition and shrinking markets in today's global economy more easily tilt the competitive balance against these enterprises. As globalisation redefines commercial expectations and relationships, the challenge is to reinvigorate insolvency systems to promote restructuring of viable businesses and the efficient closure and transfer of assets of

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30 Industrial and Provident Societies Act 1908, s 15

31 Incorporated Societies Act 1908 ss 23A – 27; for example *Re Symphonia of Auckland Foundation Inc* [1984] 2 NZLR 759.

32 Te Ture Whenua Maori Act 1993, s 282.

33 Friendly Societies and Credit Unions Act 1982, ss 90, 138 and 141.

34 Building Societies Act 1965, s 118.

35 Legal Department of IMF *Orderly and Effective Insolvency Procedures: Key Issues* (1999) foreword, vii ["IMF"].

failed businesses. To achieve this result, maximum play must be given to private creditors and debtors to develop solutions, in the knowledge that there is an ultimately reliable and fair arbiter in the courts, administrators and trustees ready to support those solutions or impose an alternative solution, if none can be achieved by negotiation.[36]

38 When moving from the international to the domestic front, it is important to remember three things about the landscape on which any insolvency law will operate:

(a) Good insolvency laws should be developed in good economic times for the purpose of dealing with the inevitable cycle of bad economic times; and

(b) Experiences with the operation of insolvency laws in good economic times do not necessarily reflect how the laws will work in bad economic times: creditors are always more magnanimous in good economic times than in bad – in bad times collection of debts takes on added importance if business is slow and losses cannot be recouped from future profits; and

(c) To test how insolvency laws devised in good economic times will work in bad times it is useful to look back and recall how similar problems were addressed in the most recent "bad" economic cycle; in New Zealand's case the period between 1989 and 1992 is the critical period.

39 The World Bank consultative draft also provides an outline of what is considered an appropriate institutional infrastructure.[37] The institutional framework involves

(a) a regulatory body overseeing the whole insolvency system;

(b) independent and sufficiently qualified insolvency administrators; and

(c) specialist courts.

40 Following our report on whether New Zealand should adopt the UNCITRAL Model Law on Cross-Border Insolvency[38] and advisory reports to the Ministry of Commerce (as the

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36 Legal Department of the World Bank *Effective Insolvency Systems: Principles and Guidelines* (October 2000) foreword, v ["World Bank"].

37 World Bank, above n 36, 50 – 51, 53 – 62 and 70 – 74.

38 *Cross Border Insolvency*, above n1.

Ministry of Economic Development was then known) on priority debts,[39] and construction contractors[40] we have been asked by the Ministry of Economic Development to provide an advisory report on four further topics as part of the insolvency law review. We have been asked to consider:

(a) the role of the State in insolvency law;

(b) whether additional provisions should be inserted into New Zealand law to deal with business rehabilitation or reorganisation;

(c) whether statutory management under the Corporations (Investigation and Management) Act 1989 should be retained in its existing or some modified form; and

(d) whether it is desirable for New Zealand to enact a single statute to deal with all insolvency law issues.

41 Insolvency law does not operate in a vacuum, but as part of a country's commercial law framework. In order to be effective the law must be part of a functioning insolvency system. The theme which we have found to underlie the four topics which we have been asked to address is the need to instil trust and confidence in a functioning insolvency law system. Once trust and confidence exists, the system can act as a pillar for both fiscal and social policy decisions. As the Legal Department of the International Monetary Fund stated:

> Recent experience has demonstrated the extent to which the absence of orderly and effective insolvency procedures can exacerbate economic and financial crises. Without effective procedures that are applied in a predictable manner, creditors may be unable to collect on their claims, which will adversely affect the future availability of credit. Without orderly procedures, the rights of debtors (and their employees) may not be adequately protected and different creditors may not be treated equitably. In contrast, the consistent application of orderly and effective insolvency procedures plays a critical role in fostering growth and competitiveness and may also assist in the prevention and resolution of financial crises: such procedures induce greater caution in the incurrence of liabilities by debtors and

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39 *Priority Debts*, above n2.

40 *Protecting Contractors*, above n2.

greater confidence in creditors when extending creditor or rescheduling their claims.[41]

42 The usefulness of insolvency law as a device to underpin fiscal and social policy was also noted by Professor Westbrook in a paper which he gave in 1999 to the New Zealand Law Society Conference.[42] Professor Westbrook said:

> We must start with the circumstances under which insolvency law, as such, is applied. Regardless of the definition of "Insolvency", insolvency law is the law applied when an economic enterprise is in general default of its obligations. A number of other laws relating to dispute resolution and asset seizure are invoked with respect to default on less-than-most obligations. Insolvency law reflects a recognition that different approaches are necessary when a debtor's default is general.
>
> As with other sorts of law, insolvency law becomes more important when a society adopts a market economy and faces the concomitant problems created by market risk, if the market is too large to permit resolution of those problems through social accommodation among persons well known to each other. Insolvency law is not necessary to impose the discipline of economic failure. The market does that without assistance. Insolvency law is important, however, to allocating the costs of failure fairly in relationship to the economic responsibility of each actor and to avoiding the fraudulent shifting of consequences from those upon whom the market risk should fall. That discipline contributes importantly to the long term strength of the market.[43]

Professor Westbrook went on to observe:

- one of the functions of insolvency law is to impose social order, and to do so rapidly;[44]

- commercial law generally should then attempt to make outcomes as predictable as possible;[45]

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41 IMF, above n35, 1.

42 J Westbrook "The Globalisation of Insolvency Reform" [1999] NZ Law Review 401 ["Westbrook: Globalisation"].

43 Westbrook: Globalisation, above n 42, 404 – 405.

44 Westbrook: Globalisation, above n 42, 405.

- the economic value of an enterprise should be maximised by encouraging disclosure by debtors at the earliest possible time on the basis that debtors know much more about their enterprises than do their creditors.[46]

43 In addressing the four issues to which we refer in para 40, we have had regard to the shape of the contemporary New Zealand economy, social and economic changes since deregulation of New Zealand's economy in 1984, the commercial law framework against which an insolvency law must work and the need for New Zealand, in an increasingly globalised market, to take account of international developments when framing its domestic laws. Each of those aspects are developed in chapters 4 and 5.

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45 Westbrook: Globalisation, above n 42, 406.

46 Westbrook: Globalisation, above n 42, 407 – 408.

2.

Development of Insolvency Law in New Zealand

BANKRUPTCY

44 The first insolvency statute in New Zealand was the Debtors and Creditors Act 1862 which repealed the Imprisonment for Debt Ordinance 1844 and its amendments.[47] In the late 19th century and early 20th century more detailed provisions were enacted by the Bankruptcy Acts of 1867, 1892 and 1908. The Bankruptcy Act 1892 followed inquiries by a Joint Select Committee to consider questions of bankruptcy law reform.[48] It was not until 1971 that the Bankruptcy Act 1908 was repealed when the Insolvency Act 1967 came into force.[49]

45 The New Zealand Bankruptcy Act of 1892 was also based on the Bankruptcy Act 1883 (UK). In speaking to the Bill introduced in the United Kingdom, the President of the Board of Trade, Joseph Chamberlain, had explained to the House of Commons that the 1883 Act had two principal objects:

- The honest administration of bankrupt estates with a view to the fair and speedy distribution of assets among creditors;
- Improvement of the general tone of commercial morality with the objective of promoting honest trading and lessening the number of failures.[50]

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47 In the context of the Debtors and Creditors Act 1862 see *Bank of New Zealand v Hart* (1867) Mac 547.

48 The work of the Joint Select Committee is discussed in some detail in P Heath "Insolvency Law Reform: The Role of the State" [1999] NZ Law Review 569 ["Heath: Role of State"]. The work of the Select Committee was limited to questions of individual bankruptcy law rather than company law.

49 The Insolvency Act 1967 came into force on 1 January 1971: Insolvency Act Commencement Order 1970 (SR 1970/244), cl 2.

50 Parliamentary Debates (England) Third Series Vol 277, 817 (19 March 1883). The second objective was based on the idea that prevention was better than cure. Compare with the principles underlying the present review of insolvency law at para 52 .

46 In order to improve the general tone of commercial morality and to promote honest trading, Chamberlain was of the view that it was necessary to have a public officer examine the circumstances of each bankruptcy. A similar view was formed in New Zealand by the Joint Select Committee.[51] The problems identified with the bankruptcy regime in 1882 which led to that recommendation continue to be issues in the current review of insolvency law.

47 While no distinct review of personal bankruptcy law in New Zealand took place prior to the enactment of the Insolvency Act 1967,[52] those responsible for drafting the 1967 Act drew on reports prepared in both the United Kingdom and Australia.[53] Changes made to the law by the Insolvency Act 1967 have been described as follows:

> The emphasis in the Imperial Act of 1883 and the New Zealand Bankruptcy Act 1908 was on the strict administration of the bankrupt's estate by an officer of the Court, the Official Assignee, although provision was made for full consultation with creditors. Strict provisions were also included to discipline the improvident debtor and encourage higher standards of commercial prudence and morality. While these provisions are retained in the new Act, the opportunity is now given [by Part XV of the Act] to the insolvent debtor to make a proposal outside of bankruptcy to pay off the debts by instalments by assigning his property or entering into a compromise under the supervision of a private trustee …
>
> Part XVI of the Act empowers the Magistrate's Court to make summary instalment orders for the payment of unsecured debts not amounting to more than $1,000.[54] This provision enables the debtor to avoid the stigma of bankruptcy and pay off his debts by instalment…. The Insolvency Act now provides a means whereby all the debts can be dealt with comprehensively by one order and repayment of instalments is to be under the supervision of a supervisor appointed by the Court. It is to be hoped that this legislation will provide the opportunity for welfare

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51 Heath: Role of State , above n 48.

52 For a discussion of the changes made by the Insolvency Act 1967 see Spratt & McKenzie *Law of Insolvency* (Wellington, Butterworths, 1972) 1 – 5 ["Spratt & McKenzie"]; for a discussion of the regime applicable under the Bankruptcy Act 1908 see Spratt, *Law and Practice of Bankruptcy in New Zealand* (Wellington, Butterworths, 1930).

53 Report of the Committee on Bankruptcy Law and Deeds of Arrangement Law Amendment (1957) Cmnd 221 (the Blagden Committee Report) and *Report of the Committee Appointed by the Attorney-General to Review the Bankruptcy Law of the Commonwealth of Australia* (8440/1962) (the Clyne Committee Report).

54 The limit under Part XVI was increased to $12,000: Insolvency Amendment Act 1990, s 6(2).

organisations to give budgeting and advisory services, and in suitable cases assume the office of supervisor.[55]

COMPANIES

48 The first company law enacted in New Zealand (the Joint Stock Companies Act 1860) was based upon the Joint Stock Companies Act 1856 (UK).[56] Subsequently, the Companies Act 1882 became the first indigenous New Zealand statute of that name. Both of those statutes contained liquidation procedures[57] and rudimentary rehabilitation regimes.[58]

49 The liquidation provisions of the Joint Stock Companies Act 1856 and the succeeding New Zealand statutes (all based on British models) permitted companies to be wound up either voluntarily or by the Court. We refer to the Companies Acts 1903, 1908, 1933 and 1955.

50 After a fundamental review of company law by the Law Commission, the Companies Act 1993 was passed.[59] The Companies Act 1993 ended the distinction between public and private companies. The fundamental distinction now drawn in New Zealand law is between entities which operate as an "issuer" of securities[60] to the public, and those which do not.

INSOLVENCY REGIMES FOR OTHER ENTITIES

51 A number of other entities exist which tend to apply the liquidation provisions of the Companies Act 1993 *mutatis mutandis*.[61]

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55 Spratt & McKenzie, above n52, para 0/2, 1-2. For a discussion of changes introduced by the Insolvency Act 1967, see also Flitton "The Insolvency Act 1967" [1968] NZLJ 394; McKenzie "Insolvency Act 1967" (1968-69) 3 NZULR 210. With regard to proposals under Part XV of the Insolvency Act 1967, see also A Sawyer "Proposing an Alternative to Bankruptcy: Part XV in Retrospect" (1995) 6 Canta LR 175, and P Heath "Proposals Under Part XV Insolvency Act 1967: Is the Public Interest Relevant?" [1991] NZLJ 52.

56 Subsequently consolidated in the Companies Acts 1862 and 1867 (UK).

57 Joint Stock Companies Act 1860, ss 62 – 125 and Companies Act 1882, ss 185 – 236.

58 Joint Stock Companies Act 1860, s 120 and Companies Act 1882, s 196. For later developments see Companies Act 1903, s 260, Companies Act 1908, s 260, Companies Amendment Act 1928, s 2, Companies Act 1933, s 159 and Companies Act 1955, s 205.

59 Generally, see *Company Law: PP5* (Wellington, 1987), *Company Law: Reform and Restatement: R9* (Wellington, 1989) ["*Company Law: R9*"] and *Company Law Reform: Transition and Revision: R16* (Wellington, 1990).

60 See Securities Act 1978, s 2(1), for definitions of "Issuer" and "Security".

61 See para 35.

3.

Insolvency Law Objectives

THE CURRENT REVIEW

52 The principles[62] for the insolvency law review are:

(i) to provide a predictable and simple regime for financial failure that can be administered quickly and efficiently, imposes the minimum necessary compliance and regulatory costs on its users, and does not stifle innovation, responsible risk taking and entrepreneurism by excessively penalising business failure;

(ii) to distribute the proceeds to creditors in accordance with their relative pre-insolvency entitlements, unless it can be shown that the public interest in providing greater protection to one or more creditors (statutory preferences) outweighs the economic and social costs of any such preference:

(iii) to maximise the returns to creditors by providing flexible and effective methods of insolvency administration and enforcement which encourage early intervention when financial distress becomes apparent;

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62 Ministerial Briefing of 23 December 1999, subsequently agreed to by the Minister of Commerce Hon Paul Swain.

(iv) to enable individuals in bankruptcy again to participate fully in the economic life of the community by discharging them from their remaining debts in appropriate circumstance; and

(v) to promote international co-operation in relation to cross-border insolvency.

53 We propose to refer, at this stage, to aims of insolvency law in other jurisdictions and to relevant academic literature. We then turn to discuss the practical application of the principles underlying the current review when they fall for consideration in the context of a particular issue. Finally, we address factors identified in recent international reports which are of relevance to the issues we are to address.

COMPARING APPROACHES IN OTHER JURISDICTIONS

54 At a national level insolvency law reform in the United Kingdom and Australia was preceded by the Cork[63] and Harmer[64] reports respectively. Both reports recognised the need to identify the relevant purposes and principles when reviewing the existing law.

The Cork Report

55 Chapter 4 of the Cork Report entitled *Principles of Insolvency Law* listed the following "aims of a good modern insolvency law":

(a) to recognise that the world in which we live and the creation of wealth depend upon a system founded on credit and that such a system requires, as a correlative, an insolvency procedure to cope with its casualties;

(b) to diagnose and treat an imminent insolvency at an early rather than a late stage;

(c) to relieve and protect where necessary the insolvent, and in particular the individual insolvent, from any harassment and undue demands by his creditors, whilst taking into consideration the rights which the insolvent (and

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63 Insolvency Law and Practice Report of the Review Committee (1982) Cmnd. 8558 para 198 ["Cork Report"].

64 Australian Law Reform Commission *General Insolvency Inquiry-No 45* (Australian Government Publishing Service, Canberra, 1988) para 33 ["Harmer Report"].

where an individual, his family) should legitimately continue to enjoy; at the same time, to have regard to the rights of creditors whose own position may be at risk because of the insolvency;

(d) to prevent conflicts between individual creditors;

(e) to realise the assets of the insolvent which should properly be taken to satisfy his debts, with the minimum of delay and expense;

(f) to distribute the proceeds of the realisations amongst the creditors in a fair and equitable manner, returning any surplus to the debtor;

(g) to ensure that the processes of realisation and distribution are administered in an honest and competent manner;

(h) to ascertain the causes of the insolvent's failure and, if and insofar as his conduct or, in the case of a company, the conduct of its officers or agents, merits criticism or punishment, to decide what measures, if any, require to be taken against him or his associates, or such officers or agents;

(i) to recognise that the effects of insolvency are not limited to the private interests of the insolvent and his creditors, but that other interests of society or other groups in society are vitally affected by the insolvency and its outcome, and to ensure that these public interests are recognised and safeguarded;

(j) to provide means for the preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country;

(k) to devise a framework of law for the governing of insolvency matters which commands universal respect and observance, and yet is sufficiently flexible to adapt to and deal with the rapidly changing conditions of our modern world; in particular, to achieve a system that:

    (i) is seen to produce practical solutions to financial and commercial problems,

    (ii) is simple and easily understood,

    (iii) is free from anomalies and inconsistencies, and

(iv) is capable of being administered efficiently and economically;

(l) to ensure due recognition and respect abroad for English insolvency proceedings.

The Harmer Report

56 The Harmer Report[65] similarly identified the principles that should guide "the development of a modern insolvency law":

(a) The fundamental purpose was to provide a fair and orderly process for dealing with the financial affairs of insolvent individuals and companies;

(b) To provide mechanisms which enable both debtor and creditor to participate with the least possible delay and expense;

(c) To provide an insolvency administration which is impartial, efficient and expeditious;

(d) To provide a convenient means of collecting or recovering property that should properly be applied toward payment of the debts and liabilities of the insolvent person;

(e) To retain, and in some cases to reinforce, the principle of equal sharing between creditors;

(f) The end of an insolvency administration should, with very limited exceptions, be the effective relief or release from the financial obligations of the insolvent person;

(g) To support, so far as is convenient and practical, the commercial and economic processes of the community;

(h) To harmonise with the general law;

(i) To enable ancillary assistance in the administration of an insolvency originating in a foreign country.

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65 Harmer Report, above n 64.

Professor Goode's Scheme[66]

57 Professor Goode has identified four overriding objectives of corporate insolvency law:

- Restoring the company to profitable trading where practicable.[67]

- Maximising returns to creditors. This objective has two aspects

  - it reflects the assumption that on insolvency individual rights give way to collective interest

  - in principle creditors' interests are to be given precedence over all other interests.

Professor Goode notes that this objective raises "the central question of insolvency law philosophy" ie the proper policy of corporate insolvency law and the extent to which it should take account of interests other than those of the consensual creditors by

- Providing a fair and equitable system for the ranking of claims

- Identifying the causes of the company's failure and imposing sanctions for culpable management by its directors and officers

58 Next he identifies the instruments of corporate insolvency law:

- Placement of the company and its assets under external management

- Substitution of collective action for individual rights of pursuit

- Avoidance of transactions and recovery of misapplied assets

- Sanctioning of delinquent directors

- Statutory authorisation of insolvency practitioners

- Dissolution of a company in winding up[68]

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66 RM Goode, *Principles of Corporate Insolvency Law* (2 ed, Sweet & Maxwell, London, 1997) 24; see also ch 4 ["Goode"].

67 He notes that this objective is rarely realised and the most common outcome is cessation or disposal of the company's business followed by winding up.

Application of Principles of Current Review

59 Inevitably, there will be conflict between some of the principles of the review when particular issues fall for consideration. In such cases, a balancing exercise is required to determine which principle should be regarded as paramount.

60 Accordingly, when weighing the principles in the context of the specific issues to which we refer in this report, we have placed emphasis on two public policy factors which insolvency law ought to address; i.e.

- reduction of the cost of credit; and

- promotion of entrepreneurship.

Both of these public policy factors are, in fact, captured within principles (i) and (iv) of the current review: see para 52.

61 Once we have identified appropriate principles to deal with a particular area of insolvency law, we endeavour to articulate appropriate incentives and sanctions to encourage behaviour which will promote those underlying values. But, even in completing that exercise, it is necessary to consider what incentives are *appropriate*. For example:

(a) Debtors may well be more prepared to co-operate in the insolvency process if there is less risk that their activities will be investigated. Investigation of the conduct of a debtor or the management of a debtor may, in certain circumstances, lead either to proceedings, brought in the public interest, to disqualify someone from being involved in a business or acting in the management of a company. The justification for such an investigation (and the enforcement action which may follow) is the need to promote commercial morality; or, to put it another way, the need to promote responsible commercial behaviour.[69] If the trade off between an incentive for a debtor to participate in the insolvency process is not properly balanced against the need for such investigations to promote responsible behaviour, the wrong solution may be found;

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68 Goode, above, n 66, 29 - 34.

69 See also *Re Anderson* (14 April 1992) unreported, High Court, Hamilton Registry, B 213/89. In that case Penlington J held that the term "commercial morality" embraced conduct which could be characterised as fraud, dishonesty, recklessness and gross negligence; a question was whether the debtor had been guilty of undesirable commercial behaviour.

(b) As we suggested in our advisory report *Priority Debts in the Distribution of Insolvent Estates*[70] an incentive for creditors to exercise remedies could be the establishment of a priority in favour of the creditor who provides the funds to bring proceedings designed to recover money or protect assets. Questions of balance arise in that context as it is important to ensure that individual creditors do not use the collective insolvency process to exact retribution against a debtor or someone involved in the management of the debtor entity at the expense of the general body of creditors. Balance is achieved through an impartial and competent administrator deciding whether good grounds exist to bring the proceedings.

INTERNATIONAL CONSIDERATIONS

62 We are of the view that while each State should primarily tailor its insolvency laws to fit its domestic needs it must, in today's environment, pay heed to standards which are required by the international community.[71]

63 A number of reports have been issued recently by international bodies which are relevant to New Zealand intended reform of its insolvency laws. Among others, reports have been prepared by the IMF, the World Bank, the United Nations Commission on International Trade Law (UNCITRAL) and the Asian Development Bank (ADB).

The IMF Report

64 Although acknowledging that there is variation between the insolvency laws of different countries this report[72] identifies two overall objectives that are generally shared by most systems:

- *The allocation of risk among participants in a market economy in a predictable, equitable and transparent manner.*

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70 *Priority Debts*, above n2, paras 188-196 and 257.

71 P Heath "Developing an Insolvency Infrastructure – A Commentary on Cross-Border Insolvency Issues" (unpublished paper delivered at the Chinese Insolvency Law Symposium, University of Hong Kong, Faculty of Law and the Asian Institute of international Financial Law, Hong Kong 17 – 18 November 00, 15) <http://www.lawcom.govt.nz/speeches/cbipercent20phqcpercent> ["Heath: Infrastructure"]. An example of standards in relation to cross-border insolvency can be found in the UNCITRAL Model Law on Cross-Border Insolvency discussed in the New Zealand Law Commission's report on cross border insolvency (above, n2).

72 IMF, above n35, 6-11.

The achievement of this objective is crucial to providing confidence in the credit system. Relevant risk allocation rules must be clearly specified in the law and must be consistently applied by those charged with implementing them. The collective nature of insolvency proceedings provides a mechanism that will provide for the equitable treatment of all creditors in an orderly fashion. For transparency in insolvency proceedings interested participants must be given sufficient information for them to exercise their rights under the law.

- *To protect and maximise value for the benefit of all interested parties and the economy in general.*

  This objective is most obviously pursued during rehabilitation but is also a primary objective of procedures that liquidate enterprises that cannot be rehabilitated.

65 The IMF report notes that some of the key policy choices to be made when designing an insolvency law relate to how the above objectives are balanced against each other. Choices also need to be made as to the beneficiaries of the value that is maximised. Some countries view rehabilitation procedures as a way to enhance the creditors' claims, others see it as giving the shareholders and managers of the debtor company a second chance, and still others regard the continuation of the enterprise as primarily benefiting the employees.

66 Under the heading of general features the report notes that insolvency procedures generally require two elements:

- A legal framework setting forth the rights and obligations of participants both substantively and procedurally; and

- An institutional framework that will implement these rights and obligations.

Since the adjudication of disputes is a judicial function, the IMF opines that insolvency proceedings should be conducted under the authority of a court of law where judges will decide disputes on factual issues and interpret the law. The IMF points to the need to appoint qualified professionals (liquidators and administrators) designated to handle administrative matters[73] as part of the institutional infrastructure.

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[73] For example, the recording of assets and liabilities, the realisation of assets and the distribution of proceeds and an evaluation of the management of the enterprise.

67 The question of discretion is raised. To what extent should the court and designated officials have the authority to make decisions on economic and business matters, in some case over the objections of creditors? The report states that

> The greater the discretion that the law confers upon the court and the designated officials the greater the need there is for an adequate institutional infrastructure. Countries that give their judges such a key role in the decision-making process often find it necessary to establish a specialised court system…In cases where the judges do not have such experience , countries often prefer to rely on qualified liquidators or administrators – or the creditors themselves – to make these decisions.[74]

The World Bank

68 The World Bank, in its consultation draft,[75] noted that "There is widespread agreement on the main objectives and principles of an effective insolvency regime" and adopted the list of objectives formulated by the G22 Working Group on International Financial Crises.[76] The list is reproduced below:[77]

- Maximise the value of a firm's assets by providing an opportunity to reorganise;
- Strike a careful balance between liquidation and reorganisation;
- Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors;
- Provide for timely, efficient and impartial resolution of insolvencies;
- Prevent the premature dismemberment of the debtor's assets by individual creditors seeking to obtain quick judgments;
- Provide a procedure that is transparent and contains incentives for gathering and dispensing information;

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74 IMF, n 35, 11.

75 World Bank, above n36, 9.

76 G-22 Working Group *Report on International Financial Crisis* (October 1998) 16 and 44-45 <http://www.imf.org/external/np/g22/>.

77 Also adopted in United Nations Commission on International Trade Law *Possible Future Work on Insolvency Law: Note by the Secretariat* (September 1999) ["UNCITRAL:Future Work"].

- Recognise existing creditor rights and respect the priority of claims with a predictable and pre-established process; and

- Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

69 In relation to maximising asset values, the World Bank observed that this is a pivotal objective of the overall insolvency process. In its view appropriate incentives should be provided to all stakeholders to maximise economic values. Maximising value may require the operation of the business pending its sale as an entire unit or merely to preserve the value of the assets. This objective raises issues as to the balance to be struck between

- rapid liquidations and rehabilitation efforts;

- whether further investment should be made to preserve or improve value, the effect of these actions on stakeholders;

- the extent of discretion available to officeholders and the extent to which creditors should be allowed to monitor activities.

70 The trend towards rehabilitation is described as an extension of the goal to maximise value on the basis that the sum of the whole is greater than the parts. This is achieved through a moratorium for a brief period to stabilise the business and to determine if it can be rehabilitated.

71 Next, the World Bank addresses the importance of properly balancing policies and points out that the design of insolvency law is influenced by the selection and balancing of numerous policy objectives pertaining to a variety of goals, rights and interests. It asks:

> …should bankruptcy law promote discipline and seek to weed out the inefficient and incompetent market players? Or should it be tolerant; and would tolerance promote a more enterprising business spirit on the basis that people will take more entrepreneurial risks? Should the law be pro-debtor ("debtor friendly") or pro-creditor ("creditor friendly") and what do these ambiguous labels mean? Should the law have a wider social or collective purpose or should it rather aim to achieve a just and reasonable resolution of the individual competing interests? For example, should the law seek to protect employment? Should it be aimed at encouraging investment capital?

> Should it be biased towards rehabilitation to shield the economy from systemic collapses which are not the fault of management?[78]

This section of the World Bank's report concludes by referring to the need for insolvency law to be reappraised at regular intervals to ensure that it is in touch with current social needs. It acknowledges that while the custodians of legal revision should aspire to internationally regarded standards of best practice:

> …they must necessarily have regard to the practical realities of the system itself, and the human and material resources that are currently available. The final choice may therefore be a reflection of what is realistically attainable within the system in question under prevailing circumstances, while at the same time aiming for optimal utilisation of available resources.[79]

The ADB Report

72 The ADB report[80] identifies the "key elements" of a rehabilitation process and lists the theoretical requirements for laws governing rehabilitation.[81] Three propositions are put forward:[82]

1. It is of critical importance to the modern rehabilitation process that the opportunity, whether prompted by possible sanction or encouraged by possible benefit, should be available to a debtor in financial difficulty to commence the process before it is too late.

2. It is critical to the modern rehabilitation process that attempts by creditors, whether secured or otherwise, to intervene upon the process and pursue their independent individual rights should be restrained , by automatic operation of the legislation, as far as possible.

3. While, in a market based economy, liquidation and rehabilitation should not be the subject of political or government influence or intervention, the presence of some exceptional economic, social or other such circumstances might sometimes justify a special process and the involvement or

78 World Bank, above n36, 11.

79 World Bank, above n36, 11-12.

80 Asian Development Bank *Law and Policy Reform at the Asian Development Bank: RETA 5795* (April 2000) ["ADB"].

81 ADB, above n80, paras 37–39 and 43.

82 ADB, above n80, paras 44–46.

intervention of Government; eg where the banking sector is itself in financial difficulty.[83]

[83] See the commentary on these propositions set out in Heath: Infrastructure, above n71.

4.

Contemporary New Zealand Society

NEW ZEALAND ECONOMY – PRE 1984

73 Until the United Kingdom joined the Common Market in 1973 the New Zealand economy had been based on a restricted range of agricultural products which were exported, mainly, to the British market. Export produce consisted, primarily, of wool, meat and dairy products. Once the transitional arrangements consequent upon Britain's entry into the Common Market began to run their course, New Zealand found itself subject to many external influences from which, to that time, it had been protected.

74 New Zealand's terms of trade decreased by 40 percent between 1973 and 1975.[84] In addition, as a result of the first oil shock of 1973, the price of oil quadrupled. The resulting rise in the cost of imported fuels, imported industrial goods and transport was accompanied by the decline in returns for agricultural commodities as a result of the British entry into Europe.[85] After the second oil shock in the late 1970s it became necessary for New Zealand to abandon its traditional protectionism.

75 The failure to adjust the structure of the New Zealand economy to changing external conditions was noted as one of the five specific examples of poor economic management in briefing papers to new Ministers published after the foreign exchange crises of July 1984 which followed the election of the new Labour Government.[86] Fox and Walker note that:

> Rather than adjusting, the Government had increased its overseas debt in an unsuccessful attempt to cushion the domestic economy from the impact of declining terms of trade in the 1970s. In retrospect, we can view this criticism as an

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84 New Zealand Planning Council *Planning Perspectives* (1978-83) 30.

85 See the discussion of this topic in B Gustafson *His Way, A Biography of Robert Muldoon* (Auckland University Press, 2000) 242.

explicit official recognition that the domestic economy should be responsive to change in the international economy. Such recognition was a powerful driver in the liberalisation of the New Zealand economy post 1984.[87]

NEW ZEALAND ECONOMY – POST 1984[88]

76 In the nine months which followed the election of the new Labour Government, a series of events occurred which transformed New Zealand from one of the most heavily regulated economies in the western world to one of the least regulated economies. The Economic Stabilisation Act 1948 had been used for many years to regulate most sectors of the New Zealand economy by executive order. The regulation making powers contained in s 11 of the Act were widely framed. The Governor-General was allowed to make such regulations as appeared to him necessary for the economic stability of the country. The courts had held that a regulation promulgated under the Act was not *ultra vires* unless it could not reasonably be considered necessary or expedient for the economic stability of New Zealand or if it was unrelated to the purposes of the Economic Stabilisation Act.[89] By early 1984, interest, rents, prices and wages had all been frozen by regulations passed by the Government under the Economic Stabilisation Act.

77 By 31 March 1984, the total public debt of New Zealand was approximately $21.9 billion, a sum equal to 64.7 percent of the gross domestic product.[90] Of the total public debt $9.4 billion was owed externally in foreign currency.[91]

78 One of the first steps taken by the new Government was to devalue the New Zealand dollar by 20 percent in order to stem the massive out flow of foreign exchange during the period between the announcement of the election and the election itself. The freeze on interest rates was lifted almost immediately; controls on wages, prices and rents were also subsequently removed. By 2 March 1985 New Zealand had floated its dollar on the

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86 New Zealand Treasury *Economic Management* (1984).

87 M Fox and G Walker "Sharemarket Ownership and Securities Regulation in New Zealand" (1997) 17 NZULR 402, 402-403.

88 Much of this section of this report is taken from P Heath "Consumer Bankruptcies: A New Zealand Perspective" (1999) 37 Osgoode Hall LJ 427, 431-433 ["Heath: Consumer Bankruptcies"].

89 For example, *New Zealand Shop Employees Industrial Association of Workers v Attorney-General* [1976] 2 NZLR 521, 529 and 535 (CA).

90 New Zealand Treasury, above n86, 81.

91 New Zealand Treasury, above n86.

foreign exchange market. Ultimately, the Economic Stabilisation Act itself was repealed in 1987.[92]

79 The economic reforms of the Labour Government were complemented by other reforms which drastically changed the shape of New Zealand society. The public service was overhauled.[93] The banking system was reformed.[94] Structures used to operate ports and the energy sector were reformed.[95] State Owned Enterprises were created to replace State controlled trading entities; the intention being that State Owned Enterprises would run their affairs with a view to profit for the Government as shareholder.[96]

ECONOMIC RELATIONS WITH AUSTRALIA

80 In July 1979 some of the controls on foreign ownership of New Zealand companies had been removed and the amount of private overseas investment which was permitted before Government approval was required was raised.[97] These changes had the effect of encouraging greater foreign investment in New Zealand.

81 In December 1982, after lengthy negotiations, the governments of Australia and New Zealand signed the Australia and New Zealand Closer Economic Relations Trade Agreement (ANZCERTA, or CER for short). The trading relationship between Australia and New Zealand is significant. There are at present over 300,000 New Zealanders living in Australia and 50,000 Australians who are resident in New Zealand. Well over 1,000,000 Australians and New Zealanders cross the Tasman in short term visits each year.[98] Australia is New Zealand's most important trading partner and New Zealand, in turn, is Australia's largest market for manufactured exports.[99]

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92 Economic Stabilisation Act Repeal Act 1987, s 2.

93 State Sector Act 1988.

94 Reserve Bank of New Zealand Amendment Act 1986; subsequently consolidated by the Reserve Bank of New Zealand Act 1989.

95 Port Companies Act 1988 and Energy Companies Act 1992.

96 State Owned Enterprises Act 1986.

97 Discussed by B Gustafson, above n85, 273. The criteria for making applications to facilitate foreign investment in New Zealand were set out in the Overseas Investment Act 1973 and in regulations made under that statute. In addition, there were stringent controls on the amount of farm land which could be acquired in New Zealand; particularly by overseas investors: Land Settlement Promotion and Land Acquisition Act 1952, particularly Parts 2 and 2A which were repealed by s 15 of the Overseas Investment Amendment Act 1995.

98 Statistics New Zealand *New Zealand Official Yearbook 2000* (David Bateman Ltd, Wellington, 2000) 66 ["Yearbook 2000"].

99 Yearbook 2000, above n 98.

82 Complete free trade in goods was achieved five years ahead of schedule on 1 July 1990. It is important for New Zealand and Australia to work together given the large amount of business that is done on both sides of the Tasman by businesses operating in one country or the other. This is a significant factor to be taken into account when developing insolvency laws for New Zealand.[100]

THE CONSEQUENCES OF CHANGE[101]

83 Economic, social, political and technological changes and advancements over the last quarter-century have wrought a distinctively New Zealand people from global origins, ideas and forces.[102]

84 Individual regions within New Zealand face reduced access to and involvement in economic opportunities and employment as well as a reduced ability to absorb and deal with change.[103]

85 Most of New Zealand's new investment capital comes from offshore. New Zealand also has very low levels of investment compared with other OECD countries and private investment is particularly low; it is suggested that some of this may be a logical consequence of a growing share of New Zealand's large firms being part of internationally networked organisations with centralised research elsewhere.

86 New Zealand's production and income have shown different rates of growth over the last few years with national income rising by less than gross domestic product. It is suggested that this is the result of increasing payments of dividends and interest to those who have invested or lent money in New Zealand. Thus, a growing proportion of income generated

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100 In the years ending in July 1999 and 2000, $4908 million and $5553 million worth of exports respectively left New Zealand for destinations in Australia. In return, New Zealanders imported $5453 million and $6943 million worth of goods respectively for the same period. Looking at the July 2000 figures there are significant gaps between the value of exports to and imports from Australia compared with our second largest trading partner, the United States. In the same period goods valued at $3025 million and $3797 million respectively were exported to the United States, with $4269 million and $5241 million being imported from the United States: see the table of major trading partners set out in appendix A to New Zealand Law Commission *International Trade Conventions: SP5* (Wellington, November 2000) 53.

101 We are indebted to the introductory essay to the *New Zealand Official Yearbook 2000* by the former Government statistician, Mr Len Cook in preparing this portion of our paper: see Cook, "Looking Through the 20th Century" in Yearbook 2000, above n 98, 1 – 3.

102 Cook, above n101, 1.

103 Cook, above n101, 3.

by New Zealand economic activity is flowing overseas. New Zealand's balance of payments deficit has increased every year since 1994.[104]

87 There remain, nevertheless, some realities of life in a small country which must be accepted. Two examples follow:

(a) In his autobiography, the then Prime Minister, Rt Hon James Bolger, referred to the problems facing the Bank of New Zealand which had been drawn to his attention following the 1990 General Election. Mr Bolger tells of a meeting with senior officials at which he was told that the Bank of New Zealand, which had to issue its six monthly statement within a few days, was insolvent and that the incoming Government would have to take steps to bail it out. Mr Bolger states that his initial reaction was to let the Bank of New Zealand crash. But, as one of the senior advisors told the Prime Minister, the Bank of New Zealand had around 40 percent of the commercial market in New Zealand on its books and if the bank became insolvent the domino effect would be severe.[105] Some businesses are too big to be allowed to fail.

(b) Over the past few years one company, Telecom Corporation of New Zealand Limited, has accounted for between 20 percent and 29 percent of the total sharemarket capitalisation in New Zealand.[106] Furthermore, information gathered by Fox and Walker suggested, in 1997, that the ownership structure of the New Zealand sharemarket had changed dramatically with individual ownership declining and corporate and institutional ownership increasing. It is likely that this trend will continue as, increasingly, New Zealand becomes what has been referred to as a "branch-office economy".[107]

88 The lessons, for those devising insolvency laws, from these realities of life are that, in a small economy,

- sufficient options must exist to address likely problems and

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104 Cook, above n 101, 3.

105 J Bolger, *A View from the Top* (Viking, 1998), 37.

106 "Business Herald " New Zealand Herald, Auckland, 24 January 2001, E1.

107 The Weekend Australian, 10-11 February 2001, 1. This observation was made in the context of concerns in Australia that in the next five to 10 years scores of companies will move offshore.

- incentives for serious problems must be provided to ensure that financial distress is confronted at the earliest possible time.

It is with those thoughts in mind that we have approached our consideration of business rehabilitation issues; particularly in the context of larger businesses or those which have a strategic importance, whether as a part of the infrastructure of New Zealand or otherwise.

OTHER IMPORTANT ASPECTS OF CONTEMPORARY NEW ZEALAND SOCIETY

89 New Zealand has a small population (estimated at 3.8 million people as at 31 December 1999) and a consequentially low tax base. Unlike some other economies of similar size,[108] New Zealand is also geographically isolated from its major trading partners. Problems caused by time differences and the distances to be travelled to reach trading partners create problems for a society which is reliant on exports for much of its income. The twin problems of time and distance may well be reduced in coming years through the advent of electronic commerce,[109] but the extent to which those difficulties are overcome in that way will need to be carefully monitored.

90 Credit cards were not introduced into New Zealand until 1981. Nevertheless, in the period between 1988 and 1999 the total value of credit card sales in New Zealand increased from about $2.6 billion in 1988 to about $6.29 billion in 1999.[110] Credit cards, electronic funds transfer at point of sale (EFTPOS) and telephone banking have become important features of contemporary New Zealand society. While the number of operating bank branches dropped from 1,447 in 1995 to 976 in 1998 the number of automatic teller machines rose from 1,419 to 1,521 in the same period.[111] It is estimated that over 1.9

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108 For example, Scotland (discussed in Part 3 Business Rehabilitation of this paper).

109 Generally, see the Electronic Transactions Bill currently before Parliament. See also, New Zealand Law Commission *Electronic Commerce Part 1: A Guide for the Business and Legal Community: R50* (Wellington, October 1998), *Electronic Commerce Part 2: A Basic Legal Framework: R58* (Wellington, November 1999) and *Electronic Commerce Part 3: Remaining Issues: R68* (Wellington, December 2000).

110 Yearbook 2000, above n98, 512; see also Statistics New Zealand *New Zealand Official Yearbook 1998* (GP Publications, Wellington, 1998) 507.

111 Yearbook 2000, above n98, 561.

million credit cards are on issue nationally in New Zealand.[112] Many of the banking changes followed deregulation of the banking sector in 1986.[113]

91 The level of international investment in New Zealand outweighs the level of New Zealand investment abroad. In Statistics New Zealand, in March 1998, noted that on a balance sheet presentation basis, New Zealand owed the rest of the world $137.5 billion and had claims on the rest of the world of $48.0 billion.[114] Similarly, in May 1998, overseas investors represented 61 percent of the value of New Zealand's sharemarket. Ninety five percent of registered banks operating in New Zealand were foreign owned. For these reasons, it is necessary for New Zealand to have regard to global trends in insolvency law when developing its domestic insolvency infrastructure.

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112 Yearbook 2000, above n98.

113 Generally, see Reserve Bank of New Zealand Amendment Act 1986 and the subsequent Reserve Bank of New Zealand Act 1989.

114 Statistics New Zealand *International Investment Position: 31 March 1998* 1.

5.
Commercial Law Framework

92 Creditors who hold securities or charges over assets of an individual or corporate debtor stand outside the insolvency regime in New Zealand.[115] Thus, there is a strong secured creditor culture in New Zealand which must be recognised when determining the shape of future insolvency laws. Care must be taken to avoid making changes to insolvency laws which could result in a decrease in the availability of credit or an increase in the cost of credit, particularly from secured lenders.[116] In particular we refer to the common practice whereby primary lenders will take a debenture over the undertaking of a business operated by a company which is then, when a closely held company is involved, usually supported by personal guarantees from shareholders.

93 When New Zealand's markets were deregulated following the events of 1984, laws designed to encourage competition and discourage the use of monopoly practices were enacted.[117] The Commerce Commission is the body charged with enforcement of these competition laws.

94 The Securities Act 1978 was passed to facilitate capital investment in New Zealand. The Act was a response to a fall in investor confidence as a result of the collapse of Securitibank Limited in 1976.[118] The role of the Securities Commission is to promote the

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115 Insolvency Act 1967, s 3 and Companies Act 1993, s 305. See also *Re H* [1968] NZLR 231, 237, 240 (CA).

116 We are aware of extensive academic literature in the United States which has suggested that there may be a case to remove the priority of secured claims in bankruptcy. In particular, we refer to Bebchuck and Fried "The Uneasy Case for the Priority of Secured Claims in Bankruptcy" (1996) 105 Yale LJ 857 and the other articles collected in fn 23 of that article. See also, in particular, Mann "Explaining the Pattern of Secured Credits" (1997) 110 Harv L Rev 626. We have not addressed this literature for two reasons: first, we have been asked to report on the assumption that secured credit will continue to stand outside the insolvency regime; second, in any event, the literature in the United States seems to be based on the fact that, under the US Bankruptcy Code 1978, a secured creditor is prohibited from exercising both its right to compel repayment of the debt and repossessory rights upon intervention of bankruptcy – a completely different position to that which pertains in New Zealand. See Bebchuck and Fried, 861, 904.

117 Commerce Act 1986 and Fair Trading Act 1986.

118 The events leading up to the demise of this company are recorded in the judgment of Barker J in *Re Securitibank Limited* [1978] 1 NZLR 97, 108-117. See also Grant *Bulls, Bears and Elephants: A History of the New Zealand Stock Exchange* (VUP, Wellington, 1997) 243 – 244.

efficiency of New Zealand's securities markets; enhance the integrity of those markets; promote the cost effective regulation of the markets and to strengthen public and institutional confidence in these markets.[119] As well as regulating the terms on which issuers of securities to the public can be exempted from compliance with certain provisions of the Securities Act, the Securities Commission has a quasi-judicial function in relation to proceedings involving the disqualification of persons from taking part in the management or being directors of a company and in filtering applications from the Registrar of Companies to place a corporation in a statutory management under the Corporations (Investigation and Management) Act 1989.[120]

95 The Credit Contracts Act 1981 provides a self-policing regime to encourage creditors to disclose the proper finance rate in respect of any lending transaction. Provisions also exist under that statute for "oppressive" credit contracts to be reopened by the court. If proper disclosure is not made the credit contract cannot be enforced without the court excusing the default in making disclosure.

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[119] We note a criticism made by Fox and Walker of the Securities Act, in particular, they suggest that a new ownership composition of the market may require a different regulatory choice which has not been addressed by Government. They say: "for example, once we understand ownership composition we can more effectively target regulatory funding. This is critical in New Zealand where the budget for securities regulation is negligible and limited funding impinges on regulatory choice. Thus, in 1996 the market capitilisation of the NZSE was approximately $50 billion, when the principal market regulator, the [New Zealand Securities Commission] had an annual funding of $2.1 million." (above, n 87). We will be addressing the question of regulatory design for an insolvency system later in this report.

[120] See paras 325-327.

6.
Business Operations in New Zealand

96 In 1990 and 1997 respectively surveys of small business operations in New Zealand were published.[121] Those surveys revealed the following information about small and medium sized businesses in New Zealand:

- As at February 1989 82.3% of enterprises operating in New Zealand employed five or fewer people. Enterprises employing between six and nine people totalled 8.3%; enterprises employing 10 to 49 people totalled 7.8%. Thus 98.4% of businesses operating in New Zealand as at February 1989 employed fewer than 49 people.

- In the 1997 survey 84.9% of enterprises operating in New Zealand employed five or fewer people. The number of enterprises employing fewer than 50 people had risen to 98.8% of New Zealand business enterprises.

The survey also tended to dispel the myth that four in five small businesses fail in the first five years. It has been suggested that about half fail in the first five years; but, even that proposition is open to question because many small businesses which stop trading (i.e. are believed to have failed) do so because the proprietor of a profitable business has been bought out or the business has been taken over by a larger entity. On that basis it is conceivable that the number of small business failures in the first five years may be closer to 40% than 50%.

97 In their 1997 article Cameron, Massey & Tweed noted:

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121 Cameron and others "Why Small Business is Important to New Zealand" (November 1990) Accountants' Journal 72 ["Cameron: 1990 article"] and Cameron, Massey and Tweed "New Zealand Small Business: A Review" (October 1997) Chartered Accountants' Journal 4, 9 – 10 ["Cameron:1997 article"]. See also, Ministry of Commerce, *SMEs in New Zealand: Structure and Dynamics* (Wellington, January 2000) <http://www.med.govt.nz/irdev/ind-dev/smes2.index.html>.

The total number of enterprises in 1996, excluding farms, was 225,996. Of these, 85 percent employed five people or fewer.

SMEs accounted for 99.4 percent of all enterprises. Only 1,243 enterprises in New Zealand could be considered "large".

The inescapable conclusion is that the New Zealand economy is overwhelming populated by SMEs.[122]

98 In addition, by adapting statistical information (because of definitional problems) the authors of the 1997 study sought to draw comparisons for the period between 1988 and 1996. The three years chosen for this comparison were 1988, 1992 and 1996. The authors described that choice as deliberate because:

> The 1988 figures were collected before the effects of the sharemarket crash began to bite significantly; the 1992 statistics provide a snapshot of the economy when the recession was at its peak, and the 1996 data is the most recent available.[123]

The comparison demonstrates an increase between 1988 and 1996 of businesses employing five or fewer people of 39 percent. Increases of 8.5 percent and 1.1 percent respectively were noted for businesses employing 6 to 9 and 10 to 49 people respectively. Most notably, however, businesses employing between 50 and 99 people and over 100 people reduced by 10.2 percent and 12 percent respectively over the same period. [124]

99 The predominance of small businesses in New Zealand raises questions about the cost effectiveness of current and potential insolvency regimes. Much attention has been given to this issue overseas.[125] In a New Zealand context what is important is to identify as

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122 Cameron: 1997 article, above n121, 5. The term "SME" stands for small and medium sized businesses.

123 Cameron: 1997 article, above n121, 5 – 6.

124 Cameron: 1997 article, above n121.

125 For example, (a) in the United Kingdom, the Insolvency Act 2000 has just been passed which is aimed at creating a rehabilitation regime which can be used more cost effectively by small to medium sized businesses; but, to qualify as a "small business" two of the three criteria set out in s 247(3) of the Companies Act 1985 (UK) must be met; i.e. (i) turnover must be not more than £2.8 million p.a.; (ii) the total balance sheet assets must be not more than £1.4 million; the business must not employ more than 50 employees; and (b) in the United States of America the National Bankruptcy Review Commission noted that evidence collected by the *Working Group on Small Business, Partnerships and Single-Asset Real Estate* suggested two distinct categories of small business cases under chapter 11 of the United States Bankruptcy Code. The first consisted of the relatively small proportion of cases in which the debtor had a reasonable likelihood of confirming a plan and succeeding as a going concern; the second consisted of the much large proportion of cases in which there was no reasonable prospect of rehabilitation – the Commission indicated that for that group of cases the primary goal was to reduce the amount of time consumed in Chapter 11: See

precisely as possible the type of business which will justify the cost of undertaking a viability assessment (with the consequential creditor negotiations) to determine whether it is or is not capable of salvage. That is an issue which we address in some detail when discussing business rehabilitations.[126]

100 In our view, it is important to shape a regulatory regime, for insolvency law purposes, to deal with the fact that less than 1 percent of all enterprises trading in New Zealand could be regarded as "large".[127] This approach impacts on recommendations we are making in relation to both the role of the state and business rehabilitation.

Report of the National Bankruptcy Review Commission *Bankruptcy: The Next Twenty Years* (October 20 1997) 609.

126 See paras 240, 255 and 260.

127 Cameron: 1990 article, above n121, 72 and Cameron: 1997 article, above n121, 5.

7.

Causes of Business Failure

101 Little empirical research has been carried out in New Zealand into business failure.[128] There is a recent unpublished dissertation by Pinfold.[129] The paper contains detailed information concerning business failure rates in New Zealand, which is broadly consistent with the studies summarised in the article by Cameron, Massey, and Tweed.[130] But it does not address in detail the causes of business failure.

102 There are four main sources of empirical data which we will briefly outline:

- an early assessment of some of the information gathered from a study of business bankruptcy in the United States by Professors Warren and Westbrook;[131] and

- a recent study of business failure published by the Productivity Commission of the Australian Federal Government.[132]

- A brief summary of empirical data collected by the Office of the United States Trustee in relation to debtors who have filed in bankruptcy under the liquidation regime contained in Chapter 7 of the Bankruptcy Code 1978 (US).[133]

- Information which we have collected from 12 insolvency practitioners throughout New Zealand. This information was designed to ascertain whether there were any

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128 See the references collected in Cameron: 1997 article, above n121.

129 J Pinfold "Evaluating the Risk of Ruin: A Critical Evaluation of New Venture Risk and Return" (unpublished dissertation for Doctor of Philosophy , Massey University, 1999).

130 Cameron: 1997 article, above n 121, 9-10. Cameron in fact refers to Pinfold's research, and the information collected by Statistics New Zealand, which Pinfold relies upon.

131 Warren and Westbrook "Financial Characteristics of Businesses in Bankruptcy" 73 Am Bankr LJ (1999) 499.

132 Productivity Commission *Business Failure and Change: An Australian Perspective* (Aus Info, Canberra, December 2000).

133 Flynn and Bermant "How Fresh is the Fresh Start?" (December 2000/January 2001) Vol xix, No 10 American Bankruptcy Institute Journal 20.

real problems apparent to those practitioners from the inability to obtain a stay against secured creditors when proposing a compromise arrangement involving a business enterprise, whether primarily a company operating under the Companies Act 1993. The responses to our questions also address some issues involving statutory management.[134]

103 Warren and Westbrook have sought, among other things, to evaluate the extent to which personal difficulties have caused business bankruptcies. The initial indication from the research is that personal factors have much more to do with business insolvency than is sometimes thought. Warren and Westbrook report that about 3 out of every 20 (17 percent) of so called business bankruptcies appear to be initiated because of a personal problem of the business owner; examples given are:

(a) bank reluctance to refinance a business because of continuing matrimonial property issues;

(b) inability to control blood glucose levels, cholesterol levels, etc due to the stress of dealing with creditors;

(c) problems caused by the need for a proprietor to look after an ill spouse;

(d) a gas explosion;

(e) a decision by a State Government to tear up a road on which the business was located;

(f) the death of a foreman; and

(g) the van used by the business was stolen and the business could no longer transport equipment necessary to carry on business.[135]

104 The link between personal difficulties and business failure is apparent from some of the examples cited. Other examples demonstrate thin margins on which businesses can operate. Others demonstrate how much reliance can be placed by businesses on key people. Yet again there is the critical element of bad luck, such as the gas explosion

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134 We reproduce the letters sent to insolvency practitioners at appendix A. The conclusions which we drew from the responses are summarised at para 227.

135 Warren and Westbrook "Financial Characteristics of Businesses in Bankruptcy" 73 Am Bankr LJ 499, 560 – 561.

which destroyed the business. Nevertheless, it is important to recognise that the linkage between personal difficulties and business failure may be greater than anticipated.

105 The Staff Research Paper prepared for the Productivity Commission of Australia notes that entry and exit of businesses are an important part of a dynamic market economy. It states:

> …despite its potentially costly consequences for the parties affected by business failure, there are often broader economic welfare gains stemming from the effect of failure on product efficiency and incentive. That said, this does not imply that the set of behaviours that bankruptcy penalises (such as poor bookkeeping, failure to set aside funds for employee liabilities and lack of business planning) should not be investigated and addressed.
>
> The set of entrepreneurial practices and characteristics that are associated with success or failure may be affected by Government regulations or the target of Government programs.[136]

106 The Australian research suggests that the causes of business related bankruptcies during the 1998 – 1999 period could be broken down into the following percentages:

- Economic conditions 15 percent
- Lack of business acumen 12 percent
- Lack of capital 10 percent
- Excessive interest costs 7 percent
- Excessive drawings 4 percent
- Inability to collect debts 4 percent
- Failure to keep proper books 2 percent
- Other causes 47 percent[137]

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136 Productivity Commission, above n132, 49.

137 Productivity Commission, above n132, 50; the source of these statistics is stated to be the Annual Report of the Inspector-General in Bankruptcy, 1998-1999.

107 The Australian data also reveal that about 7.5 percent of all businesses cease operations each year. Of those businesses, 1.5 percent change ownership and continue while 6 percent cease to operate in any form. Of the 6 percent which cease to operate in any form:

- 0.5 percent are bankruptcies in liquidation;
- 2 percent are solvent but have insufficient returns;
- 3.5 percent are solvent but exit for reasons unrelated to the financial position of the business.[138]

108 A survey was carried out by the Office of the United States Trustee using data from 1,269 cases which had been closed as "no asset" Chapter 7 (liquidation) cases from about 60 different judicial districts throughout the United States. Most cases had been filed in early to mid 2000. The survey discovered:

- Almost 90 percent of all Chapter 7 no asset debtors had a negative net worth at the time of bankruptcy. The average net worth was -$US36,623. The net worth for the median debtor was -$US20,951.
- Seven of the debtors had net worth of more than $US100,000. This tended to be through one of two things: either

  (a) a large equity in a home, or

  (b) large retirement funds.

  On closer analysis, this group included two retired widows, a permanently disabled debtor, a separate couple who filed jointly and a separated male and a separate female. The remaining case involved a low income working married couple who had $US218,000 in retirement accounts.[139]

109 Given current Government policy of encouraging citizens to save for their retirement, these findings are of some importance in relation to issues on which our views have not been requested. In particular, we refer to the contrasting macro-economic goals of

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138 Productivity Commission, above n 132, xviii.

139 Flynn and Bermant, above n133, 20.

encouraging spending to stimulate the economy while encouraging thrift to provide business investment and savings for retirement.[140]

[140] Generally, see Heath: Consumer Bankruptcies, above n88, and P Heath and J Maxton "Superannuation Schemes and Insolvency" (1997) 3 NZBLQ 43.

PART 2
ROLE OF THE STATE

8.
An Overview

110 What is the Role of the State in the insolvency law system? We have been asked to express views on the appropriate roles to be performed by the State (that is, the legislative, executive and judicial branches of Government) as part of a functioning insolvency law system in New Zealand. We go on to discuss particular problems raised by our research and consultation and to suggest possible solutions to those problems.

111 Both the IMF and the World Bank have placed great emphasis on the need to provide a regulatory framework which will provide the most efficient, effective and fair outcome to those for whose benefit an insolvency system exists. They have also stressed the need for impartiality and competence on the part of those who administer collective insolvency regimes.[141] The World Bank consultative draft notes that:

> With an increasing awareness of the important role of insolvency in wider economic policies and the increasing emphasis on promoting business rescue and reorganisation, there is an increasing demand on the knowledge and skills of office holders. That is to say, the inevitability of financial failures is no longer followed by automatic assumptions of bankruptcy/liquidation, business close down, asset break up and dissolution. That knowledge and those skills need to be evident to provide the basis of appointment as office holder, through a framework which tests competence and provides assurance that the office holder will act professionally and impartially to secure the optimum outcome. While there are clearly costs to be borne in maintaining a regulatory framework, these must be weighed against the benefits in providing a system that is efficient and effective and in which the public can have confidence.[142]

112 The reason why there is a need for some form of regulation of those who conduct collective insolvency regimes was succinctly stated by the United States Congress when the House of Representatives reported on the passage of the Bankruptcy Code which was enacted in 1978. The Congressional statement said:

> The practice in bankruptcy is different for several reasons. First there is a public interest in the proper administration of bankruptcy cases. Bankruptcy is an area

141 IMF, above n35, 11, 76 – 80; World Bank, above n 36, 55 – 62.

142 World Bank, above n 36, 55.

> where there exists a significant potential for fraud, for self dealing, and for diversion of funds. In contrast the general civil litigation, where cases affect only two or a few parties at most, bankruptcy cases may affect hundreds of scattered ill-represented creditors. In general civil litigation, a default by one party is relatively insignificant, and though judges do attempt to protect parties' rights, they need not be active participants in the case for the protection of the public interest in seeing disputes fairly resolved. In bankruptcy cases, however, active supervision is essential. Bankruptcy affects too many people to allow it to proceed untended by an impartial supervisor.[143]

113 The question of regulatory choices assumes some importance in New Zealand. New Zealand's small population and the low tax base can be regarded as disadvantages to a small economy in developing a complex institutional infrastructure. For example, it is a disadvantage to have a small pool of experienced insolvency professionals, judges and lawyers. The challenge for the New Zealand Government is to develop an infrastructure in which the public and business community can have trust and confidence, while not creating a complex and inefficient bureaucracy that is costly to maintain.

114 But, the disadvantage of the small pool of specialist insolvency practitioners is, to an extent, offset because those practitioner are well known throughout the country and tend to be regarded as credible by major creditors. The experience of dealing consistently with the same people is not necessarily reproduced in larger centres throughout the world. However this advantage must be qualified: while experienced insolvency practitioners have credibility and are well known to major creditors, they are not so well known to small creditors or to debtors who need their assistance. In policy terms, there is a problem with information assymetry.[144]

115 Our approach to designing a regulatory framework has been to take the World Bank and IMF suggestions as a starting point, and then to assess which functions are truly public in nature. In our view those functions *must* be performed in the public sector in order to ensure the level of trust and confidence required to make the insolvency system function. We have then considered what incentives can be developed to encourage both debtors and creditors to supplement that regulatory framework. A key element of our thesis is the need to encourage debtors to face their creditors at the earliest possible time so that, in turn, creditors can exercise proper judgment as to the likely economic outcome of proceeding under a particular insolvency regime. Creditor decisions should be made at a time when what ought to be objective business decisions are not clouded by mistrust or

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143 HR Rep No 95-595, 95th Cong., 1st Sess at 88 (1977) (congressional statement on passage of new US bankruptcy law in 1978).

144 See further para 123(f).

antipathy toward a debtor who has failed to disclose problems sufficiently early to prevent further loss to creditors.

116 We bear in mind also the 1998 *Guidelines for Setting Charges in the Public Sector*[145] were set by Cabinet to ensure consistency in cost recovery in the operation of the "user pays" principle of public finance. Consistent with those Guidelines, our starting premise is that functions which are truly private in nature should be paid for out of funds which would otherwise be available for distribution among creditors, while public functions should be performed by public officials and paid for by public funds appropriated for that purpose. In determining those functions which ought to be undertaken by the public sector and paid for out of taxpayer monies, we have had regard to the principles upon which the insolvency law review proceeds.[146]

117 We close these introductory remarks by referring to some observations of particular relevance to the New Zealand context which we are addressing. First, we refer to Professor Westbrook's admonition that:

> The choices made in reforming an insolvency law must be closely linked to the capacities (and institutional prejudices) of existing institutions or institutional reform must accompany legal reform.[147]

118 Second, we refer to comments made by Fox and Walker (in the content of securities law) about regulatory choices which we believe are equally applicable in the context of insolvency law:

> Regulatory choices should be assessed differently if the bulk of trading investors are small, unsophisticated investors rather than large, sophisticated, and financially robust corporations.[148]

119 Third, we refer to two aspects of the World Bank's Consultative Draft.[149] They are:

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145 Cabinet Strategy Subcommittee on Expenditure Control and Government Administration *Guidelines for Setting Charges in the Public Sector* (8 December 1998 EXG (98) 189). In particular Guideline 3 requires an analysis of outputs and outcomes for identifying options for cost recovery, and Guideline 4 uses this analysis to identify who to charge, for example those who benefit from the output and risk exacerbators.

146 See para 52.

147 Westbrook: Globilisation, above n42, 413.

148 Fox and Walker, above n87.

149 World Bank, above n36, 55.

(a) The process of insolvency affects an array of private and public interests. Therefore, it is important for those responsible for the administration of collective insolvency regimes to be subject to a system of regulation which

- will assure the integrity of the overall process; and
- identify threats to that integrity and have the authority to correct systemic problems that arise.

The regulatory system should also ensure that

- cases proceed with due despatch;
- the process complies with applicable law; and
- all professionals involved in the case comply with relevant ethical standards.

(b) The hallmarks of a properly regulated system are:

- clarity
- transparency and fairness
- predictability and accountability

120 We believe that all of these points must be addressed in determining an appropriate regulatory regime for insolvency law in New Zealand.

9
The Issues

121 From what we have discussed to date, we believe it is uncontroversial to assert that effective implementation of insolvency law will involve:

- proper and timely enforcement of duties affecting commercial morality;

- an honest, ethical and efficient administrative regime which can carry out regulatory obligations diligently;

- office holders with experience and integrity who are able to carry out impartially and efficiently the duties cast upon them on behalf of all creditors; and

- courts which have sufficient expertise and time to deal adequately with disputes that arise and which, in the way in which they function, can provide an adequate degree of predictability as to the way in which the law will be interpreted and applied in practice.

122 All of those functions bear directly upon the degree of trust and confidence that the commercial community (and the community at large) have in the proper working of an insolvency system.[150] It is necessary to consider whether, in New Zealand, the various administrative and judicial bodies which give effect to insolvency law do, in fact, provide the necessary degree of trust and confidence.

123 As a result of consultation undertaken in the preparation of this report a number of problems have been identified:

(a) A lack of trust and confidence within the commercial community caused by the belief that there is neither proper nor timely enforcement of duties

[150] IMF, above n35, 4-5.

affecting commercial morality undertaken by public officials within New Zealand charged with those enforcement duties.[151]

(b) Concern about whether there are sufficient regulatory safeguards in place to ensure that only properly qualified and impartial insolvency practitioners are appointed to act as an office holder in a collective insolvency regime,[152]

(c) A concern that, without good reasons, different standards are imposed by the legislature upon private insolvency practitioners and the Official Assignee when each are carrying out duties as a liquidator.[153]

(d) Concerns that legislation governing insolvency is not expressed as clearly as it might be.[154]

(e) Concerns about whether New Zealand has sufficient judicial expertise available to deal promptly with insolvency cases

- if a new rehabilitation regime involving a moratorium on secured creditors' rights were established; and/or

- if the court were given jurisdiction to deal with statutory management cases.[155]

(f) The "information asymmetry" as between major creditors (on the one hand) and debtors and smaller creditors (on the other) about the skill and competence of those offering their services as office holders in collective insolvency regimes.

(g) Concerns about the effective monopoly granted to the Official Assignee to act as office holder in a bankruptcy under the Insolvency Act 1967.

A related problem of transparency arises in relation to the lack of trust and confidence identified in (a) above. The Registrar of Companies and the Official Assignee are both

151 See paras 147-163.

152 In this report we use the term "collective insolvency regime" to define any formal process under which the office holder is obliged to act in the interests of the general body of creditors rather than his or her appointor. See further chapter 13.

153 Companies Act 1993, s 254(b). See further, para 177.

154 An example is Part XV of the Companies Act 1993 to which we refer at paras 223-224, 261-269.

155 See para 164.

statutory officers employed as public servants within the Business and Registries Branch of the Ministry of Economic Development. The New Zealand Insolvency and Trustee Service (which covers the activities of the Official Assignee) operates as a business unit within that Branch. Monies are not appropriated by Parliament for functions of a public enforcement nature; rather, those budgetary decisions are made within the Ministry.[156] We return to this point later.[157]

124 We need to address each of these problems when assessing the various roles which the State should fulfil in an insolvency system. In the chapters which follow, we discuss the Role of the State:

(a) as legislator;

(b) in enforcement of public functions designed to prevent irresponsible commercial behaviour;

(c) as regulator;

(d) as office holder; and

(e) as educator .

125 The State also has a role as creditor. However our view is that when a State agency (such as the Inland Revenue Department) takes action to recover a debt, it is performing a function which is private in nature rather than public. There seems to be support for this view from the approach which is now being taken to the enforcement of revenue debts within common law countries.[158] Our view that the fact that a creditor happens to be a State entity should not require a different approach to enforcement of its debts is consistent with recommendations which we made about Crown priorities in our

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156 See Ministry of Economic Development *Annual Report 2000* (Wellington, 2000) 30, 65, 66 ["MED: Annual Report"].

157 Discussed further at para 194.

158 For example, *Ayres v Evans* (1981) 39 ALR 129, 131 (per Fox J), 140 (per Northrop J). See also *Re Tucker (A Bankrupt) Ex Parte Bird* [1988] LRC (Comm) 995 and *Priestly v Clegg* (1985) 3 SA 955, which should be compared with the previously stated rule of public policy forbidding enforcement of revenue claims across borders: for example *Government of India v. Taylor* [1955] AC 491 and *Peter Buchanan Limited v McVey* [1955] AC 516n. See also, *Cross-Border Insolvency*, above n1, para 149. See also, ss 3 and 3A of the Reciprocal Enforcement of Judgments Act 1934 which allows for judgments from Australian courts to be enforced under the Act, in situations where Australian tax is payable. The corresponding Australian provision is contained in s 3 Foreign Judgments Act 1991 (Cth).

advisory report on priority debts.[159] This approach is also consistent with the views expressed by the Ministry of Economic Development in its recent discussion paper on priority debts, which adopted the Commission's views.[160]

126 As a result of our consultation we are satisfied that there is sufficient anecdotal evidence to justify a conclusion that there is a lack of business confidence in the State's performance of public enforcement duties designed to prevent irresponsible commercial behaviour. The extent of that lack of confidence cannot be assessed accurately without market survey evidence. But, we are of the view that the identified problem is more likely to be solved if the opportunity granted by the insolvency law review is taken to open a public debate (involving the private sector) to develop an institutional infrastructure in which both public and private sectors will have confidence. Our provisional view is that a new regulatory regime is necessary so that a fresh start can be made. But, if the Insolvency and Trustee Service can demonstrate that it has the capacity to meet demands on it for public enforcement the status quo, with some modifications, may suffice. We set out later some thoughts on a new regulatory framework, emphasising that our intention is to focus debate rather than to advocate a particular model to the exclusion of others.[161]

127 We are conscious that many of our recommendations will have fiscal consequences. We are in no position to advise either the Ministry of Economic Development or, more generally, the Government on competing priorities for funding.[162]

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159 *Priority Debts*, above n2; see the recommendations made in chapter 5.

160 Ministry of Economic Development, *Insolvency Law Review: Tier One Public Discussion Documents* (Wellington, January 2001), 82 – 86 ["MED: Tier One Papers"].

161 See para 192.

162 Having regard to the short time available to complete this report, we have not had the opportunity of obtaining independent economic advice on our proposals, or of discussing recommendations with officials from Treasury. We have, however, approached our recommendations on the footing described earlier in this report, that the State does not have unlimited resources to apply in this area and that attention should be focused upon those areas which are likely to derive long term fiscal benefits.

10.
The State as Legislator

128 In para 123(d) we identified a problem arising from perceptions that legislation dealing with insolvency law was not expressed as clearly as it might be. We deal with that problem in this segment of our report.

129 The rules determined by Parliament allocate risk among a collective body of creditors, unless all creditors are bound by an alternative arrangement. The most important difference between rules set by the legislature to address insolvency regimes and other rules which allocate risk is that the allocation of risk, in an insolvency regime, operates on a collective basis so that creditors of equal priority will suffer loss and receive distributions on a rateable basis.[163]

130 The insolvency rules enacted by the State provide a benchmark against which creditors and debtor can negotiate informal arrangements "in the shadow of the law".[164] Where there is unanimity, creditors and debtor can agree, contractually, on a method of resolving any shortfall in the payment of debts. Where there are dissenting creditors an agreement can be given force (assuming that requisite majorities can be obtained) by an application to the court to approve a compromise or a proposal under the relevant terms of current insolvency legislation.[165]

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163 The *pari passu* rule.

164 The importance of a strong liquidation regime to act as a benchmark for informal or formal compromises was stressed at the recent forum for *Asian Insolvency Reform* held in Bali, Indonesia on 7 and 8 February 2001. In particular, this point was addressed in a paper delivered by Mr Ronald Harmer, a consultant to the Asian Development Bank: see also Wee and Harmer "Insolvency Reform in Asian: An Assessment of Recent Developments and the Role of the Judiciary" 13 - 14 and comments made to the Forum by Mr Timothy De Sieno who referred to the relevance, in practice, of the "80/20" rule in this context. Mr De Sieno suggested that the norm should be that 80 percent of problems are solved by informal workout negotiated as a result of applying benchmarking standards derived from legislation, while 20 percent of cases would go to formal resolution through the formal insolvency regimes. These observations were made in the context of Mr De Sieno's experiences in the United States although he indicated that they were still applicable to work he is currently doing in Singapore. See also the discussion on informal workouts at para 241.

165 For example of the Companies Act 1993, Parts XIV and XV, and the Insolvency Act 1967, Part XV.

131 Insolvency laws must also be compatible with the commercial law framework within which New Zealand business operates.[166] The particular emphasis placed on the rights of secured creditors needs to be taken into account in that regard.[167]

132 Legislation should also promote transparency and accountability in the administration of the insolvency system by making the law as clear as possible to minimise conflicting decisions made by judicial (or quasi-judicial) bodies, which may undermine predictability in the application of the law.[168]

133 Ultimately, legislation which is accessible, comprehensible and predictable in its application will:

- Create a climate in which those involved in business can operate in an orderly manner based upon predictable rules;
- Provide a mechanism for collective insolvency procedures where it is necessary to liquidate assets and distribute proceeds among creditors *pari passu*;[169]
- Encourage and provide mechanisms for public officials to enforce, and thereby, promote standards of commercial morality; and
- Provide a set of rules which both the debtor and creditors can use as a benchmark when considering informal arrangements to settle debts on a collective basis.[170]

134 In developing legislation Parliament can encourage consistent application of the law by defining the principles and purposes of particular aspects of the legislation with clarity.[171] Examples of difficulties which can follow from the failure to do so are:

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166 See chapter 5.

167 See, in particular, para 92.

168 Later in this report we conclude that it would be preferable for New Zealand insolvency law to be captured within a single statute. We have come to the view that that would make the law both more accessible and comprehensible: see Part 5, *A Single Statute?* at paras 381-382.

169 In our study paper *Priority Debts* (above n2) we emphasised that the *pari passu* principle (or principle of rateable distribution among creditors of equal priority) was the fundamental principle upon which insolvency law was built. For a discussion of the *pari passu* principle see paras 19-23 of that study paper.

170 See also INSOL International *Statement of Principles for a Global Approach to Multi-Creditor Work Outs* (London, October 2000). See also para 241.

171 Issues of the accessibility and comprehensibility of legislation are discussed in Part 5 of this report, *A Single Statute?*

(a) Claimants who are unsecured in a receivership or a liquidation have sought proprietary remedies so that they can claim rights to particular assets over holders of a debenture or preferential creditors.[172] The difficulty is that appearing before the court may be one particular group of creditors who seem to have suffered badly, yet the court may not have before it all other creditors who may have suffered equally or even more.

(b) Employees have attempted to use either a constructive trust or a restitutionary remedial trust to elevate claims in respect of superannuation contributions paid into the overdrawn general account of their employer over rights of a debenture holder.[173]

(c) Issues have arisen in argument over the proper purpose of provisions dealing with the prohibition of persons from involvement in management of a company or in business on his or her own account or in partnership.[174]

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172 An illustration arising out of the recession of the late 1980s was the majority decision in *Liggett v Kensington* [1993] 1 NZLR 257 (CA) that members of the public who had acquired non allocated gold bars from Goldcorp Exchange Limited were entitled to proprietary remedies, by way of constructive trust, in relation to that gold. The granting of a proprietary remedy effectively took the gold outside of the control of the receivers appointed pursuant to a debenture granted in favour of a bank by a company. That judgment was reversed by the Privy Council on the grounds that the Court of Appeal had erred in holding that the relationship was fiduciary in nature rather than that of vendor and purchaser: *Re Goldcorp Exchange Limited (In Receivership): Kensington v Liggett* [1994] 3 NZLR 385 (PC).

173 In *MacIntosh v Fortex Group Limited* [1997] 1 NZLR 711 Gallen J upheld such a claim on the grounds that neither secured nor unsecured creditors could have complained had the employer made the payments which it was required to make and which it could have made within its overdraft accommodation. Accordingly, a restitutionary remedial trust was recognised and the employees were granted relief (722-723). This decision was reversed by the Court of Appeal in *Fortex Group Limited (In Receivership and In Liquidation) v MacIntosh* [1998] 3 NZLR 171 (CA), on the grounds that the Court ought not vary settled rules of priority (179 per Tipping J). See also the observations of Blanchard J at 181-182. A similar situation arose in England at about the same time in *Re Polly Peck International PLC (In Administration) (No 2)* [1998] 3 All ER 812 (CA). In particular, the Court of Appeal in England held that there was no general power for the court to declare assets to be held for the benefit of others, as to do that would be to give a preference to another person who enjoyed no preferential status under the statutory regime. Accordingly, as the order sought would require retrospective imposition of a remedial constructive trust on assets which would give the applicants a proprietary interest in those assets, which would operate to exclude those assets from *pari passu* distribution, the court would strike out the claim as revealing no cause of action (822 – 823 and 826 – 827 per Mummery LJ (Potter LJ concurring) and 831 per Nourse LJ).

174 Compare *Ramsay v Sumich* [1989] 3 NZLR 628 and *Re Focas* (1993) 6 NZCLC 68,417 with *Official Assignee v Randhawa* (22 November 1991) unreported, High Court, Hamilton Registry, B 296/85, Master Towle. The former cases placed weight on protection of the public while the latter referred to the need to punish the debtor. The Court of Appeal has recently emphasised that the need to protect the commercial community should be given greater weight than the punishment of debtors: *R v Gray* (19 November 1997) unreported, Court of Appeal, CA 389/97. In that case Robertson J said “Insolvency is a state mechanism to protect the general citizenry from those who have been unable to manage their financial affairs. It is a protective arrangement for the community rather than a punitive regime against insolvents”.

(d) Issues arising from the feature to define precisely the nature and extent of security interests which are to remain outside of the insolvency process.[175]

135 It is undesirable that there be litigation over such fundamental matters: particularly in insolvency law when further costs add to any loss which creditors suffer. It is important, in our view, that the legislation clearly articulate the principles and purposes of the law. The law must be predictable in its application. In our view, a law which is clearly articulated and is capable of predictable application will encourage traders operating in the market to fix the cost of credit at the lowest level possible. That, in turn, will encourage entrepreneurship, and is therefore the approach we recommend to the drafting of insolvency legislation.

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175 An example is the case of *Re Papesch* [1992] 1 NZLR 751 in which the High Court held that a general lien was sufficient to fall within the term "secured creditor" in the Insolvency Act 1967. We note that there are currently disparities between the definition of the term "secured creditor" as defined in s 2(1) of the Companies Act 1993 and s 2(1) of the Insolvency Act 1967 (see also the definition of "charge" in s 2(1) of the Companies Act 1993). In our discussion on whether a single statute should be enacted we have drawn attention to this disparity and suggested it as an advantage of a single statute (see para 374). See also the discussion of this topic in *Priority Debts in the Distribution of Insolvent Estates* (above n2, paras 212 – 218); see also MED: Tier One Papers, above n160, 90 – 91.

11.
State Role in Enforcement

PUBLIC OR PRIVATE FUNCTION?

136 In our view the State's role in enforcement should be confined to issues which are truly public in nature and which cannot be performed by the creation of adequate incentives for private sector participants in the insolvency process. This approach is likely to strike the correct balance between State and private sector interests in a country of New Zealand's size and population.

137 The State needs to foster an environment which enables traders to operate in an orderly fashion and on the assumption that others in the market will abide by good management and governance principles. We take the view that any enforcement action required to promote that environment is a function which is public in nature.

138 A function can be characterised as private in nature if the primary purpose is to obtain repayment for creditors rather than to impose a sanction for undesirable commercial behaviour.

139 The most constant criticism levelled against State involvement in the insolvency process by members of the commercial country with whom we consulted informally, was the perceived lack of enforcement action by regulatory authorities to act as a deterrent to irresponsible or undesirable commercial behaviour.[176]

140 The public enforcement function can be performed either by creating an incentive for a debtor to act in a particular way, or by applying sanctions for irresponsible commercial behaviour or dishonest conduct. This public function is independent of the recovery of money for the benefit of creditors.

176 We discuss this issue further at paras 147-159.

141 Success in performing public enforcement functions should be judged against the long term benefits of a business climate which reduces the quantum of bad debts which are written off by businesses operating in New Zealand. If better management practices are encouraged and more businesses pay their debts, fewer bad debts will be incurred. As a matter of logic, reduction of business costs should lead to reduced prices for goods and services, increased profitability and the payment of more tax. Also, by raising the standards of office holders appointed to realise assets and distribute proceeds by way of dividend, we should see greater dividends to creditors. An increase in dividends also reduces the amount of bad debts which are written off. Again, a stimulus to the economy would be the net result.

142 It is difficult to classify claims against directors for breach of duty to recover money for creditors as either a public or private function. The conduct of a director which may make him or her liable for insolvent trading is likely to be the same conduct that would render the director liable to disqualification from being involved, directly or indirectly, in the management of a company.[177] To some extent, the public function in relation to disqualification will merge with the private function in relation to recovery of loss by a liquidator under section 301 of the Companies Act 1993.

143 We conclude, however, that this blurring of functions can be overcome by a recommendation which we made in our study paper, *Priority Debts in the Distribution of Insolvent Estates*,[178] that a priority payment on insolvency which would allow creditors who were funding litigation to recover or preserve assets for the general body of creditors to use the assets recovered or preserved first, in payment of their own debt. This recommendation has been supported by the Ministry of Economic Development in its recent discussion paper on priority debts.[179] Other options which may solve the conundrum include greater ability for a liquidator to secure funding to pursue actions

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177 Compare Companies Act 1993, ss 135 (reckless trading) and 301 (power of court to require payment of money for breach of duty) with ss 382, 383 and 385 (disqualification provisions).

178 Above n2.

179 MED: Tier One Papers, above n160, para 10.1. See also arguments for and against public enforcement in the company law context can be found in M Berkahn and L Trotman "Public and Private Enforcement of Company Law in New Zealand 1986-1998" (2000) 7 Canta LR 516. The costs of bringing a private action, the lack of information available to shareholders, and their inability to evaluate that information are some reasons for favouring public enforcement (518). However private enforcement reduces overall costs, and imposes them on the parties who stand to benefit most from enforcement proceedings (519).

through insurance and similar means[180] and the possibility of relaxing the rules of champerty and maintenance to address funding problems in an insolvency situation.[181]

144 We consider this to be an appropriate balance which requires the State to exercise public functions fully while providing an incentive for the private sector to act when recovery of debts is the prime objective. This is also consistent with our view that the institutional infrastructure for the insolvency law system should meet the particular needs of the New Zealand economy and contemporary society.

THE STAGES OF ENFORCEMENT

145 In our view there are four stages in the public enforcement function:

- investigation of the affairs of a debtor, to determine whether enforcement action (civil or criminal) ought to be taken;[182]
- determination by a public official whether there is sufficient evidence to issue either civil or criminal proceedings to obtain a public pronouncement that a person has breached the standards required by law, and to seek the imposition of sanctions for that breach of duty;
- criminal prosecution or taking civil action once the decision has been made to seek the imposition of sanctions;
- decision of a court of competent jurisdiction, which determines whether the duties have been breached and, if so, what penalty should be imposed. The Court's processes should generally be open to promote confidence.[183]

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180 *Re Nautilus Developments Limited* [2000] 2 NZLR 505 (HC).

181 Generally, see New Zealand Law Commission *Subsidising Litigation: PP 43* (Wellington, December 2000) paras 18 – 19.

182 Most investigative functions are performed by the Registrar of Companies pursuant to powers conferred by Part I of the Corporations (Investigation and Management) Act 1989 or s 365 Companies Act 1993.

183 Compare with our recommendations in relation to the criminal prosecution procedures used in New Zealand: *Criminal Prosecution: R66* (Wellington, October 2000) ["*Criminal Prosecution: R66*"]; in particular see our discussion of control and accountability at paras 30 - 78; powers of a prosecutor discussed at paras 79 – 126; prosecution decisions and the discretion to prosecute at paras 127 – 140; and court supervision of the discretion to prosecute at paras 141 – 170. We note that our approach to the distinction between public and private functions accords with the observations which we made in relation to private prosecutions in our *Criminal Prosecution* report; see paras 255 – 270. See also the Solicitor-General's Prosecution Guidelines which are reproduced in appendix C to *Criminal Prosecution*.

146 In para 123 we identified two apparent problems stemming from lack of trust and confidence in relation to questions of commercial morality:

- A belief that there was neither proper nor timely enforcement of duties affecting commercial morality undertaken by public officials within New Zealand charged with those enforcement duties; and

- Issues of transparency in relation to the funding of public enforcement functions.

We now address those two issues.

TRUST AND CONFIDENCE: COMMERCIAL MORALITY ISSUES

147 The thrust of the concerns expressed to us by members of the commercial community is that the relevant public officials have failed:

- to investigate adequately allegations of commercial misconduct; and

- to take appropriate action to enforce the law in cases where there has been commercial misconduct.

These concerns have been expressed as referable to both personal bankruptcy and corporate failure.

148 In our view the concerns expressed by members of the commercial community are supported by a consideration of recent reports issued by the Insolvency and Trustee Service and by observations made in some cases about the manner in which the Official Assignee has discharged certain duties.

149 In relation to criminal prosecutions the Insolvency and Trustee Service reported that:

- during the 1997/98 year 261 charges were laid with 111 convictions being secured.[184]

- during the 1998/99 year 75 convictions had been secured as a result of prosecution action taken by the Official Assignee.[185]

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184 New Zealand Insolvency and Trustee Service *Business and Strategic Plan for 1998/99* (Wellington, 1998) 9. It is unclear whether the convictions relate to the charges; if so, the success rate was 42.53 percent.

- no prosecutions or convictions are reported in the Insolvency and Trustee Service's *Annual Report and Business and Strategic Plan 2000-2001* .

150 The Insolvency and Trustee Service has advised us that the number of convictions compare favourably with prosecutions against bankrupts in Australia, Hong Kong and the United Kingdom in the 1997/98 and 1998/99 years.[186] That may be so, in so far as it compares convictions secured against bankrupts only. It does not take account of comparable activity in those jurisdictions either in relation to the prosecution, or the disqualification, of company directors.

151 No criminal prosecutions appear to have been taken in the 1999/2000 year. No disqualification action was progressed that year either. No comparable international statistics for prosecution action against bankrupts have been made available to us for the 1999/2000 year.

152 The New Zealand Insolvency and Trustee Service also acknowledges that there has been little progress with disqualification procedures involving directors of companies over the past few years because of disagreements between the Registrar of Companies and the Securities Commission over the method of dealing with those procedures. We suspect that this disagreement has arisen because of the way in which the Securities Commission and the Registrar of Companies view their respective roles. The core function of the Securities Commission is to regulate the securities market in New Zealand[187] while, in this particular context, the role of the Registrar of Companies is to enforce corporate governance standards to promote responsible commercial behaviour. The Securities Commission does not, currently, have any similar enforcement function. It may well be that the disagreements between the Registrar and the Securities Commission could be adequately met by some alternative process to enable prompt adjudication of disqualification issues once the Registrar had investigated the circumstances and determined that there was sufficient evidence to justify the bringing of disqualification procedures. We respectfully suggest that consideration be given to the possibility of establishing either a single senior barrister or a small panel of senior barristers[188], all

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185 New Zealand Insolvency and Trustee Service *Building the Business*, *Annual Report/Business and Strategic Plan 1999-2000* (Wellington, 1999) 12. The number of charges laid is not disclosed.

186 Letter from Insolvency and Trustee Service to Law Commission dated 20 February 2001 at p 2; see also New Zealand Insolvency and Trustee Service *Insolvency Quarterly* (Wellington, December 1999) 1.

187 See para 94.

188 To ensure consistency of approach.

experienced in commercial law and appointed by the Solicitor-General, who could hear on a regular basis applications for disqualification with appropriate appellate procedures to enable their decisions to be challenged in the High Court. That may well solve the particular problem identified in relation to the disqualification procedure, from the perspective of both the Registrar of Companies and the Securities Commission.

153 The New Zealand Insolvency and Trustee Service established (in June 1999) at its Auckland office a National Enforcement Unit which, we understand, is currently investigating cases involving alleged irresponsible or fraudulent commercial behaviour. Four experienced investigators with a police background are employed full time[189], and there are four regional liaison officers throughout the country. There are currently 17 cases (totalling 244 charges) before the Courts.[190] Three disqualifications of directors have occurred this year.[191] While this is a step in the right direction, it seems to us that there remains a need for greater involvement in this enforcement area in order to meet the justifiable criticisms which have been made to us by members of the commercial community.

154 In assessing the extent to which remedial action is required, we have had regard not only to what has been said to us in the context of informal consultation, but also to a number of criticisms which have been made of the Official Assignee in cases which have come before the High Court and the Court of Appeal over the last few years. We give two examples:

- In *Quinby Enterprises Limited (In Liquidation) v General Accident Fire and Life Assurance Corporation*[192] Barker J took the rare step of awarding costs against the Official Assignee who was acting as liquidator of the plaintiff, on the grounds of the Official Assignee's failure to seek advice from independent and experienced counsel, particularly at a time when information concerning dishonesty on behalf of a company officer was disclosed.[193] His Honour noted that an in-house solicitor

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189 In addition, the Unit has the ability to call (when their duties permit) on two full time senior professionals who are primarily responsible for dealing with compliance issues under the Securities Act 1978 and the Companies Act 1993.

190 Letter from S Keohane, Manager of National Enforcement Unit, to Law Commission, 21 February 2001. We have relied upon the New Zealand Insolvency and Trustee Service's Annual reports for information as to the role of the National Enforcement Unit within the Insolvency Service; for example the organisational chart in the 1999/2000 report (above n 185, 7).

191 Letters from Insolvency and Trustee Service to Law Commission, 20 February 2001, 2. See also "Families of failed businesspeople put on notice" National Business Review, 23 February 2001, 11.

192 (4 December 1995) unreported, High Court, Auckland Registry, CP 681/89.

193 *Quinby*, above n 192, 17.

had deposed that, whilst he accepted a basis existed for referring the company officer's conduct to the Police for prosecution, the reality was that if it had been so referred, it would not have been investigated, much less prosecuted, as he was unable to secure Police response until representations had been made through his Head Office and the Minister.[194] Barker J noted that these difficulties "may be more the fault of the system than of any individual. However I find that there was a lowering of standards in the manner indicated".[195]

- In *Edmonds Judd v. Official Assignee*[196] the Court of Appeal criticised the Official Assignee for abandoning a cause of action (and thereby enabling the bankrupt to resume his position as plaintiff in a case brought against former solicitors) on the grounds that the Official Assignee did not ascertain whether there were reasonable grounds for success. The Court of Appeal held that, in effect, the Official Assignee had allowed a hopeless and vexatious proceeding to be taken. Richardson P, delivering the judgment of the Court of Appeal, said that it was no part of the functions of the Official Assignee to traffic in frivolous and vexatious claims.[197]

155 At the time when *Quinby* was decided, Barker J was the Senior Puisne Judge of the High Court. He was acknowledged as being one of the most experienced judges on the High Court bench in commercial law matters. We believe that Barker J's "systemic" criticism would only have been made after careful consideration. While the criticism was made in 1995 it does demonstrate that problems have existed for some time; not just during the 1999/2000 year when the Insolvency and Trustee Service was being restructured.

156 We are not in a position to assess whether the steps taken by the New Zealand Insolvency and Trustee Service to establish a National Enforcement Unit in Auckland are likely to improve market confidence significantly. We express doubts that it will because:

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194 *Quinby*, above n 192, 18-19.

195 *Quinby*, above n 192, 19. As a result of *Quinby* the costs ordered against the Official Assignee were paid out of an indemnity which the Official Assignee had procured from a major unsecured creditor. Subsequently, that creditor recovered 80 percent of the costs paid under the indemnity as a result of an action brought by him against the Official Assignee under section 9 of the Fair Trading Act 1986. The High Court held that the Official Assignee had withheld crucial information which meant that the creditor had been misled on the merits of the case. The creditor was required to bear 20 percent of costs as the judge held that he may not have acted differently had the true position been conveyed to him (*Harris v Simonetta* (1998) 6 NZBLC 102,61).

196 [2000] 2 NZLR 135 (CA).

197 *Edmonds Judd*, above n 196, 146. Other cases involving similar criticisms are referred to in the Court of Appeal judgment.

- we believe it will be difficult for a single office with only four full time investigative personnel adequately to enforce duties throughout the country;[198] and

- the lack of confidence which has been expressed to us, seems to be based on both:

  - a failure to take action when appropriate; and

  - a failure to exercise proper judgment in determining what action should be taken;

- the problems of enforcement are so long standing (going back, on our brief review, at least to the mid 1990s) that a fresh start may be needed to instil the necessary degree of trust and confidence.

157 What options are available to deal with this particular problem? On the face of it, there appear to be three options:

(a) First, to retain the status quo but to allow further time to see whether the public enforcement issue can be addressed adequately through the steps which have been taken to establish the National Enforcement Unit; or

(b) Second, to design a new regulatory framework to meet the particular problems which we believe have been identified; or

(c) Third, to consider better utilisation of all public enforcement agencies dealing with issues of commercial morality by providing an independent enforcement unit from which investigators could be used for particular tasks of, for example, the Serious Fraud Office, the Securities Commission, the Commerce Commission, the Registrar of Companies, the Official Assignee or other public officials.[199]

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198 See "Families of failed businesspeople put on notice" National Business Review, 23 February 2001, 11. Mr Keohane comments that "If I had 20 investigators we'd still have to turn down some work".

199 We do not explore this option in this report as it goes much wider than our terms of reference. But, we think it appropriate to put the suggestion forward for further consideration. If the Ministry of Economic Development thinks it appropriate, it could carry out further investigations in this area. For example, we could envisage different enforcement agencies being appropriated funds by Parliament through which they would secure use of personnel within this Unit; the total budget would equate to one year's work from the pool of investigators plus professional costs for prosecutions and other court or quasi judicial proceedings.

158 Although we have referred to criticisms which have been made of the performance of public enforcement functions, we must also note plaudits given by the commercial community to online services now available through the Companies Office, which have been provided through the initiatives of those currently responsible for the management of the Business and Registries Branch. We are told by senior credit managers that those services, in particular the ability to cross check directorships held by particular individuals, have provided enormous benefits to the commercial community in credit management. Also, there have been no criticisms made to us of the role undertaken by the Registrar of Companies in relation to pre-insolvency issues; some of the worst cases of which can lead to the Registrar declaring a corporation to be “at risk” under Part II of the Corporations (Investigation and Management) Act 1989 or seeking the imposition of statutory management under Part III of that Act.

159 We recommend that in its further work on insolvency, the Ministry of Economic Development consider surveying the private sector on the extent of the current lack of confidence.

TRUST AND CONFIDENCE: TRANSPARENCY ISSUES

160 Official Assignees are salaried public servants appointed to hold office under the State Sector Act 1988[200] who have statutory responsibilities conferred by the Insolvency Act 1967, the Companies Act 1993 and the Proceeds of Crime Act 1991. Although part of a Government Ministry, the Official Assignee is required to act independently and is, in effect, seen by the courts as the guardian of the public interest.

161 The Registrar of Companies is also a creature of statute appointed under the State Sector Act 1988.[201] The Registrar has a number of different functions, some of which are archival in nature and others which are investigative and quasi-judicial in nature. In the latter categories fall the powers conferred upon the Registrar to take action to disqualify the persons from acting as directors in New Zealand and the investigative powers, “at risk” powers and powers to seek statutory management conferred by the Corporations (Investigation and Management) Act 1989.

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200 Insolvency Act 1967, s 15.

201 Companies Act 1993, Part XX, s 357(1).

162 Some public enforcement duties are cast upon the Official Assignee while others are for the Registrar of Companies. In our view it would be preferable for all public enforcement functions to be exercisable by one statutory officer appointed for that purpose.

163 The three principal functions of the Official Assignee[202] are the trustee administration of insolvent estates, Proceeds of Crime Act 1991 issues[203], and prosecution and enforcement. These functions create diverse obligations which the Business and Registries Branch must perform in addition to other roles, such as the operation of the Companies Office, the Intellectual Property Office and the Government Actuary's Office.[204] The lack of transparency in relation to the appropriation of funds for public enforcement functions is, in our view, a problem which could be addressed more readily through the institution of a new regulatory regime.[205]

THE COURTS

164 In para 123(e) we identified a problem which had been articulated to us in our informal consultation. This problem is prospective in nature. It anticipates the possibility that courts will be required to deal quickly with difficult business rehabilitation or statutory management issues, something which is dependent on the response to views expressed in this report. The concern is whether current court processes would be adequate to deal with such cases. We deal with this particular problem in this segment of our report.

165 Many countries have specialist courts to deal with insolvency issues. A small country such as New Zealand, with a limited number of insolvency practitioners, an even more limited number of specialist barristers and fewer still judges experienced in insolvency law, can not afford that luxury. Nevertheless, there are specialist requirements which must be addressed in rehabilitation or statutory management cases which tend to involve greater business judgment than is the case in orthodox court proceedings.

166 Mr Justice Farley (of the Superior Court of Ontario) recently noted at the UNCITRAL Colloquium on Insolvency Law, that insolvency litigation, particularly that involving

202 These three principal functions are taken from New Zealand Insolvency and Trustee Service *Annual Report/ Business and Strategic Plan 2000-2001* (Wellington, 2000) 20 –21.

203 The role of the Official Assignee is, primarily, to gather in assets which have been made the subject of a restraining order or a pecuniary penalty order issued under that Act and, when convictions are obtained, to realise that property as agent for the Crown.

204 MED: Annual Report, above n156, 30.

205 See further para 194.

cross-border and rehabilitation issues, is “real time” litigation rather than “autopsy” litigation. He said:

> The court must be capable of being accessed on a timely basis as required. Insolvency is what I term “real time” litigation which must take precedence over what I call “autopsy” litigation, which is not adversely affected if it is dealt with tomorrow, next month or the next year. …The insolvency case must be entrusted to a judge who has a commercial mentality, awareness and approach. He should not only rely upon his own skills and experience, but know how and when to rely upon the business expertise and experience of others in the case. He should be one who has developed experience with dealing with insolvency proceedings and their special needs, including knowing when to allow the affected parties the opportunity to negotiate outside the court, even with recess in the proceedings of a matter which is underway in court. … Appeal periods should be kept to the minimum, consistent with fairness to the affected parties. The appeal court, especially if it does not have the functional expertise of the lower court, should through experience with that judge, come to appreciate that reversal, in whole or in part, should rarely occur and only when there is a true miscarriage of justice. We recognize that it is not desirable to have insolvency cases randomly assigned to members of the general court. While a specialized court of commercially-oriented judges may be possible, we anticipate that frequently flexibility and accessibility would be enhanced if certain of such judges of the general court were designated to handle insolvency cases, which cases would have a first trial priority as to their scheduling. To the maximum extent possible, the same judge would be involved in the continuing insolvency proceeding.[206]

167 In a recent paper given to the *Forum for Asian Insolvency Reform* Mr John Lockhart QC (formerly Mr Justice Lockhart of the Federal Court of Australia) discussed the topic of the role and training of judges. He said:

> Insolvency law is complex. You either know a little or a lot about it. As Alexander Pope, the great British poet, ‘a little learning is a dangerous thing, drink deep or taste not the Pyrrhean spring.’ A judge sitting in insolvency matters must have a sound knowledge of the law in practice in this field. Ideally, this is developed over years before the judge is appointed to the bench, both in legal education courses and in practice; but this is not always available…[207]

168 There are two improvements which we think could, usefully, be considered to improve the quality of the service which would need to be provided to the business community by the if greater jurisdiction in rehabilitation and statutory management cases were conferred on the court. We propose to state the options which will need to be discussed fully with the Chief Justice and the Department for Courts. We do not express any views on a preferred option at this stage.

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[206] Transcript of Evaluation and Synthesis Session from UNCITRAL/INSOL/IBA Global Insolvency Colloquium, 4-6 December 2000, Vienna.

[207] J Lockhart “Role and Accountability of Judges” (Paper presented at Forum for Asian Insolvency Law Reform, Bali, Indonesia 7 February 2001) 1.

169 In our view, there are two options:

(a) to retain the status quo;

(b) the formal nomination by the Chief Justice of specialist judges and Masters to preside over particular insolvency cases.

Both options would, in our view, involve training judicial officers to meet the challenges created by "real time" insolvency litigation.

12
The State's Role as Regulator

170 In this chapter we address the State's role as regulator. There is some inevitable overlap between this chapter and our discussion of enforcement, office holders and a proposed new regulatory regime. What follows should be read in that content.

THE ISSUES

171 The problems which we have identified in relation to the current regulatory regime are:

(a) Concern about whether there are adequate quality controls in place to ensure that only properly qualified and impartial insolvency practitioners are appointed to undertake the administration of a collective insolvency regime for the benefit of the general body of creditors.[208]

(b) The different standards imposed by the legislature upon private insolvency practitioners and the Official Assignee when each are carrying out duties as a liquidator.[209]

(c) Information asymmetry between major creditors (on the one hand) and small creditors and debtors (on the other) in identifying qualified and impartial insolvency practitioners to act as office holders in collective insolvency regimes.[210]

THE CURRENT ROLE OF THE STATE AS REGULATOR

172 The current regulatory regime for insolvency law envisages three distinct situations:

208 See para 123(b).

209 Companies Act 1993, s 254(b). See further, para 123(c).

210 See para 123(f).

- In respect of the period preceding the placement of an entity into a formal insolvency regime, powers have been conferred upon the Registrar of Companies to obtain information concerning and to investigate the affairs of corporations to which the Corporations (Investigation and Management) Act 1989 applies. Those powers are exercised, among other things, to limit or prevent corporations from operating fraudulently or recklessly or to enable an application to be made for statutory management to be imposed to bring order to a situation in which no other formal insolvency regime will operate adequately.[211] Those functions address both investor protection and creditor protection goals.[212]

- Powers conferred upon the Official Assignee to investigate conduct and to take action to disqualify or prohibit certain people from either being involved in certain business activities or from holding offices created by statute.[213] Without being exhaustive, examples include

  - the power to require a bankrupt to be examined publicly, not only to obtain information relevant to the bankruptcy but also on matters of public interest;[214]

  - the power to seek an order for the prohibition of a bankrupt from being engaged in business activities for such time as the court may order after discharge from bankruptcy;[215]

  - the power to apply to the High Court to disqualify a person from being involved in the management of a company;[216] and

  - the power to prosecute criminal offences under the Insolvency Act 1967.[217]

- Other functions are cast upon the Registrar of Companies. Again, without being exhaustive, these include

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211 Generally, see Corporations (Investigation and Management) Act 1989, s 5(1). For a more detailed discussion of these powers see paras 322-324.

212 See further, paras 330-331.

213 These public enforcement issues are also addressed in chapter 11.

214 Generally, *Laws NZ: Insolvency*, above n10, para 239; see also *Re Paget, Ex Parte Official Assignee* [1927] 2 Ch 85.

215 Generally, *Laws NZ: Insolvency*, above n10, paras 428-429.

216 Companies Act 1993, s 383(3).

217 Insolvency Act 1967; see in particular s 129.

- an implicit obligation to act upon reports provided by receivers under section 28 of the Receiverships Act 1993;[218]

- the power to bring an application to the High Court for disqualification of a director;[219] or to exercise powers to prohibit persons from managing companies;[220] and

- the power to inspect records to ascertain whether rights or powers under the Companies Act 1993 or the Financial Reporting Act 1993 should be exercised and for the purpose of detecting offences against those Acts.[221]

173 There is an inconsistency between the Insolvency Act 1967 and the Companies Act 1993 in relation to the use of a public examination. The ability to examine a director publicly under section 263 of the Companies Act 1955 was omitted from the Companies Act 1993, probably because of the Law Commission's view that court intervention should only occur where there was a dispute on matters of fact.[222] In our view, it is necessary to synthesise the provisions of the two Acts.

174 We recommend that directors should be able to be examined publicly before a Master of the High Court where there are concerns about irresponsible commercial behaviour. It is only by exposing that conduct that members of the public (as opposed to the more limited number of creditors directly affected) can become aware of concerns about the practices of particular directors.[223] We recommend that if public examinations are reintroduced the provisions of section 70 of the Insolvency Act 1967 regarding self-incrimination should apply (a similar provision applied with respect to public examinations under sections 263(4) and (4A) Companies Act 1955).

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218 By s 28(1) of that Act a receiver who considers that the grantor or any director of the grantor has committed an offence against the Companies Act 1955 or the Securities Act 1978 or the Companies Act 1993 or the Financial Reporting Act 1993 or the Takeovers Act 1993 must report that fact to the Registrar and a receiver who fails to do that commits an offence and is liable on summary conviction to a fine not exceeding $10,000. A new s 258A of the Companies Act 1993, which would extend this provision to liquidators, is proposed in cl 13 of the Business Law Reform Bill 1999.

219 Companies Act 1993, s 383(3).

220 Companies Act 1993, s 385.

221 Companies Act 1993, s 365.

222 *Company Law: R9,* above n59, para 43.

223 It should be noted that when a bankrupt is publicly examined under the Insolvency Act 1967 there is a prohibition on the use of any evidence secured at that examination in any criminal prosecution which may follow: see Insolvency Act 1967, s 70.

175 We also favour giving the court the power to disqualify a director from involvement, directly or indirectly, in the management of a business or a company after hearing evidence from the director at a public examination. Just as a view expressed by a Master as to whether a director has explained certain conduct would be helpful in providing information to the commercial community about the reasons for failure of a particular entity, an order of disqualification which followed a public examination would validate concerns which, ordinarily, would simply pass by way of rumour through the commercial community.

QUALITY CONTROLS: INSOLVENCY PRACTITIONERS

176 We address means by which the assurance of competence and impartiality of insolvency practitioners appointed to undertake the administration of collective insolvency regimes in New Zealand in chapters 13 and 14. We are of the view that it is necessary to improve public enforcement of standards of competence and impartiality for the reasons given in those chapters.

PRIVATE AND PUBLIC SECTOR LIQUIDATORS

177 Private liquidators are required to carry out duties cast upon them by law irrespective of whether funds are available to meet their fees and disbursements. However the Official Assignee is absolved from any requirement to perform functions when there are no assets available for distribution to creditors of the company.[224] This is an illogical distinction; if anything, the requirement not to fulfil duties if there are no assets should be expressed conversely because the public official should be expected to bear the cost of liquidating assetless companies rather than the private practitioner.[225] We discuss this issue further in our chapter on office holders.

178 We also have concerns that some of the duties which have been cast upon the private sector are passed on to consumers of goods and services. For example, the obligation placed upon a receiver (usually one appointed pursuant to a debenture held by a secured creditor) to report to the Registrar of Companies if he or she considers that an offence has been committed under the Companies Act 1955, the Securities Act 1978, the Companies

224 See Companies Act 1993, s 254 (b) and the principal functions of liquidators imposed by s 253.

225 See para 189.

Act 1993, the Financial Reporting Act 1993 or the Takeovers Act 1993[226] passes the cost of public interest enforcement to a private trader, which may in turn be passed onto consumers of its product or services. That, in our view, is inappropriate.

179 For reasons which we develop further in chapter 13 that the State should undertake the role of administrator in an assetless insolvency regime but leave the administration of other liquidations, and indeed, bankruptcies, to the private sector. But this recommendation proceeds on the premise that there must be improvements in the oversight and enforcement of obligations owed by administrators of collective insolvency regimes if the private sector is to fulfil that role.

INFORMATION ASYMMETRY

180 We propose, through improvements to a regulatory regime, to provide better information to debtors and small creditors about the availability of qualified and impartial insolvency practitioners to act as office holders in collective insolvency regimes. We address this issue further in chapter 14; see also our comments on education issues in chapter 15.

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226 Receiverships Act 1993, s 28.

13
Office Holders

GENERAL

181 There are no constraints upon a person acting as an insolvency practitioner or being appointed as an administrator of a collective insolvency regime, save for the listing of persons prohibited from holding office.[227] However the High Court has the power to make an order prohibiting a person from acting as a liquidator for a period not exceeding five years, if it is demonstrated to the satisfaction of the court that a person is unfit to act as liquidator by reason of persistent failures to comply with the obligations imposed by the Act or the seriousness of a failure to comply.[228] While an Official Assignee is entitled to make an application,[229] we are unaware of any case in which such an order has been sought by the Official Assignee. The Registrar of Companies may not seek an order under section 286 of the Act.

182 Similarly, a person may be prohibited from acting as a receiver or liquidator for a period not exceeding five years if it is demonstrated to the court that that person is unfit to act by reason of persistent failures of the type to which the liquidation provisions apply.[230] The Registrar of Companies is the public official who may make the application under s 37 of the Receiverships Act 1993.[231] The Official Assignee may make an application but only if the application is made qua Official Assignee of the estate of the grantor.[232]

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227 See s 280 Companies Act 1993 and s 5 Receiverships Act 1993.

228 Companies Act 1993, s 286(5); a person subject to such prohibition order is thereafter disqualified from acting as a liquidator: see s 280(1)(g) of the Act.

229 Companies Act 1993, s 286(1)(h).

230 Receiverships Act 1993, s 37(6)-(7) and (9). A copy of every order made under s 37(6) is meant to be delivered by the applicant to the Official Assignee, who is required keep it on a public file indexed according to the name of the receiver concerned. However in practice this applicants do not forward copies to the Official Assignee, and no actual file is kept.

231 Receiverships Act 1993, s 37(1)(a).

232 Receiverships Act 1993, s 37(1)(k).

BANKRUPTCIES

183 The Official Assignee has a monopoly on the administration of bankrupt estates, although it is possible for private insolvency practitioners to administer proposals commenced under Part XV and compositions effected under Part XII of the Insolvency Act. Reform of the law governing bankruptcies has been proposed in the Discussion Paper *Bankruptcy Administration* released by the Ministry of Economic Development in January 2001. We agree with the broad thrust of those proposals (particularly the proposals which provide alternatives to bankruptcy to deal with consumer debt and which promote the involvement of private sector practitioners in bankruptcy administration).[233]

LIQUIDATIONS

184 The Official Assignee is the public official entitled by statute to be appointed as a liquidator. The Official Assignee and private practitioners may conduct court-ordered and voluntary liquidations under the Companies Act 1993; save that the Official Assignee's powers to accept appointment in a voluntary liquidation are expressly limited by s 241(3) of the Companies Act 1993.[234] Private practitioners can act as liquidators in voluntary or court ordered liquidations.

PROPOSALS AND COMPROMISES

185 There is no barrier to private practitioners acting as

- A trustee in a Part XV Proposal under the Insolvency Act 1967; or
- A scheme manager of a compromise or arrangement under Parts XIV or XV Companies Act 1993; or
- As a statutory manager under the Corporations (Investigations and Management) Act 1989.

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233 MED: Tier One Papers, above n160, 17.

234 The Restrictions on the ability of the Official Assignee to act as a liquidator in a voluntary liquidation are curious in that the need for some relationship between the Official Assignee, qua Official Assignee of a bankrupt estate and the company could give rise to questions of conflict of interest.

ISSUES

186 The issues which we have identified which relate to office holders can be summarised as follows:

(a) Concern about whether there are sufficient regulatory safeguards in place to ensure that only properly qualified and impartial insolvency practitioners are appointed to act as an office holder in a collective insolvency regime,[235]

(b) Concerns about the effective monopoly granted to the Official Assignee to act as office holder in a bankruptcy under the Insolvency Act 1967.

REGULATORY SAFEGUARDS

187 Regulatory safeguards would address two issues. First, it would provide a level of assurance that only properly qualified and impartial insolvency practitioners are appointed to act as office holders in a collective insolvency regime; second, it may provide a partial answer to the information asymmetry identified in para 123(f).

188 With regard to the need for qualifications for office holders we make the following additional points:

(a) It may be necessary for New Zealand to develop an accreditation[236] regime to provide Australian courts with confidence that they can appoint New Zealand practitioners to deal with assets in Australia notwithstanding the lack of any licensing regime in New Zealand. If bilateral arrangements are to be discussed with Australia to deal more effectively with cross border issues that is a factor to be taken into account; and

(b) It is too easy for directors or shareholders to appoint "friendly" liquidators who have no or insufficient knowledge of insolvency procedures or who do not carry out duties and inform creditors of their rights. Appointment of a "friendly" liquidator removes the assurance of impartiality on which creditors may be expected to act. There is also an issue in respect of the current procedures for

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235 In this report we use the term "collective insolvency regime" to define any formal process under which the office holder (eg, a liquidator) is obliged to act in the interests of the general body of creditors rather than his or her appointor. See above, n 152.

236 We have in mind, for example, a self-regulation process.

nomination, by a petitioning creditor, of a liquidator in a court ordered process: at present there is no mechanism for the Court to receive evidence of competence or impartiality; similar concerns about partial conduct could arise because of this.[237]

189 In our view, the following allocation of duties reflects the distinction between public and private functions discussed at paras 136-138:

(a) All bankruptcies and liquidations which are, prima facie, assetless should be administered, in the first instance, by the Official Assignee. If after the financial audit contemplated by the proposed regime developed in the *Bankruptcy Administration* paper issued by the Ministry, the Official Assignee is of the view that assets can be identified a meeting of creditors could be called so that creditors can determine whether to appoint an administrator in place of the Official Assignee.[238] If creditors elected not to appoint a different administrator we would see no difficulty in the Official Assignee then exercising a discretion not to require the full processes of bankruptcy to be undertaken in the particular case.

(b) We propose that all persons appointed as administrators of a collective insolvency regime (whether appointed by the debtor or by the court) should be deemed to be officers of the court with all the duties attendant to that.[239] This would mean that

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[237] Concerns have been raised with us about activities of "rogue" liquidators; but we are also told that misconduct has not been reported to the Insolvency and Trustee Service. More evidence is needed about the nature of concerns expressed to us but what is clear is that a regulatory regime should, at least, minimise such concerns.

[238] We express no view on whether meetings of creditors should be mandatory: we believe that it is an issue on which there should be an informed debate after further consultation by the Ministry of Economic Development.

[239] As an officer of the Court, the Official Assignee can be required to abstain from asserting legal and equitable rights to which he or she would otherwise be entitled (*Ex Parte James, In re Condon* (1874) 9 Ch App 609; discussed in Laws NZ: Insolvency, above n10, para 214). The four conditions that must be present are derived from *Re Clark* [1975] 1 WLR 559:

- there must be some form of enrichment of the assets of the bankrupt by the person invoking the rule;
- the claimant must not be in a position to submit an ordinary proof of debt (except in the most unusual cases);
- if an honest person who would be personally affected by the result would nevertheless be bound to admit: "It's not fair that I should keep the money; my claim has no merit", then the rule applies so as to nullify the claim;
- the rule applies only to the extent necessary to nullify the enrichment of the estate. It does not restore the claimant to the status quo ante.

These cases have been applied in New Zealand in *Official Assignee v Westpac Banking Corporation* (1993) 4 NZBLC 102,939, *Re Morton (No 2)* (17 May 1993) unreported, High Court, Auckland Registry, B 283/90 and *Re Ness* (20 December 1995) unreported, High Court, Auckland Registry, M 118-95.

the High Court could exercise supervisory jurisdiction over all such insolvency practitioners in a summary way.[240]

(c) When a private sector insolvency practitioner consents to appointment by the court to a collective insolvency regime that practitioner should, in our view, be required to certify to the court, as one of its officers[241] his or her experience as an insolvency practitioner and whether any action has ever been taken to prohibit him or her from being a liquidator, receiver or other form of insolvency practitioner.

(d) Private sector insolvency practitioners should be eligible to be appointed as a trustee in bankruptcy of a bankrupt estate. However, we would prefer an option whereby the Official Assignee was appointed as trustee in bankruptcy in the first instance if a debtor's petition was filed with the right for the court to appoint a private sector insolvency practitioner on a creditor's petitioner.

(e) The distinction between the need to carry out duties as an insolvency practitioner in a collective regime should be removed so that private practitioners and the Official Assignee have the same obligations.[242]

MONOPOLY ISSUES

190 We are of the view that, provided adequate enforcement mechanisms exist to ensure that competent and impartial people act as office holders in a collective regime, that there is no reason in principle to bar a private practitioner from acting as trustee of a bankrupt estate. We address enforcement mechanisms in chapter 11.

191 We see no reason to retain the statutory monopoly on administration of bankrupt estates which the Official Assignee current enjoys. Indeed, we see merit in relieving the Official Assignee of some of these duties so that State resources can be freed up to perform public enforcement and regulatory obligations which we see as being necessary to instil the requisite level of trust and confidence in the insolvency process.

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240 See further *The Laws of New Zealand* (Butterworths, Wellington, 1992) vol 16, Law Practitioners, para 46.

241 We envisage that if the certificate is false that the court could take action for contempt against the practitioner with all the consequences that would follow from that.

242 See para 123(c).

14
A New Regulatory Authority

FRAMEWORK FOR REFORM

192 It is impracticable in a report of this nature to deal exhaustively with a new regulatory environment. Accordingly, as this report is to form the basis of further consultation by the Ministry of Economic Development, we propose to outline the functions of a new regulatory authority which we consider will meet the needs of the commercial community. We do not suggest that the solution which we prefer is necessarily the best solution. The best solution will be found after consultation with private sector interests and after full debate on the role of the State issues, which should arise from the Ministry's further work on insolvency. Our views should be regarded as provisional. They are intended to focus the debate.

193 We propose that three separate business units be established within the Ministry of Economic Development, at least one of which, the proposed Inspector-General, would be funded directly from Parliamentary appropriations. Those three offices would comprise:

- What is currently the New Zealand Insolvency and Trustee Service; this office would provide operational services through the Official Assignee in relation to matters involving consumer bankruptcies.[243] The Official Assignee's functions under the Proceeds of Crime Act 1991 should also fall under this particular office.

- The Registrar of Companies would continue to operate the Companies Office. We envisage that the Registrar would carry out functions of an archival nature in relation to that office and some quasi-judicial functions.[244]

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243 Broadly along the lines suggested by the Ministry of Economic Development in its recent discussion document: MED: Tier One Papers, above n160, 14 – 15, 38 – 41.

244 For example, decisions from which appeals to the High Court may be made under s 370 Companies Act 1993.

- The third, and new, office would be the creation of an independent office of what we call, for present purposes, an Inspector-General in Insolvency. We propose that this office take over all public enforcement functions cast upon both the Official Assignee and the Registrar of Companies as well as the investigative functions currently cast upon the Registrar.

194 Earlier we noted that it was inappropriate to create a complex bureaucracy in New Zealand. We do not believe that our proposals do that as, apart from the creation of the new independent office of Inspector-General, the other two offices are existing business units within the Ministry of Economic Development. The difference is that funding for enforcement functions would be made more transparent through Parliamentary appropriation. An important element of our proposal is that Parliament appropriates what it considers necessary for enforcement purposes and is answerable for that decision to the electors which, of course, includes the business community.

195 Additional funding may be required for the office of Inspector-General. But some of the funding could come from existing sources. For example Parliament could appropriate monies currently standing to the credit of the bankruptcy surplus account[245] and the liquidation surplus account[246] together with all accumulated interest thereon. If our views about the distinction between public and private functions are accepted[247] there is no good reason to use those accounts for "private" purposes. All funds which would otherwise have been paid into those surplus accounts would continue to be accumulated on the existing basis. Any costs ordered to be paid to the Inspector-General should be accumulated within the office's budget rather than paid directly to the consolidated fund. Another option for funding may be to require a percentage of each company registration fee to be paid to the office on an annual basis. We note also that organisational changes (such as (a) our recommendation to limit the Registrar of Companies's role to archival and quasi-judicial functions and (b) the removal of the State monopoly on bankruptcy administration) may free up personnel to perform services for the Inspector-General without increase in the overall budget for the Business and Registries Branch.

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245 Insolvency Act 1967, s 134.

246 Companies Act 1993, s 316.

247 See paras 136-138.

196 The Inspector-General would have responsibility for all investigations and prosecution (including the prosecution of civil disqualification proceedings) and would be funded for that purpose. The Inspector-General would also have responsibility for other public functions conferred by insolvency law[248] and the oversight of other office holders; including the Official Assignee.

197 We believe it is important that the Inspector-General be a person of standing who has the trust and confidence of the commercial community and established credentials in insolvency administration; perhaps a person appointed from outside the public sector. We envisage that the Inspector-General would oversee office holders by carrying out a function akin to the Education Review Office established under the Education Act 1989. Under that statute, the Chief Review Officer, whose powers and functions are described in Part 28 of that Act,[249] is required to administer reviews (either general or relating to particular matters) of the performance of educational institutions and report the results to the Minister.

198 In our view, the Inspector-General's powers should include oversight of office holders appointed voluntarily or by the court as part of a collective regime. He or she should determine whether the office holder is complying with the obligations conferred by statute and take appropriate action to seek disqualification of a person from acting as an office holder in the event of maladministration or other just cause.

199 This level of oversight takes account of our recommendations that office holders in a collective insolvency regime will be officers of the High Court (whether appointed voluntarily or compulsorily) who are also answerable to the court under its inherent jurisdiction to supervise its officers.[250] The Inspector-General would be entitled to act on complaints from the private sector, and it is envisaged that he or she would liaise closely with the Registrar of Companies and the Registrars of the High Court in relation to matters falling under their jurisdiction. The Inspector-General's oversight of

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248 For example, reports to the High Court on applications for discharge from bankruptcy. We note that a discretionary discharge regime similar to that currently operating in Singapore may also be worthy of consideration: see Tan Kiat Pheng and Karen Loh, "The Singapore Experience in the Administration of Insolvency Regime" (Paper presented to Forum of Asian Insolvency Reform, 7-8 February 2001, Bali, Indonesia) 7-8. Under the Scheme of Discretionary Discharge enforce in Singapore, the Official Assignee has power to grant a discharge from bankruptcy and there is no need for court intervention unless a creditor disagrees with the Official Assignee's decision and applies to court to challenge it: (see p 8).

249 Education Act 1989, ss 325 – 328.

250 See para 189(b).

insolvency practitioners would be in addition to that of the Court's oversight of those practitioners as officers of the Court. In this way the Inspector-General's oversight is analogous to the Solicitor-General's oversight of Crown Solicitors, who are also officers of the Court.[251]

200 We also recommend that the Inspector-General be required to set standards for performance by office holders: these standards could be issued as enforceable Directives in a manner similar to those issued by the Superintendent in Bankruptcy in Canada.[252] Public education functions could also be undertaken to ensure that small creditors and debtors have adequate knowledge about the choices available to them if a collective insolvency regime is to be initiated.

201 We recommend that consideration be given to whether the Inspector-General could also undertake roles currently cast upon the High Court, for example, the sanctioning of remuneration payable to a liquidator appointed by a court in excess of regulatory limits.[253]

202 These recommendations are made on the assumption that it would be impracticable to consider and, if thought appropriate, to implement a registration or licensing regime for insolvency practitioners before introduction of a Bill dealing with issues raised in the Insolvency Law Review. Some of the duties cast upon the Inspector-General could be made less onerous by the creation of some form of accreditation through industry led bodies. We invite longer term consideration of that issue.[254]

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251 *Criminal Prosecution: R66*, above n183, paras 67-69. Similarly the New Zealand Law Society has a degree of oversight over its members in addition to the Court's inherent jurisdiction.

252 See the Bankruptcy and Insolvency Act 1992 (Canada), ss5(4)(b) and (c).

253 In that regard, see *Re Medforce Healthcare Services Limited* (2000) 8 NZCLC 262,246.

254 The policy framework by which occupational regulation is determined in New Zealand is set out in the paper, CO (99) 6 *Policy Framework for Occupational Regulation*: <http://www.dpmc.govt.nz/cabinet/circulars/co99/6.html>. If this issue was to be developed further it would be necessary to persuade Government that there was a problem or a potential problem in the way in which collective insolvency regimes were operated which was unlikely to be solved or would solved more inefficiently or ineffectively in some other way. We have set out in this report (see para 189) a summary of the recommendations which we have made in relation to office holders which we believe, in the absence of occupational regulation, would be required to provide the necessary degree of trust and confidence. We suggest consideration of the relative costs of the system which we have proposed as against the costs involved in occupational regulation. We have not developed any argument based on occupational regulation further in this report as, on the information available to us, it would be impossible to bring into force occupational regulation provisions within the timeframe suggested for completion of the insolvency law review. We also refer to Rt Hon Mr Justice McKay "Professions at Risk" [1993] NZLJ 104, 106 – 108. At this juncture we note that we see the absence of a regulatory regime for insolvency practitioners as a barrier to introducing a targeted business rehabilitation regime with a short automatic stay against both secured and unsecured creditors. We expand on our reasons for that view later in this report. In the main, we are concerned that rogue practitioners could well be appointed by dishonest or incompetent management and may do damage to the insolvency system should they be permitted to act as a steward of the assets of a business entity during the period of a moratorium against both

203 A further regulatory responsibility which the Inspector-General could usefully undertake is the collection of statistical information on which to base future policy decisions for insolvency law reform. We envisage that the Inspector-General could co-ordinate the collection of the raw data;[255] This possibility is also raised in the *Bankruptcy Administration* Discussion Paper which suggests including sections on demographic information in the proposed Request for Solvency Assessment form.[256] Currently there is no consistent nation-wide approach to information gathering.

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secured and unsecured creditors. We do not wish to see the rehabilitation regime which we recommend being brought into disrepute at an early time because of an inability to ensure that properly qualified and experienced people are appointed as scheme managers.

255 For example, information filled out by bankrupts and directors in Statements of Affairs. We are advised by the New Zealand Insolvency and Trustee Service that it proposes to commence publication of quarterly statistics in the near future.

256 MED: First Tier Papers, above n160, para 7.2.3.

15
Role as Educator

204 In this chapter we consider whether the State should have a role in educating its citizens about credit management and the bankruptcy processes. For example, in the United States of America, most citizens know of "bankruptcy protection" to be garnered from the use of chapter 11 of the Bankruptcy Code 1978. In New Zealand, where credit cards have only been used since 1981[257] the time has come to ensure that citizens are educated properly about the use of credit; especially as the use of cash seems to be decreasing.

205 We propose to set out, in this chapter, a series of options which can be considered by Government for education requirements. Some of the suggestions which we are about to make fall outside of the domain of the Ministry of Economic Development and would be dealt with more appropriately by the Ministry of Education. We set out some options for consideration. We do not propose to make any recommendations on these issues.

206 First, we note that the Ministry of Consumer Affairs is currently in the process of producing papers for Cabinet as part of the Consumer Credit Law Review. Both Parts 4 and 5 of the Review[258] comment on the need to educate consumers about their rights and responsibilities in relation to credit. In particular, Part 5 of the review states that about 45 percent of New Zealand adults are "functionally illiterate" and will not fully understand what they are signing[259]. The Consumers' Institute reports that in a 1997 survey some budget advisers claimed that the vast majority of their clients did not understand the nature of their contracts.[260]

207 The Ministry of Consumer Affairs has suggested establishing an enforcement agency, perhaps modelled on the role of the Commerce Commission under the Fair Trading Act, one of the functions of which could be to raise awareness of consumer credit legislation

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257 See para 90.

258 Ministry of Commercial Affairs *Over Indebtedness, Insurance and E-Credit* (Part 4) and *Redress and Enforcement* (Part 5).

259 *The Reform of Consumer Credit Law in New Zealand*, para 3.4.

260 Consumers Institute, August, 1998.

and the protections and redress it provides. Possible activities could include publishing information pamphlets and compliance guides, giving industry seminars, and releasing regular publications and media statements.

208 We believe there may be merit in the proposal made by the Ministry of Consumer Affairs and commend it for consideration. We also suggest that some consideration be given to the possibility of combining the enforcement agency suggested by the Ministry of Consumer Affairs with the enforcement agency under the control of the Inspector-General of the Insolvency Service which we have suggested in this report. There may be economies of scale which could usefully be addressed.

209 Part 4 of the Review suggests that consumer education and budgeting advice could receive more prominence in the school curriculum, and that information could be targeted at beneficiaries and low income earners (agencies working with these people could be given this responsibility). It also suggests that a greater role be played by existing voluntary groups which educate consumers on good money management. The UK Consumer Credit Counselling Service is mentioned, which has the unique feature that it is funded by subscribing lenders who voluntarily donate 15 percent of the money recovered from their debtors. We believe that provision of budgetary advice in the course of secondary education would be desirable in the current economic environment.[261]

210 The office of the Inspector-General could also be required to carry out educational functions in respect of directives which he or she may issue to deal with the standards to be followed by insolvency practitioners. This should dovetail with private sector education (such as that operated by Polytechnics, Universities, the New Zealand Credit and Finance Institute and the Institute of Chartered Accountants of New Zealand) which would provide more specialist training in their own areas.

211 In Canada, trustees in bankruptcy have statutory obligations to counsel debtors under sections 5(4)(b) and (c) of the Bankruptcy and Insolvency Act 1992. Section 5(4)(b) provides that the Superintendent of Bankruptcy may issue to various persons, including those who provide counselling under the Act, Directives requiring them to keep such records and provide such information as the Superintendent may require. Section 5(4)(c)

[261] Currently intermediate and lower secondary students (up to Year 10) learn about financial resources and consumer rights as part of the Social Studies learning area, and also learn about manipulating sums of money in mathematics. At the more senior level, Accountancy and Economic Studies students learn about finances and budgeting, however not all students take these courses. Some schools offer a life skills programme at Year 12 level which may include time management, money management etc, but this is not mandated as a national programme.

provides that the Superintendent may issue such directives as may be necessary to give effect to any decision made pursuant to the Act. Section 66.13(2)(b) provides that an administrator assisting a consumer debtor should provide, or provide for, counselling in accordance with directives issued by the Superintendent pursuant to section 5(4)(b). Consideration could be given to whether the Official Assignee could carry out a similar function in New Zealand; employment of staff trained in budgetary advice would enable the Official Assignee to carry out that task. We note that the issue of budgetary advice has been raised in the Ministry of Economic Development's Tier 1 paper *Bankruptcy Administration* (paragraph 7.2.1).

212 We note that information (including debt management advice) is available through BIZinfo, a business information service that provides free access to information about assistance available to businesses. The programme is funded through the Ministry of Commerce, and its Business Development Unit manages the contracts for delivery of the programme, including quality assurance monitoring. The programme aims to provide a comprehensive database of business assistance available in New Zealand. For further details see www.bizinfo.co.nz

PART 3
BUSINESS REHABILITATION

16
Background

INTRODUCTION

213 We have been asked to advise whether New Zealand should introduce a business rehabilitation regime (akin to voluntary administration) into its insolvency laws. Parts XIV and XV of the Companies Act 1993, and Part XV of the Insolvency Act 1967, already provide procedures whereby companies and individuals may enter into binding compromises or arrangements with their creditors. Unlike many schemes in other jurisdictions however, the provisions do not impose an automatic moratorium on claims, to enable the company to continue to operate, without interference, while a plan is being formulated and put to creditors. Further, the provisions do not expressly provide for an independent administrator to be appointed.

214 Voluntary administration schemes in other jurisdictions typically contain the following elements:[262]

- Voluntary submission by an entity to the process, which may or may not involve judicial proceedings and judicial control or supervision;
- Automatic and mandatory stay or suspension of actions and proceedings against the property of the entity affecting all creditors for a limited period of time;
- Continuation of the business, either by existing management, an independent manager, or a combination of both;
- Formulation of a plan which proposes the manner in which creditors, equity holders and the entity itself will be treated;
- Consideration of, and voting on, acceptance of the plan by creditors;

262 UNCITRAL:Future Work, above n77, para 104.

- Possibly, the judicial sanction of an accepted plan;

- Implementation of the plan.

215 This paper will consider whether a regime of this nature should be introduced into New Zealand and, if so, what form it should take. It is essential that any reforms to the law be appropriate to New Zealand conditions.

216 From our discussion in Part 1 of this report we highlight the following aspects which assumed significance in our approach and our recommendations:

- New Zealand has a small population, and the economy is largely comprised of small businesses; small and medium businesses comprise 99.4 percent of all enterprises, and only approximately 1200 could be considered "large;[263]

- New Zealand has an extremely small number of insolvency professionals, judges and lawyers; so specialist insolvency courts are impractical. Conversely, because the pool is so small, persons with expertise in the field are well known to each other, and to large lenders;[264]

- The economy as a whole may be affected simply by the performance of one or two major players; consequently options must exist to deal with the situation where such a business gets into difficulties;[265]

- There is substantial overseas investment in New Zealand businesses, particularly in companies listed on the stock exchange.

- There is no occupational regulation of insolvency practitioners in New Zealand; this is at odds with the practice in most of our major trading partners and, in particular, with the practice in Australia.

217 At the outset we mention an option which we considered but dismissed. It was the possibility of introduction of a regime akin to Chapter 11 of the Bankruptcy Code 1978 (US). That regime involves an automatic stay against secured and unsecured creditors on filing of proceedings of 120 days and does not require any insolvency criterion to be met

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263 See paras 96-97.

264 See paras 113-114.

265 Para 87.

to enter the regime. As mentioned earlier in this report, the United States' laws relating to secured creditors are different from those which apply in New Zealand: once a bankruptcy regime is commenced in the United States, a secured creditor is prohibited from exercising both its right to compel repayment of its debt and its repossessory rights.[266] Having regard to the strong secured creditor culture in New Zealand, we are of the view that introduction of a regime akin to Chapter 11 of the Bankruptcy Code (US) would introduce considerable uncertainty and is likely to increase the cost of credit. While the cost of credit in the United States reflects the existence of Chapter 11, New Zealand businesses are likely to add an additional risk premium to their costs if such a regime was introduced here. In addition, New Zealand is not of sufficient size to justify the specialist bar and court used in the United States to give effect to this procedure. Thus, risk that the cost of credit would increase is, in our view, sufficient justification for dismissing this option.

APPROACHING REHABILITATION ISSUES

218 Both a rational debtor and a rational creditor would be expected to desire maximisation of the economic value of the debtor enterprise if there were well grounded fears that the business was, or was likely to become, insolvent. But, for reasons which follow, it would be unrealistic to expect debtors and creditors to act that rationally in the absence of stern sanctions or incentives to bring about that result.

219 A rational debtor[267] would be expected to approach creditors as soon as it became clear that the business was in financial difficulties. A rational debtor might be expected to realise that it would antagonise creditors if full disclosure of financial difficulties was not made promptly. A rational debtor might also be expected to realise that if creditors are antagonised, their ability to consider settlement proposals may also be adversely affected. But all of that assumes that someone whose business is facing financial problems will act rationally: the stresses brought on by the prospect of business failure or the possibility that living standards may need to be reduced tend to make most people act irrationally at such times.

220 Similarly, a rational creditor might always be expected to agree to any proposal from a debtor which is likely to maximise returns to it. But, the problem is that in a collective

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266 Above n 116.

267 Including, for present purposes, the management of a trading entity other than a sole trader.

regime it is the impact on the general body of creditors which is the focus of attention: not necessarily the individual creditor's return. So,

- creditors may, in the absence of efficient and effective state enforcement of debtor conduct infringing acceptable bounds of commercial morality, be tempted to decline an economically reasonable offer to settle in order to exact some retribution against the debtor and to demonstrate that others dealing with the creditor should not regard it as a "soft touch";

- similarly, creditors may be angered by the conduct of the debtor in failing to disclose material information about its financial position in a timely manner; in some cases failure to make that disclosure will have led (wittingly or unwittingly on the part of the debtor) to an increase in the loss suffered by the creditor who, otherwise may have acted differently to minimise its loss;

- personnel within creditors who have contributed to their own loss (eg by making an imprudent lending position) may not welcome the need to explain the loss to their superiors and may, therefore, prefer to let the law take its course, as a liquidator will rarely examine lending conduct of a creditor in the course of his or her duties;

While these choices may be seen as beneficial to a particular creditor, the problem is that the choice may adversely affect the likely dividend to be received by other creditors; and a rehabilitation regime is a collective regime based on equitable distribution of proceeds for the benefit of all creditors.[268]

EXISTING NEW ZEALAND PROCEDURES

221 There are currently three statutory procedures available in New Zealand whereby insolvent businesses can enter into agreements with their creditors as an alternative to liquidation/bankruptcy. They are Parts XIV and XV of the Companies Act 1993 (for companies) and Part XV of the Insolvency Act 1967 (for individuals).

222 The key elements of Part XIV of the Companies Act are:

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[268] The pari passu rule.

- Either a company's directors, its receiver or liquidator, or a shareholder or creditor of the company (with leave of the court) may propose a compromise between a company and its creditors;[269]

- The proponent of the compromise must call a meeting and provide detailed information to the creditors about the proposal and its affect. Pending the meeting there is no automatic stay, although one may be sought from the court. Such a stay cannot be ordered against secured creditors;[270]

- If different classes of creditors have different interests, it is usually necessary to hold separate meetings for each class;

- A compromise is binding on all creditors that received notice of the proposal if 75 percent at each meeting vote in favour (unless there is provision in the compromise for classes of creditors to be separately bound). There is no need for the court to approve the compromise, however a creditor may apply to the court for relief on certain prescribed grounds (insufficient notice, irregularity in obtaining approval, unfair prejudice).[271]

223 Part XV of the Companies Act 1993 permits an application to be made directly to court by the company, a shareholder, or a creditor, for an order that a compromise is binding on the company and "on such persons … as the Court may specify … on such terms … as the Court thinks fit".[272] No other guidance is set out as to how the court should exercise its discretion, although tests have been set out in subsequent cases.[273]

224 Part XV gives the court power to make initial orders regarding the provision of information and reports to shareholders, and the calling of meetings. It is usually appropriate to make such orders before considering whether a final order should be made.[274]

225 Part XV of the Insolvency Act applies to insolvent individuals. Its key elements are:

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269 Companies Act 1993, s 228.

270 Section 229.

271 Section 230.

272 Section 236.

273 For example, *Suspended Ceilings (Wellington) Ltd v CIR* (1997) 8 NZCLC 261,318 (CA); but, see also paras 265-269.

274 *New Zealand Company Law and Practice* (CCH, Auckland, 1993) paras 62-125.

- The insolvent individual provides a proposal to his creditors, together with other detailed information including his financial position;[275]

- A trustee named in the proposal then calls a meeting of creditors. The proposal is accepted if a majority of the creditors in number, and 75 percent in value, vote in favour. Pending the meeting there is no stay, however bankruptcy petitions against the debtor are commonly adjourned to enable the proposal to be voted on;[276]

- The trustee must then apply to the court for an order approving the proposal. Certain prescribed grounds are set out for refusing the application (Act not complied with, proposal not reasonable, not expedient to approve). If approved by the court then the proposal is binding on all creditors with provable debts;[277]

- After approval the trustee has a continuing duty to file reports with the court.[278]

COMMENT ON ADEQUACY OF STATUTORY PROCEDURES

226 In considering whether to introduce an administration scheme we considered it useful to seek the views of a number of specialist insolvency practitioners as to the adequacy of the current set of formal procedures for compromising debts. We accordingly circulated a letter to 12 practitioners. We asked:

(a) Has an attempt to negotiate a rehabilitation procedure failed due to the lack of an automatic stay against secured creditors?

(b) For their views on Parts XIV and XV of the Companies Act 1993.

We also asked for estimates of costs for a straightforward compromise. Our letters are annexed at appendix A. A summary of responses to our second letter is set out in appendix B.

227 The responses to our first letter were reasonably consistent. In summary:

275 Insolvency Act 1967, s 140.
276 Sections 141 and 142.
277 Sections 143 and 144.
278 Section 144.

- None of the practitioners said that an attempt to negotiate a rehabilitation plan had failed due to the lack of an automatic stay against secured creditors. Most said that secured creditors acted reasonably; as long as (a) their interests were not prejudiced, and (b) the insolvency practitioner was reputable, the secured creditors would tend to agree to a rehabilitation plan;

- Several practitioners said a stay would be useful in that the cost and time in negotiating with secured creditors would be avoided;[279]

- None of the practitioners had made great use of Parts XIV and XV; some had never utilised the procedures. A minority of the practitioners considered that the procedures were too costly and time consuming to be of any use in most cases. But it was reasonably clear that informal negotiations took place against the backdrop of Parts XIV and XV of the Act. None of the practitioners were able to identify any specific areas in which the procedures could be made less costly or time-consuming; several in fact said that when it was suitable to use the procedures, they were very useful and flexible.

228 After we received written responses from insolvency practitioners we had the benefit of a meeting with a number of senior insolvency practitioners in Auckland on 2 February 2001. In relation to the questions posed in appendix A, the following points were made at that meeting:

- There was general confirmation that circumstances could not be articulated in which a rehabilitation procedure with genuine prospects of success had failed *solely* because of the lack of an automatic stay against secured creditors;

- Parts XIV and XV of the Companies Act 1993 were "grossly under utilised"; an educational issue was raised in relation to some creditors, ie whether they tended to focus on the benefits to shareholders or directors from the use of those procedures rather than on the potential benefit to the creditor by way of distribution if the economic value of the business was preserved; an educational issue was also raised with regard to the managers of insolvent companies;

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279 As we understand their responses however, they were referring to a stay, which would last for the entire rehabilitation period. This is unrealistic. The stay is only intended to allow businesses time to negotiate, not to trade its way out of difficulty.

- The importance of a moratorium was to provide stability while an evaluation of the viability of the business was undertaken; it was accepted that it was necessary to provide incentives for directors to face up to creditors as early as possible.

- In some cases Parts XIV or XV of the Companies Act 1993 could not be implemented economically because poor information systems were maintained by the directors of the debtor company.

229 One of the participants at that meeting referred us to a paper presented to the INSOL Pacific 99 conference in Auckland in February 1999 by Derek Williams, Controller, Asset Structuring of the Bank of New Zealand at Wellington.[280] In relation to compromises involving the continued operation of the business, Mr Williams noted that a secured creditor would be influenced by:

- The nature of the relationship with the debtor and the professional advisors;

- Whether the "problem" which created the insolvency would continue to exist if the compromise was implemented.

- Whether the secured position would be weakened or disadvantaged by consent.

- Whether reckless trading or fraud was involved; this being a factor which would weigh against acceptance.

230 Mr Williams emphasised that each proposal was considered on its own merits but that if there was to be agreement by a secured creditor there would normally be

- a full reservation of rights should there be default,

- a requirement of full financial disclosure, including budgetary information, for the compromise and

- confirmation of what was required from the bank in terms of the compromise.

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280 In his paper Mr Williams made it clear that the views he was expressing were personal and not necessarily those of the Bank of New Zealand. See Williams "The Secured Creditor" (Paper presented at INSOL Pacific 99 Conference, Auckland, February 1999).

The bank would also want to know what fiscal position was being taken by the shareholders or directors of the company in relation to the compromise; eg was any money being injected to pay creditors?

231 The observations which we have set out tend to be consistent with what evidence exists as to experience in other jurisdictions.[281]

232 In order for readers to assess the observations which we are about to make, we have set out in appendices C, D, E and F summaries of the main elements of business rehabilitation legislation the United Kingdom, Australia, Canada and the United States.

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281 See, in particular, Routledge "An Exploratory Empirical Analysis of Part 5.3A of the Corporations Law (Voluntary Administration)" (1998) 16 Comp&Sec LJ 4.

17
The Issues

233 At first sight there would appear little point in introducing a different rehabilitation regime to New Zealand given that none of the practitioners with whom we have consulted with, consider that the lack of a stay against secured creditors is a problem.[282] The nature of the New Zealand economy is also a disadvantage given;

- The large number of small businesses, meaning administration is unlikely, generally, to be cost effective;[283] and
- The lack of a large pool of insolvency practitioners, lawyers, and judges with expertise in insolvency issues.

234 We consider, however, that there are justifications for introducing a targeted rehabilitation regime in order to improve the law in this area. Our reasons for reaching that view are set out below.

235 First, we consider that insolvency laws should provide incentives for debtors with financial difficulties to face their creditors at the earliest possible time. Voluntary administration regimes provide these incentives. The early recognition of problems provides benefits for both the debtor and creditor. This objective is clearly spelled out in the third principle for review approved by Cabinet.

236 Second, as emphasised earlier,[284] insolvency laws should be developed in good economic times to cater for circumstances that may arise in bad economic times. In bad economic times the number of cases requiring prompt resolution will increase markedly; in larger businesses or those controlling strategic local or national assets, a "standstill" period to

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282 We contrast this with earlier writings which assumed that a voluntary administration scheme would be desirable: eg *Company Law: R9*, above n59, paras 114 and 650.

283 See paras 96-97.

284 See para 38.

assess whether rehabilitation is a better economic outcome is likely to promote better decision making.

237 Third, we consider that it is desirable to have a flexible array of remedies available to fit any circumstances that may arise.

238 Fourth, a rehabilitation scheme which targets businesses run by honest and competent management is likely to reduce circumstances in which management of a debtor may wish to invoke statutory management for rescue purposes. We have in mind particularly, issues which could arise through temporary liquidity problems caused by a calamity (eg an earthquake) to a business operating an infrastructure asset of national significance (eg the railway) which, in the absence of such a procedure, may be required to seek protection under the statutory management regime. We believe, for reasons on which we expand in Part 4 of this report, that there is merit in restricting the circumstances in which resort may be had to the statutory management regime created under the Corporations (Investigation and Management) Act 1989.

239 Having considered the benefits of introducing such a regime, we note that there is currently a disincentive for debtors to enter into compromises which result in part of their debt being released; that is that the written-off debt may be assessible for tax.[285] Given the benefits of encouraging collective compromises, we recommend that consideration be given to removing the tax liability of debtors under such arrangements. A full fiscal assessment of the consequences of such removal would need to be undertaken.

240 Having regard to the large number of small to medium sized enterprises which carry on business in New Zealand we have concluded that there would be little or no benefit to creditors as a whole in introducing a widely drawn voluntary administration regime, as it is likely that the costs involved in implementing the regime would be prohibitive. Ultimately, the aim is to maximise the economic value of a business; if the likely costs of rehabilitation exceed any benefit, which would be gained from salvaging the business, any creditor is likely to regard liquidation as the better option.

241 Ideally, creditors will wish to negotiate informal agreements in the shadow of the law. We have endeavoured to develop a legal framework, which will enable creditors to do

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[285] Income Tax Act 1994, s EH 4.

that. Of some importance in that regard are recent principles developed by INSOL International's Lenders Group which comprise representatives of world wide major banking organisations.[286] Eight principles have been developed to guide informal work outs. Those principles are:[287]

(a) **FIRST PRINCIPLE**: Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to co-operate with each other to give sufficient (though limited) time (a "Standstill Period") to the debtor for information about the debtor to be obtained and evaluated and for proposals for resolving the debtor's financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

(b) **SECOND PRINCIPLE**: During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced.

(c) **THIRD PRINCIPLE**: During the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the Standstill Commencement Date.

(d) **FOURTH PRINCIPLE**: The interests of relevant creditors are best served by co-ordinating their response to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative co-ordination committees and by the appointment of professional advisers to advise an assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

(e) **FIFTH PRINCIPLE**: During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisers

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286 In particular, the following were represented on the Lenders Group: Hong Kong Shanghai Banking Corporation, Barclays Bank PLC, Royal Bank of Scotland, National Westminster Bank PLC, J P Morgan, The Industrial Bank of Japan, Deutsche Bank, Credit Agricole Indosuez and The British Bankers Association.

287 INSOL International, London, October 2000.

reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.

(f) **SIXTH PRINCIPLE**: Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.

(g) **SEVENTH PRINCIPLE**: Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.

(h) **EIGHTH PRINCIPLE**: If additional funding is provided during the Standstill Period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

242 The INSOL Lenders Group's principles are premised on the need to benchmark proposals for salvage of a business against what a lender is likely to receive if liquidation occurs.

18
Corporate or Business Rehabilitation?

243 A point of some importance is whether New Zealand should focus any rehabilitation regime on a particular entity (this will usually involve the corporate model) or businesses generally. This question also has significance on the question whether there should be a single statute.[288] We address that question now.

244 When attempts are made to salvage a company it is really the core business which is the subject of salvage rather than the corporate shell itself. As one American commentator put it to us, it is the entrepreneur who lies behind the corporate shell.[289] And, of course, promotion of entrepreneurship and innovation is a goal of the insolvency law review.[290]

245 Plainly, there are differences between individuals and companies[291] which require some of the rules applicable on insolvency to be expressed differently in each case; eg the need for property to vest in an insolvency administrator and the provisions for discharge from bankruptcy of individuals. But there are many common features also; eg the rules relating to antecedent transactions,[292] priority debts[293] and the rules relating to proof of debts for distribution purposes.[294] In our view the common threads can be expressed more clearly

288 See Part 5 at para 371.

289 We are indebted to Professor Westbrook for this insight.

290 See para 52

291 As Sir Donald Nicholls VC noted in *Re Paramount Airways Ltd* [1992] 3 All ER 1 (CA), a corporate debtor, after liquidation and distribution of funds to creditors will be dissolved while the law is more merciful to individuals who will be discharged from bankruptcy (usually) after distribution and permitted to resume a normal life free from the burden of past debts. So far as individuals are concerned this is known as the "fresh start" principle.

292 A good example because of the way tests were changed for companies as a result of the Companies Act 1993; this has resulted in different tests applying to individuals and companies with no good reason for the difference.

293 *Priority Debts*, above n2.

294 See s 302 Companies Act 1993 which states:

302 **Application of bankruptcy rules to liquidation of insolvent companies**

(1) Subject to this Part of this Act, the rules in force under the law of bankruptcy with respect to the estates of persons adjudged bankrupt apply in the liquidation of a company that is unable to pay its debts to--

(a) The rights of secured and unsecured creditors:

in a single statute. Further, nothing will be lost by dealing with both individuals and businesses in the same statute, as different Parts of the same statute can contain "purpose" provisions which identify the unique characteristics of the particular regime.

246 The main criticism which could be directed at a general business rehabilitation scheme is that it ignores problems which would develop from the use of individual or household assets when it is the business of the individual (as sole trader) or a firm (eg a partnership) which is the subject of restructuring.

247 However, that criticism can be answered in this way. Both a sole trader and a partnership must take into account, when considering the prospect of bankruptcy or dissolution of a partnership, the fact that if there are any debts which remain unsatisfied after application of business assets, they will be personally liable to pay those debts. To that extent, the assets which they hold in a personal capacity will come into play in any event. They will certainly be taken into account by any creditor who is considering the hypothetical outcome on bankruptcy of an individual or the partners of a firm as a benchmark for a proposal to restructure. Thus, sole traders or partnerships who wishes to avail themselves of a rehabilitation regime will need to factor personal assets into any compromise.

248 There are also advantages in being able to address business rehabilitation directly. For example, there have been a number of criticisms made of Part XV of the Insolvency Act 1967 because a partnership cannot file a single proposal to restructure because of the way in which the term "insolvent" is defined in s 139 of the Insolvency Act 1967.[295]

249 It is clear that if the focus of our insolvency law shifts from the entity to the activity, that a single statute will be easier to craft and is more likely to promote the twin goals of making the law both more accessible and understandable.

(b) Claims by creditors:

(c) The valuation of annuities and future and contingent liabilities--

and all persons who in any such case would be entitled to make claims and receive payment in whole or in part are so entitled in the liquidation.

(2) In applying in a liquidation the rules in force under the law of bankruptcy, a claim made under section 304 of this Act and admitted by a liquidator is to be treated as if it were a debt proved in accordance with the requirements of the Insolvency Act 1967.

This causes an accessibility problem as the "rules.. of bankruptcy" to which s 302 (1) refers are unstated and must be divined by a decision-maker.

295 Generally, see *Laws NZ: Insolvency*, above n10, para 450, *Re Falconer* [1981] 1 NZLR 266 and *Re Chard* [1985] 2 NZLR 614; cf Part III of the Bankruptcy Act 1949 (Canada) which entitled a proposal to be made by a partnership or an unincorporated body.

250 We are of the view that rehabilitation regimes should be directed to the activity of the business rather than to the particular entity concerned because:

- less legislation will be required;
- the risk of inconsistency is reduced and
- policy goals can be developed in a coherent fashion.

Accordingly, we recommend that the new insolvency legislation be drafted in that way.

19
Conclusions: Business Rehabilitation

THE QUESTION

251 Debtors and creditors may each have selfish reasons to avoid the rational choice of co-operation to maximise the economic value of the entity.[296] How then can the law develop incentives or sanctions to persuade debtors and creditors to ignore those selfish reasons and concentrate on the task of maximising the value of the enterprise for the benefit of the general body of creditors?

OUR APPROACH

252 Our starting point is the provisions of the law which deal with liquidation. Creditors need to assess the value of what is being proposed to them against what they would be likely to receive if the enterprise was liquidated. If the creditor gets nothing more than what would be received on liquidation there is no incentive for it to agree to any rehabilitation proposal.

253 The next step is to consider the way in which competent people conduct negotiations which can lead to a rehabilitation. The following factors are relevant:

- The debtor will have, or ought to have, kept accounting records, which enable the financial position of the business to be determined with reasonable accuracy at any time.[297] Where such records have been kept, an honest and competent debtor should know when the business is entering troubled financial waters. Using the tests set out in Part XIV Companies Act 1993,[298] in the absence of a calamitous event, the debtor should know that the enterprise is likely to become insolvent before it becomes clear that the enterprise is, in fact, insolvent.

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296 See para 220.

297 Companies Act 1993, s 194 (1) (b).

298 Companies Act 1993, s 228 (1).

- A competent and honest debtor would then seek advice. The adviser must be able to advise quickly, or to refer the debtor for expert assistance where necessary.[299]

- In conducting a viability assessment of the core business, an experienced and competent insolvency practitioner would be expected to talk to the debtor (or the management of the debtor), to key employees, and, after considering the information available from the accounting and other records of the business, discuss the issues with major creditors before deciding whether a rehabilitation plan was likely to be viable and have the support of major creditors. Certainly, any creditors holding security over all or substantially all of the debtor's assets or over a strategic asset necessary to continue the business should be consulted early in the piece.

Early disclosure of material financial information to creditors will encourage the likelihood of a sympathetic ear to rehabilitation proposals. Trust and confidence is the key to success.

254 If this process is undertaken, both debtor and creditor will know, well before determining whether to lodge a rehabilitation application with the High Court, the likelihood of the business being salvaged, the prospects that the restructured business will be worth more to creditors than in a liquidated state, and the likely view of creditors to a formal application. At that stage, if there is unanimity, it will be possible to reach an informal arrangement by consent; if there is not unanimity the question will be whether the requisite majorities can be attained to ensure the success of the rehabilitation plan.

PART XIV COMPANIES ACT 1993

255 We are satisfied from the research which we have carried out that there is no need to make alterations to Part XIV of the Companies Act 1993, although we do suggest that in focusing on the activity rather than the entity, it is necessary to synthesise the provisions of Part XIV of the Companies Act 1993 and Part XV of the Insolvency Act 1967. Generally, we would urge a reconciliation which tended to focus on the procedures set out in the Companies Act 1993, Part XIV. In our view the provisions of Part XIV Companies Act are, generally, as simple and as inexpensive as can reasonably be

299 There are very few people in New Zealand practising as insolvency practitioners who have the skill to undertake a reliable viability assessment of the core business and be able to present that

achieved. Nothing more can be done to make those regimes more cost effective for the very small businesses, which still find the cost of proceeding prohibitive.[300]

256 In determining the likely use by smaller to medium sized enterprises of an administration system, rather than Part XIV, we have considered statistics extracted from the United Kingdom which demonstrate the number of administration proceedings in Scotland compared with the rest of the United Kingdom.

257 The following table is extracted from small business statistics taken from the website of the Department of Trade and Industry in the United Kingdom and from a report from the Bank of England entitled *Quarterly Report on Small Business Statistics.* The breakdown of businesses is very similar to New Zealand; the big difference, of course, is in the number of businesses as opposed to the percentages.

Table 1

No of employees	New Zealand	United Kingdom	European Union
>100	0.5 percent	0.4 percent	
50 to 100	0.5 percent	0.4 percent	
<100	99.5 percent	99.6 percent	
<50	98.9 percent	99.2 percent	98.9 percent
<10	92.5 percent	94.9 percent	93 percent
<5 (<6 for New Zealand)	86 percent	89.4 percent	

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assessment in a credible manner to major creditors, such as banks, finance companies or large suppliers of goods.

300 In the course of our consultation we wrote to 12 insolvency practitioners asking for a response as to the likely cost of a straightforward compromise under Part XIV of the Companies Act 1993 which involved about 20 creditors (see appendix B for summary of responses). The estimated cost was between $7,000 and $10,000. Thus, assuming there are assets to distribute of $100,000 that would amount to between 7 percent and 10 percent of the monies available for distribution. It can be seen from that brief analysis that one must be careful in considering the cost/benefit analysis in relation to rehabilitation issues.

258 Table 1 demonstrates that the percentage of businesses which can be characterised as small to medium is much the same in the United Kingdom as in New Zealand.[301]

259 Table 2 demonstrates, however, that there are 14 times more businesses in the United Kingdom than in New Zealand but that the number of businesses in Scotland is similar to the number in New Zealand.

Table 2

Jurisdiction	No of business entities
United Kingdom (Including Scotland)	3 676 935
New Zealand	259 304
Scotland	233 430

260 Less than 1 percent of businesses in New Zealand can be characterised as large. On the figures extracted earlier, the number appears to be about 1,200.[302] Given the size of businesses in New Zealand we have formed the view that in most cases it would be uneconomic to pursue a rehabilitation regime with mandatory stays against both secured and unsecured creditors. Instead, we favour an approach, which will provide an alternative rehabilitation regime targeted at bigger businesses but capable of being employed by smaller businesses if circumstances permit and if it is likely to be cost effective in the particular case.

PART XV COMPANIES ACT 1993

261 In our view, Part XV of the Companies Act 1993 should be repealed. Our reasons for reaching that view are twofold: i.e.

- The test expressed in s 236 of the Act is too imprecise; [303] and

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301 The Ministry of Commerce, in its publication *SMEs in New Zealand: Structure and Dynamics* refer to statistics indicating that large business in the United Kingdom and the United States in fact employ a significantly higher percentage of the work force than large businesses in New Zealand (above n121, 26-27).

302 See para 97.

303 See our discussion of the need for clarity in legislation in chapter 10.

- Creditors who do not agree to a compromise should not have a compromise forced upon them by the court unless the majorities set out in Part XIV are attained.[304]

262 We believe the reason why the legislation has not been used is that it is regarded as being unpredictable in nature, and anyone seeking to use the provision would need to be aware that high court costs may be involved in litigating issues. We expand on that summarised view below.

263 Part XV of the Companies Act 1993 permits an application to be made directly to court by the company, a shareholder, or a creditor, for an order that a compromise is binding on the company and "on such persons … as the Court may specify … on such terms … as the Court thinks fit".

264 Part XV gives the court power to make initial orders regarding the provision of information and reports to shareholders, and the calling of meetings. It is usually appropriate to make such orders before considering whether a final order should be made.[305]

265 Difficulties have arisen in determining the test that the court should apply, in deciding whether to order that a compromise is binding. The issue was considered in two Court of Appeal decisions arising out of the same case: ie *Suspended Ceilings (Wellington) v CIR*[306] and *Suspended Ceilings (Wellington) v CIR*[307].

266 In the first case the court held that there was no requirement that the company and its creditors needed to have arrived at an agreement prior to applying to the court; it considered that the provision gave the court the power to impose a proposal on creditors. In the second case, the court (differently constituted) considered what test it should apply in deciding whether to order that a proposal was binding. All of the judges decided that the test under the predecessor to Part XIV should not be applied to Part XV, since under the previous legislation, no application could be made unless 75 percent of creditors had

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304 See para 267.

305 CCH, above n274, para 62-125.

306 [1995] 3 NZLR 143.

307 (1997) 8 NZCLC 261,318.

already voted for the proposal. Since under Part XV no creditor approval was needed, the judges believed that a more stringent test was needed.[308]

267 The court was divided as to what the test should be. Henry and Keith JJ expressed the tentative view that the applicant needed to show the court at least that[309] "it would be unreasonable not to make the order sought". Thomas J declined to put forward any test, believing that the first *Suspended Ceilings* case had been wrongly decided. His reasoning was essentially that it was wrong to impose a proposal on creditors when they did not agree to it; they were entitled to rely on their legal rights, and it was not appropriate for the court to enquire whether they were being "unreasonable"; that was a matter for their commercial judgement. Thomas J distinguished Part XV from Part XIV in that in the latter case, most creditors wanted the proposal to go ahead. In such a case it is necessary to balance the rights of different creditors; and one creditor should not be able unreasonably to prevent the proposal going ahead.[310]

268 We consider that the position under Part XV is now hopelessly uncertain. We also see force in Thomas J's views. On this basis, our view is that Part XV should be repealed.

269 We note that Part XV of the Act was inserted into the Companies Act 1993 by the Select Committee late in the piece and was not the subject of a recommendation by the Law Commission. In *Suspended Ceilings (Wellington) Limited v. Commissioner of Inland Revenue* [311] McKay J, speaking for the court said:

> Part XV of the Act was inserted when the Bill was reported back to the House by the select committee. The committee's report refers to a number of submissions to the effect that the preceding parts dealing with amalgamations and compromises did not cover all situations. The Committee suggested that corporate reconstructions and arrangements and compromises with creditors that could not be practically effected within those parts should be brought within the Act.

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308 *Suspended Ceilings*, above n307, 261,321.

309 *Suspended Ceilings*, above n307, 261,321.

310 The appropriate test to apply under Part XV was also considered by the Court of Appeal in *Weatherston v Waltus Property Investments Ltd* (judgment 4 December 2000, with reasons 14 December 2000) unreported, Court of Appeal, CA 251/00. The case involved an application to approve a reconstruction arrangement involving 30 solvent companies; creditors were not directly affected by the proposal. In these circumstances the court said that the test proposed by Henry and Keith JJ in *Suspended Ceilings* "may not be pertinent" (at 13) and that this test was most appropriate where orders were sought "binding a creditor to a company's unilateral proposal to compromise a debt for a sum less than the amount". We agree with the court's interpretation. However the decision again illustrates the uncertainty inherent in Part XV applications.

311 [1995] 3 NZLR 143 (CA) at 148.

We are of the view that the reasons for introducing Part XV were speculative and are not justified in the current business environment.

CLASSES OF CREDITORS

270 In relation to classes of creditors we believe that a case can be made out to limit classes of creditors to secured and unsecured creditors. There is no requirement for class voting in Part XV of the Insolvency Act 1967. If different classes of creditors have different interests, it is usually necessary to hold separate meetings for each class. The reason is to prevent larger classes of creditors voting for a proposal that benefits them, but prejudices the smaller classes, for example unsecured creditors voting for a proposal to prevent a secured creditor from enforcing his security.

271 The situations in which separate class meetings will be needed is explained in the statement from Bowen LJ in *Sovereign Life Assurance Co v Dodd.*[312]

> It seems plain that we must give such a meaning to the term 'class' as will prevent the section being so worked as to result in confiscation and injustice, and that it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

272 Simply because creditors dissent from the proposal does not mean that they are entitled to constitute a separate class; it is their rights that must be dissimilar, not their opinions as to the merits of the proposal. A related rule is that members of a class must cast their votes for the purpose of benefiting the class as a whole. If the member votes out of a personal or special interest, then the vote may be discarded.[313]

273 It is arguable that the requirement for classes should be removed since it complicates the procedure, and enables a small class to defeat an entire proposal, contrary to the interests of the other creditors.

274 We have referred to the issue of classes because it seems to us that this is an issue which should be considered in the course of the Ministry's further work on insolvency. The answer to whether classes should or should not remain may depend upon the weight to be attached to the need to protect members of small classes from having their rights affected by the interests of larger classes. In any event, we are of the view that the same rules

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312 [1892] 2 QB 573, 582.

313 *Re Farmers Co-operative Society of NZ* Ltd (1987) 3 NZCLC 100,154; Re *Farmers Co-operative Society of NZ Ltd (No 2)* (1988) 4 NZCLC 64,101; *Re Farmers Co-operative Society of NZ Ltd* (1991) 5 NZCLC 67,191.

should apply to both Part XV Insolvency Act 1967 and Part XIV Companies Act 1993 irrespective of whether a decision is taken to amalgamate those Parts into a single business rehabilitation regime or not.

A TARGETED REHABILITATION REGIME

Introduction

275 We propose that a new rehabilitation regime be developed. The target of such a scheme should be larger businesses, but the regime should be capable of use by smaller to medium sized businesses which can meet entry criteria. We also propose that the new regime be developed to deal with problems which could arise either through the insolvency of a State-Owned Enterprise or a strategic infrastructure business such as railways or water supply. We deal below with some specific aspects of our proposed rehabilitation regime. We recognise, however, that it is only possible to outline our thoughts at this stage: we accept that they will be capable of much improvement if further consultation is carried out by the Ministry of Economic Development (which we suggest).

Entry Criteria

276 As has been seen, different jurisdictions have relied upon different criteria in determining whether a business is eligible to take advantage of a rehabilitation regime; for example Part II of the United Kingdom Insolvency Act 1986 imposes strict criteria, conversely the regime under Chapter 11 of the United States Bankruptcy Code is extremely simple to enter.[314] Rehabilitation schemes typically require that the proponents of the scheme establish one or more of the following:

- That the company is insolvent;
- That there is a real prospect that the creditors will agree to some proposal;
- That entry into the proposal is likely to achieve some purpose such as the rehabilitation of the company, or the realisation of its assets at a higher price than in a liquidation.

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[314] The differing criteria are set out in appendices C to F. Under Chapter 11 there is no requirement even to prove insolvency.

277 The disadvantages of strict entry criteria are firstly that proving them can be costly, and secondly that they may dissuade companies from entering rehabilitation at an early stage.

278 In a regime targeted at larger businesses, which are run by honest and competent management, we suggest that appropriate entry criteria would be:

- Proof that the business was, or was likely to become, unable to pay its debts as they fall due.[315]

- A certificate from an appropriately qualified insolvency practitioner[316] that as a result of his or her inquiries:

  (a) The records of the business are such that a prompt report may be made to creditors;[317]

  (b) There is a real prospect

    (i) that the creditors will accept a proposal to restructure the business; and

    (ii) that once the restructuring proposal is implemented, the business will be able to pass the solvency test;[318]

  (c) If the proposal is accepted, it is likely to result in the unsecured creditors receiving more than they would in a liquidation.[319]

The reasons for forming those views should be expressed briefly in the certificate.[320]

279 As there are very few insolvency practitioners in New Zealand who have the skill and competence to make a viability assessment of this type, and to carry it into execution,[321]

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315 Compare Companies Act 1993, s 228(1).

316 See further at para 279.

317 Companies Act 1993, s 194 (accounting records) and Financial Reporting Act 1993, s 10 (preparation of financial statements).

318 Companies Act 1993, s 4; this could take the form of a cash injection or a debt for equity arrangement already negotiated with existing creditors.

319 Although the dividend to a debenture holder may not be improved there are duties on receivers to exercise powers with regard to the interests of unsecured creditors under the Receiverships Act 1993.

320 See also para 279.

321 See para 123(b).

we recommend that a certificate must be given by a practitioner who can demonstrate to the court that he or she

- has been appointed as an insolvency practitioner by the court in not less than ten collective insolvency regimes; and
- has not been the subject of a prohibition order preventing him or her from being appointed to a collective insolvency regime.

Evidence would be required in each case to prove these elements. We do not believe that such a requirement would unduly restrict competition because all that is required is a demonstration of sufficient experience to undertake a difficult task.

280 We envisage that a court order would be made ex parte, upon receipt of the appropriate certificate, proof of insolvency, and the insolvency practitioner's standing. The order would grant a moratorium against secured and unsecured creditors for a period of 14 days, with an ability to extend the moratorium for a further period of 14 days, if the insolvency practitioner certifies that there is a reasonable likelihood that the creditors will approve the proposed restructuring by requisite majorities currently in use under Part XIV of the Act.[322] The certificate would need to state the basis of that belief which, usually, would arise from discussions with the debtor (or its management) and creditors and from a consideration of the business' records.[323] A right for creditors to apply to set aside the

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322 In its discussion paper the Ministry of Economic Development recommend that an automatic 14 day stay be imposed once a "Request for Solvency Assessment " form is filed (MED: Tier One Papers, above n160, 40-41). Although this may seem inconsistent with our proposal, there may be reasons related to consumer bankruptcy, which justify such a stay, which are not relevant to our proposal which relates solely to businesses.

323 As can be seen we consider that a court order should be required for the initial moratorium, rather than an automatic stay as is allowed in other jurisdictions (for example, Australia). An automatic stay would be our preferred option; the costs of a court application would be avoided, and an appointment could be made without any delay. Unlike most jurisdictions we have considered however, insolvency practitioners in New Zealand are not regulated; virtually anyone can be appointed as a liquidator or receiver. In the context of voluntary administration this means that administrators could be appointed who were either unable to do the job competently, or who consciously acted to the prejudice of creditors. The issue is of considerable significance in voluntary administrations since creditors essentially have their rights removed as soon as the stay comes into effect. We consider that the issue of regulating insolvency practitioners is a complex one which needs to be considered in the context of insolvency law as a whole. Consequently we have considered the issue of granting a stay on the basis that in the medium term the profession will remain unregulated. On this basis, in order to ensure that creditors are not prejudiced by incompetent, or biased administrators, we consider that a court order should be required. Before making any order, the proposed administrator would first have to satisfy the court of his or her expertise.

stay should exist; courts would need to be able to accommodate argument on such applications at short notice.[324]

281 We have given consideration to the question whether the introduction of a moratorium against secured creditors under our proposed regime, affecting secured creditors, is likely to increase the cost of credit. If no similar regime had been in existence in New Zealand, we would have been more wary of introducing a stay against secured creditors for fear that the cost of credit would increase. But, it is apparent that secured creditors already build into their cost structures an element to include the risk of action on their securities being stayed through the operation of the statutory management regime. As we are recommending that the statutory management regime be amended to be a short term remedy of last resort designed to act as a filter to determine how a corporation in distress should be dealt with in the future, we believe, if anything, the overall risks faced by secured creditors will be diminished and that, as a matter of logic, there would be no justification for increasing the cost of credit.

Control of Business

282 The issue is whether the existing management should continue to run the business. Obviously if there appears to have been fraud or incompetence on the part of the management, then they should take no further part in the running of the company; but, our proposed regime is deliberately targeted at businesses run by honest and competent people, so that is not an issue. Other possibilities include:

- That the existing management continue to run the company, but with reporting duties to the court and the creditors;
- That the existing management run the company, but under the supervision of an administrator (who may have "the final say" on certain transactions);
- That the company be run by an administrator, possibly with the assistance of the previous management;
- That the company be run by a creditors' representative.

283 We see the role of the insolvency practitioner in our recommended regime as four-fold:

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324 See also our comments on court issues at paras 166-169.

- first, to investigate and report on whether it is likely the business can be salvaged;
- second, to negotiate with creditors[325] and management;
- third, to protect and secure the assets of the business; and
- fourth, to oversee continued management.

284 We envisage the insolvency practitioner being given power of veto in respect of management decisions but the management of the business remaining, for the duration of the stay, under the control of the existing management. The stay, itself, would also prohibit management from using bank accounts so an injection of new capital would be required on any view if this regime was to be implemented. That approach is consistent with a view that the benefits are in maximising the economic value of the enterprise and in liquidating it should the value as a going concern be less.

285 The appointee must have credibility to deal with all creditors. Disincentives must be put in place to management appointment or nomination of unsuitable persons. We suggest personal liability for any debts arising during the course of the scheme and a provision stating that the business would be liquidated immediately upon cessation of the stay if creditors had not agreed to reorganisation.

286 Confidence in the appointee is necessary for both creditor and debtor. The debtor must have confidence in order to remove the disincentive to face up to creditors as early as possible by removing the perceived threat of precipitate action. Creditors must have confidence to hold their hand for the period of the stay to allow the independent third party an opportunity to review the situation and report to them. This is no different than the standstill period which creditors accept is reasonable for the purposes of voluntary workouts.[326]

287 We set out the following reasons in support of a targeted rehabilitation regime:

- Competent and honest management of a debtor should be given incentives to face up to creditors as early as possible so that the fear (whether justified or not) of

325 The appointment by creditors of a Committee to represent them may both facilitate disclosure of information and promote a more efficient means of negotiation.

326 See para 241.

precipitate action by a major creditor does not dissuade management from trying to salvage the business where appropriate.

- The criteria have been strictly drawn so that incompetent or dishonest debtors or management are unlikely to pass the entry criteria. Dishonest or reckless management will rarely wish to face up to creditors because they stand to be exposed. The incompetent generally will not know until it is far too late that a problem exists. If the problem has not been identified early, there will be little prospect of salvage;

- It is in the interests of creditors to allow an opportunity for honest and competent people to disclose their position early as creditors (even secured creditors) invariably know less about a business than the debtor. Information gives the power to address a problem.

- There is a public interest in encouraging good corporate governance and in promoting honest and responsible behaviour by debtors. Existence of this system, even with tight entry criteria, will (with proper education) promote responsible behaviour, including maintenance and retention of financial information;

- Even though the regime is targeted at larger businesses, smaller to medium sized enterprises with good information systems may also be able to make use of it on a cost effective basis.

PART 4
STATUTORY MANAGEMENT UNDER THE CORPORATIONS (INVESTIGATION AND MANAGEMENT) ACT 1989

20
Criticisms of Statutory Management

INTRODUCTION

288 In order to put our review in context, we start by identifying a number of criticisms of the statutory management process under the Corporations (Investigation and Management) Act 1989. We address the significant ones in detail later in this report.

Distortion of market signals

289 In an efficient market, investors should price the risk of loss into their respective investments. It is inappropriate that those who, in hindsight, make a bad investment decision should receive government intervention and support. The statutory management regime may result in the distortion of market signals by providing inappropriate investor protection instead of allowing weak businesses to fail.

Moral hazard

290 The existence of the statutory management regime may give rise to a moral hazard problem by reducing incentives for members and creditors to scrutinise the actions of management, and in the process, reduce the incentives for management to perform. The primary responsibility for monitoring a corporation's operations and taking court action should rest with members and creditors.

Interference with creditors' rights

291 Members of the business community must have confidence that the contracts they enter into will not be overturned or adversely modified if a climate conductive to business growth is to be achieved. Statutory management prevents secured creditors from exercising their contractual rights by placing a moratorium, with no time limit, on enforcing those rights.

Negative effect on credit

292 Creditors demand an increased return to compensate for this uncertainty that the Act creates as to whether they will be able to enforce the securities that they have bargained for. This raises the cost of credit and hence the cost of doing business in New Zealand.

Lack of overseas precedent

293 There is no legislation similar to the statutory management regime in any other country.[327] Most comparable jurisdictions do have regimes, which enable arrangements to be made between businesses and creditors. These regimes often provide for a limited interference with creditors' rights. However, this occurs within the framework of insolvency law, and both creditors and the court usually have a role in initiating, controlling or approving such arrangements.

Adequacy of existing rules

294 Some suggest that existing company insolvency rules would have been adequate to deal with the collapse of the companies that have been put in statutory management. These criticisms are, however, of necessity, case specific.

Political involvement

295 There has been strong criticism of the use of a political process in the procedure for placing a corporation in statutory management.[328] This is said to give rise to concerns among overseas financiers that the government would try to influence the outcome of statutory managements.

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327 There are, however, provisions designed to deal with essential industries in the United Kingdom which are particular to those industries: eg Water Industries Act 1991 and Railways Act 1993; both are discussed in detail in Brown, above n6, ch 10.

328 The Securities Commission acknowledged in its 1992 report that there were problems with a regime that was initiated by political action. For this reason, it had recommended that the Securities Commission, rather than the minister, make the decision to place a corporation in statutory management. The Commission was relatively independent of Government and had links to the business community. It could access professionals who could advise and oversee, but not be involved in the day to day running of the statutory management. While there would still be transparency issues if the Securities Commission was the decision maker, the process would remain swift and confidential. These factors may be diminished if the decision became a judicial one.

Transparency and accountability

296 Recent international reports to which we have already referred have stressed the need for transparency and accountability in an insolvency law system. Transparency and accountability are vital to establishing trust and confidence in the insolvency process.

297 As an insolvency procedure, statutory management is neither transparent nor accountable. The decision making process whereby a corporation is placed in statutory management is confidential and interested parties are not entitled to be heard as of right; nor do they have a right to see the material on which the decision is based. Nor are they able to challenge the decision except on the limited basis of judicial review.

21.
History of Statutory Management

THE 1934 ACT

298 Statutory management has a long history in New Zealand. It was first used in the early 1930's in relation to certain investment companies and their associated companies. There were concerns for the financial viability of the investment companies and suspicions of fraud. The Government instituted a Commission of Inquiry to inquire into "the promotion, financial methods, control, and operation of companies and other corporations which seek to raise capital and loan funds in the Dominion".[329] In an interim report the Commission stated that there was a case for investigating the affairs of several named companies.

299 As a consequence, the Legislature passed the Companies (Special Investigation) Act 1934. The Act empowered the Governor-General to appoint inspectors to investigate the affairs of these companies. Provision was made for other companies to be brought under the Act.[330] Essentially, the Act was an adjunct to the provisions of the Companies Act 1933, ss 142-145, which gave the Court power to appoint inspectors into the affairs of a company on the application of a certain proportion of its members. Such inspectors had power to require the production of books and documents, the power to examine officers and agents of the company on oath concerning the affairs of the company, and reported to the Supreme Court. The investigatory powers of inspectors appointed under the 1934 Act were strengthened by making it an offence for those associated with the company under investigation to attempt to thwart the inquiry by destroying or altering or sending records out of the country. Provision was made for winding up the companies on the recommendation of the inspectors (s5). However, management of the companies was left in the hands of the directors.

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329 Commission of Inquiry into Company Promotion Methods "Final Report" [1934] AJHR H 25B.

330 On recommendation from the Commission of Inquiry or on request from a foreign government (s2(2)).

300 The Companies (Temporary Receivership) Act 1934 was passed three months later because of fears that the directors would dissipate the remaining assets. The Act essentially created a statutory management. The Public Trustee was appointed as receiver and manager of the companies. The Public Trustee's duty was to "conserve and keep intact the assets of the company" (s 5) and it was granted wide powers to manage the property. All persons having possession or control of any moveable property belonging to one of the companies were required to deliver it to the receiver (s 8), regardless of whether they were entitled to a lien or charge over it. No action or proceeding could be proceeded with or commenced against any of the companies or the receiver except by leave of the Supreme Court and subject to such terms as the Court might impose (s9(3)).

301 In April 1935, after the inspectors reported back, the Companies (Special Liquidations) Act was passed, providing for the winding up of the group of companies. The inspectors had found a complex web of loans to companies controlled by the directors of the two main investment companies. The Act appointed the Public Trustee as liquidator, creditors and depositors were able to apply to the court with respect to the exercise of any powers by the Public Trustee, and the Public Trustee was subject to the control of the Court in the exercise of those powers.

COMPANIES SPECIAL INVESTIGATIONS ACT 1958

302 In 1958 similar concerns arose in relation to the Intercity Group of companies. To deal with the situation, the Companies Special Investigations Act 1958 was passed. The 1958 Act was based on the 1934 Acts (which it repealed). Like the 1934 Acts, it was not of general application but applied only to those companies that were listed in a schedule.[331] The Attorney-General said the Bill was necessary because of the complex, interlocked relationships of the 29 companies, the strong suspicion of fraud, the need to act quickly to prevent the destruction of documents and the dispersal of assets (some of the companies being in liquidation), and the inadequacy of ordinary company law to deal with an interlocked group of companies in a swift manner.[332]

303 The Act provided for receivers and managers to be appointed to the companies, investigation of the affairs of the companies, and the winding up of the companies. As with the 1934 Act, all persons having possession or control of any moveable property

331 Although provision was made for the addition of other companies in certain circumstances.

332 (18 September 1958) 318 NZPD 1903.

belonging to one of the companies were required to deliver it to the receiver (s 9), regardless of whether they were entitled to a lien or charge over it, and no action or proceeding could be proceeded with or commenced against any of the companies or the receiver except by leave of the Supreme Court and subject to such terms as the Court might impose (s 10).

304 Those affected by the Act could apply to the court for an order to have a receivership determined (s 12). The Court could not make such an order if it considered that the receivership was desirable for the protection of any of the shareholders or creditors (whether secured or unsecured) or any of the companies to which the Act applied, or was otherwise in the public interest, and that the shareholders, creditors or the public interest could not be adequately protected under the companies Act 1955 or in any other way.

305 In 1963 the Act was amended to apply to any company declared by Order in Council to be subject to it. The grounds for making such an order were:

> Where it is desirable for the protection of any of the shareholders or creditors (whether secured or unsecured) of any company or companies, or for the protection of any beneficiary under any trust administered by any company, or it is otherwise in the public interest, that the provisions of this Act should apply to any company or companies, and the said shareholders or creditors or beneficiaries or the public interest cannot be adequately protected under the Companies Act 1955 or in any other lawful way …

306 When the Bill was introduced the Minister of Justice noted that the House had previously twice passed bills to deal with one-off situations involving complex intertwined groups of companies that were suspected of being vehicles of fraud (in 1934 and 1958).[333] Ordinary company law could not deal effectively with such situations. In each case the legislation had been passed in a single night while the House was sitting under urgency. Because it would be very awkward if a similar situation arose in the future and the House was not sitting, the Government had decided, on the advice of the Company Law Advisory Committee,[334] to make the 1958 Act of general application to any company by Order in Council. The Minister emphasised that the Advisory Committee would have to make a recommendation to the Minister of Justice before an order could be made. The Advisory Committee was independent and made up of professional people from relevant disciplines. This was considered a sufficient safeguard against government abuse of the Act.

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333 (24 September 1963) 336 NZPD 2018.

334 The Company Law Advisory Committee was established by the Companies Act 1955.

307 Over the period the 1958 Act remained in force (1958 to 1989) the statutory receivership provisions were invoked on 17 separate occasions. When introducing the 1989 Act, which replaced the 1958 Act, the Minister of Justice said that the 1958 Act had, in the main, been used in cases where a group of companies had been run as one company or when a group's affairs were so inextricable intertwined that the ordinary procedure of placing each individual company in the group in a separate receivership or liquidation would be cumbersome, unrealistic, unfair, and time consuming.

308 After the passing of the 1963 Amendment, at least two further special acts were passed to deal with commercial failures that did not fall under the 1958 Act. These acts may be distinguished from the 1934 and 1958 Acts in that their purpose was not to deal with complex intertwined groups of companies that were suspected of being vehicles of fraud. Rather, they were conceived as rescue or damage containment packages for "innocent" corporate failures.

CORNISH COMPANIES MANAGEMENT ACT 1974

309 The Cornish Companies Management Act 1974 was passed in response to the need to act in the face of the impending collapse of the large Cornish group of trading concerns. Mr Cornish had approached the Reserve Bank the previous week with regard to the group's impending insolvency. The Government determined that the best course was to pool the assets and liabilities of the group, to appoint a statutory manager,[335] to freeze the group's liabilities, and to provide for an orderly disposition of its assets.[336] The intention was to prevent a fire sale in which the investors, unsecured creditors and employees would suffer loss. The Government was unable to invoke the Companies Special Investigations Act 1958 because 45 percent of the group's assets belonged to Mr Cornish personally, rather than to his companies.

310 There was no suggestion of fraud and the Act was only deemed necessary to prevent a run on deposits and a forced sale of assets. It was believed that an orderly winding up would produce a better result for depositors and unsecured creditors. In addition, the Government appeared to believe that some units of the group might be salvaged as going concerns. The Act removed original management from control and the statutory manager was given extensive powers to run the businesses. A moratorium was imposed on

[335] The Act appears to be the first instance of the use of the term "statutory manager".

[336] (2 July 1974) 391 NZPD 2498.

creditor's rights.[337] The statutory manager was to report to the minister on a regular basis and copies of the reports were to be lodged with the Registrar of Companies. The statutory management could be terminated by the Governor-General, by Order in Council. The Act was passed under urgency and was supported by both sides of the House.

PUBLIC SERVICE INVESTMENT SOCIETY MANAGEMENT ACTS 1979

311 Like its predecessors, the Public Service Investment Society Management Act 1979 was passed in a single night with the support of both sides of the House. It was passed as a rescue package for the Public Service Investment Society. The PSIS's general manager had approached the Governor of the Reserve Bank earlier that week because he feared that the Society's accounts, which were due to be published, would spark a run on funds. There was no suggestion of fraud. The Companies Special Investigations Act 1958 did not apply because the PSIS was an industrial and provident society. In the event of insolvency, the provisions of the Industrial and Provident Societies Act were considered inadequate because they had not been designed for a society of the size of the PSIS. The first statute was followed a week later by a slightly more detailed statute, the Public Service Investment Society Management Act 1979 (No 2). Both statutes were closely modelled on the Cornish Companies Management Act 1974.

312 The Cornish Companies Management Act 1974 and the Public Service Investment Society Management Acts bear a stronger resemblance to statutory management under Part III of the Corporations (Investigation and Management) Act 1989 than do the previous Acts that were aimed at situations of fraud. There were suggestions in materials, that we located at the Ministry of Justice, that the statutory management provisions in the Reserve Bank Amendment Act 1986 were based upon these acts.

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337 8(1) After the commencement of this Act, no person shall,-

(a) Bring or continue any action or other proceedings against the said Arthur Scott Cornish or any company to which this Act applies, except with the leave of the Court or under section 10 of this Act:

(b) Issue any execution, attach any debt, or otherwise enforce or seek to enforce any judgment or order obtained in respect of the said Arthur Scott Cornish or any company to which this Act applies or the pooled property:

(c) Petition for the winding up of any company to which this Act applies:

(d) Foreclose, enter into possession, distrain for rent, sell, appoint a receiver, or take or continue any power or rights whatsoever under or in pursuance of any mortgage, charge, debenture, instrument, or other security over the pooled property.

(2) Subject to the provisions of this Act, nothing in subsection (1) of this section shall affect the existence of any security over the property of any company to which this Act applies or of the said Arthur Scott Cornish or its priority in relation to other debts.

THE RESERVE BANK AMENDMENT ACT 1986

313 The Reserve Bank Amendment Act 1986, now the Reserve Bank Act 1989, set up a system whereby registered banks are subject to ongoing supervision by the Reserve Bank. The Act sets up a disclosure regime, empowers the Reserve Bank to require information from banks and to investigate them, allows the Reserve Bank to declare banks to be at risk and to advise and direct such banks, and sets up a statutory management regime for failing banks in certain circumstances. For a bank to be placed in statutory management the Reserve Bank must recommend that course of action to the Minister of Finance, who must then give advice to the Governor-General, who will, if the advice is accepted, appoint a statutory manager by Order-in-Council.

314 The focus of the Reserve Bank Act is the protection of the state's financial system as a whole. Unlike some other countries, depositor protection is not an objective of bank regulation. Section 68 of the Reserve Bank Act requires the Reserve Bank to carry out its bank registration and supervision functions for the purposes of:

- promoting the maintenance of a sound and efficient financial system; or
- avoiding significant damage to the financial system that could result from the failure of a registered bank.

315 Section 118 of the Reserve Bank Act sets out the grounds upon which the Reserve Bank may make a recommendation to the Minister of Finance that a statutory manage be appointed:

> (1) The Bank shall not make a recommendation under section 117 of this Act unless it is satisfied on reasonable grounds that--
>
> (a) The registered bank is insolvent or is likely to become insolvent; or
>
> (b) The registered bank has suspended, or is about to suspend, payment or is unable to meet its obligations as they fall due; or
>
> (c) The registered bank or any associated person has failed to consult with the Bank pursuant to section 111 of this Act; or
>
> (d) The registered bank or any associated person has failed to comply with a direction under section 113 of this Act; or
>
> (e) The affairs of the registered bank or any associated person are being conducted in a manner prejudicial to the soundness of the financial system; or
>
> (f) The circumstances of the registered bank or any associated person are such as to be prejudicial to the soundness of the financial system.

316 We have referred to the Reserve Bank Act simply to distinguish it from the form of statutory management which we are considering in this report. The question for our consideration is whether statutory management under the Corporations (Investigation and Management) Act 1989 (to which we refer in the next chapter) should continue in New Zealand in its existing or some modified form.

317 DFC New Zealand Ltd is the only financial institution to have been placed under statutory management under the Reserve Bank Act.

22.
Corporations (Investigations & Management) Act 1989

318 The Corporations (Investigations & Management) Act 1989 (the 1989 Act) replaced the 1958 Act. Although intended as an update of the 1958 Act, the 1989 Act was largely modelled on the Reserve Bank Act.[338]

319 The application of the 1989 Act is wider than that of the 1958 Act. The 1958 Act applied only to companies, while the 1989 Act applies to corporations. A corporation is defined as "a body of persons, whether incorporated or not, and whether incorporated or established in NZ or elsewhere" (s 2). The 1989 Act also applies in a broader range of circumstances than the 1958 Act. Section 4 of the 1989 Act states:

> This Act applies to any corporation--
>
> (a) That is, or may be, operating fraudulently or recklessly; or
>
> (b) To which it is desirable that this Act should apply--
>
> (i) For the purpose of preserving the interests of the corporation's members or creditors; or
>
> (ii) For the purpose of protecting any beneficiary under any trust administered by the corporation; or
>
> (iii) For any other reason in the public interest,--
>
> if those members or creditors or beneficiaries or the public interest cannot be adequately protected under the Companies Act 1955 [or the Companies Act 1993] or in any other lawful way.

Section 4(b) replicates the grounds for applying the 1958 Act while s 4(a) is a new ground.

320 The general objects of the Act, set out in sub-section 5(1), are:

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[338] Which in turn may have owed something to the 1958 Act and the special Acts passed during the 1970s to deal with specific financial collapses.

(a) To confer powers on the Registrar of Companies to obtain information concerning, and to investigate the affairs of, corporations to which this Act applies:

(b) In the case of a corporation that is, or may be, operating fraudulently or recklessly, to limit or prevent--

(i) The risk of further deterioration of the financial affairs of that corporation; and

(ii) The carrying out, or the effects of, any fraudulent act or activity:

(c) In the case of a corporation referred to in section 4(b) of this Act, to preserve the interests of its members or creditors or beneficiaries or the public interest:

(d) To provide for the affairs of corporations to which this Act applies to be dealt with in a more orderly and expeditious way.

321 The powers conferred on the Governor-General, the Minister, the Securities Commission, and the Registrar of Companies by the Act must be exercised in accordance with the general objects of the Act (s 5(2)). This includes the power to place a corporation in statutory management.

322 Part I of the 1989 Act gives the Registrar enhanced powers to investigate corporations. The Registrar did have investigatory powers under the 1958 Act. However, Part I was almost entirely modelled on the Reserve Bank Act.

323 Part II empowers the Registrar to declare a corporation to be at risk (s 30). Such a corporation is obliged to consult with the Registrar as to its circumstances and the methods of resolving its difficulties (s 31). The Registrar is empowered to give advice to the corporation concerning its affairs, and advice and assistance in connection with the corporation’s capital, business undertakings, or any scheme for resolving the corporation’s difficulties (s 32). The Registrar may also, with the consent of the Securities Commission, give directions to an “at risk” corporation requiring it:

(a) Not to remove from New Zealand, transfer, charge, or otherwise deal with any of its property or funds except with the prior approval of the Registrar and subject to such terms and conditions as the Registrar may specify:

(b) To place in a trust account any money received for investment:

(c) To take such other action as is specified in the notice to preserve the interests of the corporation's members and creditors. (s 33)

Such directions are effective for up to 21 days (s 34) and contravening such directions is an offence under the Act (s 35).

324 Part II, like Part I, is a confidential procedure and it is an offence to disclose that a corporation had been declared to be at risk (s 36). Part II is entirely based on the Reserve Bank Act. It did not have any counterpart in the 1934 and 1958 Acts.

325 Part III of the Act is also largely modelled on the Reserve Bank Act. Part III empowers the Governor-General, by Order-in-Council, on the advice of the Minister given in accordance with a recommendation of the Securities Commission, to place any corporation and any "associated person"[339] in statutory management (s 38). Section 39 states that the Securities Commission shall not make a recommendation that a corporation be placed in statutory management unless it is satisfied on reasonable grounds:

(a) That the corporation is, or may be, a corporation to which this Act applies; and

(b) That, in the case of a corporation that is, or may be, operating fraudulently or recklessly, it is desirable that the corporation be declared to be subject to statutory management for the purpose of:

(i) Limiting or preventing the risk of further deterioration of the financial affairs of the corporation; or

(ii) Limiting or preventing the carrying out, or the effects of, any fraudulent act or activity; or

(iii) Enabling the affairs of the corporation to be dealt with in a more orderly or expeditious way:

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339 Section 2(2): a person is an "associated person" of a corporation if -

(a) That person directly or indirectly controls the management of the corporation; or

[(b) That person owns directly or indirectly, -

(i) In the case of a corporation that is a company registered under the Companies Act 1955, 20 percent or more in nominal value of the equity share capital (as defined in section 158 of that Act) of the corporation; or

(ii) In all other cases, 20 percent of the issued shares of the corporation, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital:]

(c) The corporation directly or indirectly controls that person; or

[(d) The corporation owns directly or indirectly,--

(i) In the case of a person that is a company registered under the Companies Act 1955, 20 percent or more of the equity share capital (as defined in section 158 of the Companies Act 1955) of that person; or

(ii) In all other cases, 20 percent or more of the issued shares of that person, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital:]

(c) That, in the case of a corporation referred to in section 4(b) of this Act, it is desirable that the corporation be declared to be subject to statutory management for the purpose of--

(i) Preserving the interests of its members or creditors or beneficiaries or the public interest; or

(ii) Enabling the affairs of the corporation to be dealt with in a more orderly or expeditious way.

326 Statutory managers are granted very wide powers under Part III to manage the corporation[340] and a widespread moratorium is imposed on claims against the corporation. Statutory managers have very limited reporting requirement and are not judicially supervised. A statutory management may only be terminated by the Governor-General by Order-in-Council.

327 In the exercise of the powers conferred by Part III, a statutory manager is required to have regard to:

(a) The need to preserve the interests of members and creditors of the corporation, or, where appropriate, the need to protect the beneficiaries under any trust administered by the corporation or the public interest:

(b) The need to resolve the difficulties of the corporation:

(c) As far as practicable, the need to preserve the business or undertaking of the corporation.

328 Although the 1989 Act is largely modelled on the Reserve Bank Act, it is not aimed at systemic regulation of the corporate sector. Section 7 provides that nothing in the Act shall be regarded as imposing on the Registrar, or any other person, any duty or

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340 The management of the corporation vests in the statutory manager (s45); the statutory manager has the power to suspend the payment of debts or the discharge of obligations, notwithstanding the terms of any contract (s 44); all the powers, rights and authorities necessary to carry out the powers conferred by Part III of the Act: specifically all the powers of the corporation, directors or governing body (s 46); the powers of a liquidator under s 269 of the Companies Act 1993 (s 46); power to carry on the business of the corporation (s 47); power to pay creditors and compromise claims (s 48); power to terminate contracts of service or agency, notwithstanding that the contract could not otherwise legally be terminated until a future date (s 49); power to sell business undertakings of the corporation (s 50); power to sell property or assets subject to a security (s 51); power to apply to have the corporation put into liquidation or would up(s 52); power to trace improperly disposed of property (s 54); the statutory manager may apply to court for directions (s

obligation to supervise the affairs of any corporation; or to apply or operate any system of supervision of any class of corporations or of corporations generally; or to exercise any power conferred by this Act in respect of any particular corporation.

329 This contrasts with section 67 of the Reserve Bank Act, which provides that:

> The Bank shall, in accordance with this Part of this Act … undertake prudential supervision of registered banks.

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58); the court may confer additional powers on statutory manager (s 59); the statutory manager may only be removed by the Minister (s 59)

23. Goals of Statutory Management Under the Corporations (Investigation and Management) Act 1989

330 The then Minister of Justice, on introducing the Corporations (Investigation and Management) Bill, stated that it had two broad purposes:

- first, to enable action to be taken earlier when a company is, or may be, operating fraudulently or recklessly; and
- second, to enable companies to be given a decent burial when ordinary remedies are inadequate.[341]

Thus, the Act has two quite distinct goals: one to do with general investor protection through the prevention of fraud and abuse, and one to do with insolvency issues.

331 The different parts of the Act promote either, or both, of these goals. Part I of the Act, which gives the Registrar enhanced powers to investigate corporations, promotes the investor protection/fraud and recklessness prevention purpose of the Act. Part II, which empowers the Registrar to declare a corporation to be at risk and to give it directions, also promotes this purpose.[342] Part III of the Act, which enables a corporation to be placed in statutory management, may support either goal. It enables current management to be replaced where fraud or recklessness is suspected, thus preserving the assets of the business while the situation is sorted out. It also may be used to rehabilitate or liquidate in extraordinary situations. However, as all corporations placed in statutory management have so far gone on to liquidation, some see it principally as an insolvency measure.[343]

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[341] (13 September 1988) 492 NZPD 6494.

[342] Conceivably, Part 2 could be a staging post on the way to Part 3 and liquidation. However, in practice, none of the corporations that have been declared at risk have subsequently gone on to statutory management.

[343] M J Ross "Political Expediency and Misguided Insolvency Reform – The New Zealand Experience with the Corporations (Investigation and Management) Act 1989" (1994) 2 Insolv LJ 25.

DIVISION OVER THE INTENT AND EFFECT OF THE ACT[344]

332 On the introduction of the Bill, views as to its intention and effect were sharply divided. The Reserve Bank perceived the bill as committing the government to investor or depositor protection. It suggested that this would severely distort market signals and competitive disciplines, and would tend to penalise institutions that have developed reputations for integrity and competence. The Reserve Bank even went so far as to say that in weakening market disciplines the bill would tend to undermine the effectiveness of the Bank's own system of prudential supervision and failure management of financial institutions.

333 The Department of Justice, disagreed with the Reserve Bank. It considered that the Act was restricted in its application by clause 4, and that clause 8 of the Bill (now s 7) clarified that the Registrar is under no duty to operate any system of supervision. The Department of Justice saw the Bill as a means of intervening in extraordinary situations rather than a means of systemic control. The subsequent history of the Act would support the Department's view.

334 Our review of the relevant material leads us to conclude that difficulties of the type to which the Reserve Bank referred have not occurred but that there have been problems in identifying the precise purpose for which the statutory manager is to act. Once it is accepted that there will be a wide moratorium against rights of secured and unsecured creditors to exercise remedies, it is necessary for balance to exist so that that period can be made as short as possible and the goals that the statutory manager is intended to pursue are defined precisely.

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344 See Reserve Bank of New Zealand "Submission to the Justice and Law Reform Committee on the Corporations (Investigation and Management) Bill 20 October 1988", and Department of Justice "Report to the Justice and Law Reform Committee on the Corporations (Investigation and Management) Bill 7 February 1989".

24.
The Securities Commission's Review

335 We now turn to consider the Securities Commission's review of the statutory management regime which was published in 1992. Initially, a discussion paper was published[345] - that discussion paper referred to a number of concerns which had been expressed about the statutory management regime by, in particular, various bodies and professionals.[346]

336 In 1992, due to the continuing controversy over statutory management, the Securities Commission reported to the Minister of Justice on Part III of the Act. At that stage the Commission appeared to view statutory management principally as an extraordinary insolvency procedure, no doubt because all of the statutory managements up to 1992 had been of that nature. The Report examined the need for a statutory management regime and concluded that a need did exist, principally due to the deficiencies of our corporate insolvency rules.

337 The deficiencies in the insolvency laws were identified as:

- the lack of any provision under the general law for the appointment of a single manger or body of managers to take central control of a group of companies in financial difficulty;
- problems of timeliness and confidentiality under general insolvency law procedures;
- the absence of any procedure by which a company in financial distress may obtain a "breathing space" from creditors' demands.

345 See Securities Commission *Corporations (Investigation and Management) Act 1989: A Discussion Paper*) (July 1991) ["Securities Commission: Discussion Paper"]; the Commission's final report was issued in April 1992: Securities Commission *Statutory Management: Report to the Minister of Justice on Part III of the Corporations (Investigation and Management) Act 1989* (April 1992) ["Securities Commission: Report"].

346 See Securities Commission: Discussion Paper, above n345, 8–13.

338 The Securities Commission recommended that statutory management be retained but that the Act be amended to incorporate amendments recommended in the report. A further review was suggested which would be part of a comprehensive review of the law dealing with insolvent and "at risk" corporations.[347] The Summary of Recommendations to be found in the Securities Commission's report is reproduced in appendix G.

[347] Securities Commission: Report, above n345, p (i)

25.
Addressing the Problems

INTRODUCTION

339 As set out in the introductory part of this chapter, the statutory management provisions of the Act have been the subject of strong criticism. Some criticisms were directed at any use of statutory management as an insolvency procedure. Others were directed at aspects of the statutory management procedure that offended against the principles of transparency and accountability referred to in paras 296-297 above.

340 It is instructive to consider how a leading author on insolvency law views statutory management. Philip Wood,[348] said:

> New Zealand has a broadly pro-creditor bankruptcy culture based on English ideas. But in the centre of this smooth-flowing river lies a rock which seeks to divert the strong current and throws up a mighty splashing in the process: the [Corporations] (Investigation and Management) Act 1989.
>
> This legislation allows the executive to appoint a statutory manager of a New Zealand company in the public interest and has been used either because of suspected misdoings or because of a labyrinthine corporate structure or to protect the public, usually meaning public shareholders or public debt holders. Creditors have virtually no influence on the proceedings. The manager has very wide powers to run the company. The stay freezes proceedings, executions, winding up petitions, enforcement by secured creditors, repossessions under retention of title, hire purchase agreements, leases or mortgages, forfeiture of land leases, landlord's distraint, set offs, and acceleration by secured creditors. Apart from that, the stay apparently does not nullify *ipso facto* clauses in ordinary commercial contracts. …
>
> It is believed that the procedure has in practice usually been operated by statutory managers with proper attention to acquired rights, consistent with the New Zealand tradition of fairness. But, like the Italian *amministrazione straordinaria*, the procedure raises the question of whether it is right for the political executive to take strong arm powers on the bankruptcy of ordinary commercial corporations.

341 Not for the first time in this report, we observe that trust and confidence can be affected by perception as well as by reality.

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348 Wood, above n9, 222. .

Relationship to institutional infrastructure and enforcement issues

342 The statutory management procedure relies on both the institutional infrastructure and the private sector. The Registrar of Companies plays an investigative role and determines whether statutory management should be recommended in any particular situation. The Securities Commission, in combination with the Minister, plays an adjudicative role in deciding whether a corporation will be put into statutory management. The Courts play a very limited supervising role, through judicial review, in ensuring that the minister and his officials do not act outside their powers when acting under the statute.[349] Finally, the administration of the statutory management is carried out by private sector insolvency practitioners. There is very limited supervision of the statutory manager. The Minister may appoint an advisory committee (s 60) and terminate the appointment of a statutory manager on various grounds (s 57). The statutory manager may apply to the courts for directions (s 58) and the court may allow a proceeding to determine the existence of a right or liability (s 42), but otherwise the conduct of the statutory management is largely unregulated.

Does Statutory Management offer any benefits as an extraordinary insolvency procedure?

343 Statutory management appears to have three potential benefits as an insolvency procedure:

- it provides an extraordinary procedure for business rehabilitation,
- it enables insolvencies involving groups of companies to be dealt with as a whole, and
- it provides an emergency measure for ensuring the continuing supply of essential services if the companies which provide them are faced with collapse.

344 In its 1992 report, the Securities Commission identified the lack of any provision for the appointment of a single manager, or body of managers, to take central control of a group of companies in financial difficulty, as a deficiency in our insolvency law. It considered

349 An example is *Hawkins v Davison* [1991] NZLR 530 (CA).

that it would be difficult to provide for an effective measure in general insolvency law because a mainstream administration regime acceptable to the commercial community (particularly the banking and finance sectors) would have to give much greater recognition to claimants' rights than would an emergency regime such as statutory management (the latter being applicable in only extraordinary situations). In particular:

- The Commission thought it essential that any form of administration regime make provision for the appointment of a manager to a group of companies. However, it was not always easy to determine if a particular company should be treated as a member of a group. Where there is no formal group structure (for example, companies are merely connected by cross-directorships) and yet the companies are run as a group, it is unlikely that a mainstream administration regime would allow the appointment of an administrator. Yet, in an extraordinary situation, this might be appropriate and beneficial.

- A mainstream administration regime would be likely to contain safeguards for claimants that would allow them to challenge the appointment and decisions of the administrator and the extent of any moratorium put in place. While this would suitable for the vast majority of cases, in the case of the collapse of a large corporate group, possibly involving fraud or allegations of misconduct, or where there is a great deal of acrimony between the various interested parties, that level of access to the courts may result in the insolvency/corporate distress remedy becoming bogged down in litigation.

- An administration regime may not be available to deal with a vehicle for carrying on business other than as a company, whereas the statutory management regime has a much wider application. The Act also applies to the business of a body incorporated outside New Zealand or having its head office outside NZ, to the extent that the body concerned has assets or business in NZ (s 2(4)). The broad reach of the Act has distinct advantages in addressing large scale or complex fraud affecting a group of inter-connected companies, trusts and other associations.

345 Our proposals:

- to adopt a targeted rehabilitation regime;[350] and

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350 See paras 275-287.

- to use statutory management as a short term filtering process supervised by the courts;[351] and

- to focus the new rehabilitation regime on the business activity rather than the corporate entity;[352]

will limit the use of statutory management and answer, we believe, the points raised by the Securities Commission.

Possible use as an emergency measure

346 A compulsory statutory management procedure may be useful where the public interest is involved. For example, if a company supplies an essential commodity, the continued supply of the commodity would not be left to depend on the decision of creditors.

Problems with statutory management as an insolvency procedure

Transparency and accountability

347 It may be accepted that statutory management has some benefits to offer as an extraordinary insolvency procedure. Nevertheless, there are considerable problems with the current procedure. As noted in the World Bank draft report (above paragraph x), efficiency, transparency and accountability are important features of any system of insolvency. Further, the administration of the insolvency must be subject to an adequate system of regulation.

348 As an insolvency procedure, statutory management is neither transparent nor accountable. The decision making process whereby a corporation is placed in statutory management is confidential and interested parties do not have input as of right, nor access to the material on which the decision is based. Nor are they able to challenge the decision except on the limited basis of judicial review.

349 The administration of the statutory management is not subject to an adequate system of regulation. The lack of reporting requirements on the statutory manager, and the constrained ability of interested parties to challenge decision-making in the courts, limit

351 See paras 353-362.

352 See chapter 18.

the transparency and accountability of the administration process. While the optional appointment of advisory committees, and the voluntary provision of reports by the statutory manager, provide transparency and accountability to a limited degree, this is scarcely adequate.

Cross-border issues

350 Statutory management may also be problematic in cross-border insolvencies. Because the procedure is commenced by executive order rather than judicial order, foreign courts may decline relief on the ground that statutory management does not constitute an administrative procedure.[353]

Systemic issues relating to confidence and trust

351 A well functioning economy requires a high level of confidence among those who invest in it, both as creditors and as shareholders. This confidence depends on trust that systems are in place to prevent undue risk to the investing public though fraud and recklessness on the part of those who have the management of their investment. It also depends on trust on the part of creditor that the bargains they make in good faith will be respected and that they can base their decision making on laws that enable them to assess risk as reliably as possible. A well functioning economy also requires laws that ensure that both the New Zealand public and investors from overseas will have confidence that their legitimate interests will be protected. This issue has attained greater importance with the privatisation of much of the New Zealand infrastructure in large part through sales to overseas investors.

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353 See the discussion of this topic in *Cross Border Insolvency*, abover n1, para 152.

26
Conclusions: Statutory Management

352 We propose to set out our conclusions in relation to statutory management in broad outline rather than in detail. This is because, while we recognise the benefits to be gained from many of the recommendations which were made by the Securities Commission in its 1992 review, we believe a fresh approach is now demanded. The detailed recommendations of the Securities Commission are set out in Appendix G. Thus, they will be available when this report is published for submitters to consider.

353 In the review of statutory management carried out by the Securities Commission, a number of amendments were suggested with which we agree. Other amendments were suggested which we would prefer to modify. In particular:

(a) We agree that statutory management (whether or not it continues to be known by that name) should be preserved as a remedy of last resort to be used if:

- the affairs of a corporation cannot adequately be dealt with by any other formal and collective insolvency regime; or
- the public interest requires it to be used.

(b) We disagree that the maximum period of statutory management should be six months; we prefer a limit of three months. We prefer three months because the object of statutory management is, generally, to bring order to a chaotic situation. The statutory manager will need to investigate and report on what he or she finds and then be given a clear direction as to what should be done. We consider however that there should be provision for the statutory manager to apply to court for an extension of the statutory management for a period not exceeding a further three months. The application would be on notice to all affected parties, and the statutory manager would need to satisfy the court that the extra time is needed to complete his/her investigation and to make a recommendation on the most appropriate way to deal with the corporation.

354 The Securities Commission took the view that applications to bring corporations under statutory management ought appropriately to be dealt with in a confidential manner. We disagree. In our view, a decision to invoke statutory management should be made by the High Court. Transparency and accountability are important when the legal rights of secured and unsecured creditors are to be severely restricted. While we fully understand that confidentiality is needed for investigations under Part I of the Corporations (Investigation and Management) Act 1989, and for declarations that corporations are "at risk" under Part II, we see no such justification for the decision in respect of statutory management[354]. In our view, statutory management should be invoked by court order on the application of the Registrar (or, if our earlier recommendations are adopted, our proposed Inspector-General). Only where a registered bank is the subject of an application should it be necessary, in addition to normal evidence to establish entry criteria, to file evidence[355] from the Governor of the Reserve Bank, or his or her delegate, confirming that the Governor does not intend to seek statutory management under the Reserve Bank of New Zealand Act 1989. We believe that the court should be required to give reasons for any decision imposing statutory management which can be made available to all creditors on request. It will be necessary for the court to arrange for statutory management applications to be dealt with urgently by the court and for notice requirements in respect of the moratorium to be built into the statute.[356]

355 As with our proposal for a targeted rehabilitation scheme, we recommend that statutory managers must satisfy the court of their skill and competence before being appointed.[357] We note however that difficulties are unlikely to arise in practice since statutory managers are appointed on the application of public officials who are aware of the relative competence and experience of insolvency practitioners.

356 We do not agree that the Corporations (Investigation and Management) Act 1989 currently provides sufficient guidance for statutory managers as to the purpose of their

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354 We envisage that a model for a court based statutory management regime could be the judicial management regime currently operated under Part iA of the Life Insurance Act 1908. See, more particularly, the observations of Barker J in *Re ACL Insurance Limited* [1991] 1 NZLR 211 at 214.

355 A certificate should suffice.

356 Compare Securities Commission's report (above n345, para 29), which stressed the need for timely resolution of such issues.

357 See para 279.

role. We believe that the Act should be amended to require a report after one month to creditors and shareholders (with copies to the Securities Commission and either the Registrar of Companies or the Inspector-General) with a meeting of creditors to be held during the second month to determine what action should be taken. Statutory management should be used as a filter to determine what insolvency procedure should ultimately be used, or whether the corporation can be returned in a solvent state to management.

357 If there is an interlocking group situation, that can be addressed by the statutory manager requesting an order that the entities be placed into a pooled liquidation regime. Otherwise, options could be return of the entity to existing management, liquidation or rehabilitation under an equivalent of Part XIV of the Companies Act 1993 or the targeted regime which we have proposed. Where the subject or subjects of a statutory management are not corporate entities, it may be necessary for specific legislation to be enacted to enable pooling of assets to occur as part of a liquidation process.

358 Although we agree that, as one of the entry criteria, a ground determined by reference to the public interest should remain, we would like to see the definition of the public interest more carefully circumscribed. We have in mind emergency situations where no other person can or will act; a problem with an infrastructure asset or an essential industry may also call for such action.

359 There would be a more limited scope for statutory management if our targeted rehabilitation regime is adopted. It would provide an additional option to deal with cases for which there is no appropriate and conventional insolvency regime.

360 Statutory managers will be given a privilege in respect of reports so that there is no fear of action for defamation unless malice is proved. It is plainly desirable that statutory managers state with frankness the conclusions which they have reached in reports directed to the court, the creditors, or an advisory committee. In our view, a privilege is required to encourage frank reports.

361 By giving the final decision making power to the High Court, both the Minister and the Securities Commission should be relieved of decision making and recommendatory functions respectively. But, we see a role for the Securities Commission to appoint (after consultation with interested parties) an Advisory Committee with whom the statutory manager can confer, and to whom the statutory manager can also report. The market knowledge of the members of the Securities Commission is important in that regard.

362 The statutory management regime would be targeted (except in public interest situations) at dishonest, reckless or incompetent management which has reduced a business to chaos. The primary object of the standstill period is to bring order to chaos, and then to allow the court to choose the most appropriate insolvency regime as quickly as possible. The use of statutory management as a filter in that way justifies the invasive nature of the moratorium in respect of secured creditors.

363 Statutory management should be capable of termination on order from a court which can then determine whether to hand back control of the corporation to management, or to place it into an appropriate insolvency regime.

364 It will be necessary to determine an appropriate way to deal with costs. We believe that the statutory manager should agree the cost regime in conjunction with the advisory committee which should be appointed in each case. That arrangement would be subject to sanction from the High Court. Similar reporting requirements to those found in the Receiverships Act 1993 for receivers will be required.

PART 5
A SINGLE STATUTE?

27.
Advantages and Disadvantages of A Single Statute

BACKGROUND

365 We have been asked to advise the Ministry of Economic Development whether it is appropriate to enact a single statute dealing with all insolvency regimes. One of the functions cast upon the Law Commission by s 5(1)(d) of the Law Commission Act 1985 is to advise the Minister of Justice on ways in which the law of New Zealand can be made as understandable and accessible as practicable. The collection of all insolvency law under one umbrella statute has appeal: such a statute is likely to promote both accessibility to, and comprehension of, the law.

ADVANTAGES

366 In paras 367 – 376 we list the advantages which we foresee will accrue if a decision is taken to establish one single statute.

367 First, a single statute will encourage –

- Integration of insolvency regimes under a principled policy which, either in its general or specific application, can be expressed through "purpose" and "principles" provisions contained in the Act; and
- Expression of the policy, and the more detailed practical rules, in a more accessible and comprehensible fashion.

368 The Interpretation Act 1999 requires the meaning of an enactment to be ascertained from the text of the enactment which, in turn, must be read in the light of the purpose of the statute.[358] In ascertaining the meaning of an enactment all indications given as to the

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358 Interpretation Act 1999, s 5(1).

purpose of the statute may be taken into account.[359] Indications of purpose can be given in a variety of ways: examples are the use of preambles, the analysis of sections, a table of contents, headings to Parts and sections, marginal notes, diagrams, graphics, examples and explanatory material, and the organisation and format of the enactment.[360] The insolvency system must be enhanced if courts are able to establish the policy which underlies the system from one generic statute.

369 The issue of accessibility is important not only to New Zealanders but also to likely offshore investors. Less costs are likely to be incurred by a foreign investor if all relevant information is available from the one source.

370 Second, it is likely that fewer difficulties will be encountered with attempts to introduce amendments to insolvency law by the sidewind of an amendment to another statute. A particular area in which this difficulty has arisen in the past is in the articulation of priority payments to be made by the administrator of an insolvent estate. In our earlier Advisory Report, *Priority Debts in the Distribution of Insolvent Estates*[361] we noted that priority payments had been introduced into insolvency legislation through the use, inter alia, of the Layby Sales Act 1971, Volunteers Employment Protection Act 1973, Fisheries Act 1983, Goods and Services Tax Act 1985 and the Radiocommunications Act 1989. We consider it less likely that attempts to change insolvency law will be carried out by the amendment of other statutes if there is one generic statute covering all insolvency regimes.[362]

371 Third, a generic statute will enable the focus of insolvency law to be shifted from the nature of the entity which has become insolvent to the nature of the activity which has been carried on by the enterprise. As we have concluded in our recommendations on rehabilitation procedures[363] that it is preferable for an insolvency regime to be activity based a generic statute will enable that policy decision to be implemented more readily.

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359 Interpretation Act 1999, s 5(2).

360 Interpretation Act 1999, s 5(3).

361 *Priority Debts*, above n2.

362 While the Ministry of Economic Development has not accepted our recommendation that the House of Representatives be notified of any provision which would affect the order of priority set out in either s 104 of the Insolvency Act 1967 or the Seventh Schedule to the Companies Act 1993 (see *Priority Debts*, above n2, para 237) the Ministry has supported an amendment to the Cabinet Office Manual to provide that officials must consult with the Ministry of Economic Development before recommending a provision which could affect the order of priorities. We are satisfied that that recommendation meets the concerns we identified in our advisory report.

363 See chapter 18.

372 Fourth, it will be possible to deal, in a generic statute, with both collective and non collective insolvency regimes; although it may be necessary to make clear when dealing with cross-border insolvency that particular non collective insolvency regimes will not be covered by the cross-border insolvency provisions.[364] There is no reason in principle, however, why both collective and non collective regimes could not be covered under the one statute.

373 Fifth, a generic statute encourages the development of a flexible array of remedies to deal adequately with the problems which arise at different stages in the insolvency process. Ideally, the statute would be drafted to deal sequentially with the remedies available from the earliest to the latest times.

374 Sixth, the adoption of one statute will enable modern terminology employed in recent statutes (such as the Companies Act 1993 and the Personal Property Securities Act 1999) to be used consistently in the context of all insolvency regimes. This will remove the necessity to reconsider the appropriateness of individual definitions throughout the statute book. Examples of the use of more modern terminology are:

- "Security interest"[365] instead of the terms "securities" (used in the Insolvency Act 1967) and "charge" (used in the Companies Act 1993); and

- "Statutory demand"[366] instead of "acts of bankruptcy" used in s 19 of the Insolvency Act 1967.

The use of a generic statute will also permit greater alignment between the common processes of bankruptcy (for individuals) and liquidation (for companies) which essentially rely upon the same idea of realisation of assets of the insolvent debtor and the distribution of proceeds pro rata among creditors in accordance with statutory priorities. The statute will, however, have to deal carefully with differences between individuals and other entities (of the body corporate kind) which do require distinct rules.

375 Seventh, a generic statute will provide a framework against which reviews of the law relating to corporate governance and particular business entities, can be carried out.

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364 Assuming New Zealand adopts the UNCITRAL Model Law on Cross-Border Insolvency it is clear that an administrative receivership commenced by the appointment of receivers by a debentureholder will not come within the definition of a "foreign proceeding" under the Model Law; see in particular *Cross Border Insolvency*, above n1, paras 158 – 162.

365 Defined in s 17 of the Personal Property Securities Act 1999.

366 Used in s 289 of the Companies Act 1993.

376 Eighth, the drafting of a generic statute is likely to be substantially easier to achieve than amending, in a piecemeal fashion, the numerous statutes which currently govern insolvency regimes.

DISADVANTAGES

377 We have identified three potential disadvantages which we discuss in paras 378-380.

378 First, unless care is taken in the crafting of the statute potential for confusion exists when an insolvency regime has a dual purpose: for example:

- Although receivership is primarily a self help remedy for a secured creditor rather than a collective insolvency regime, there are other purposes for which "receiverships" might be used. A court may order a receiver to be appointed by way of equitable execution or to enable an independent person to protect property while disputes between protagonists are resolved;[367]

- The dual roles of statutory management under the Corporations (Investigation and Management) Act of (a) investor protection and (b) insolvency.[368]

379 Second, there is potential for confusion if the purposes lying behind alternative regimes are not articulated clearly. If a particular regime is designed to fulfil a particular purpose (eg an alternative to bankruptcy to meet the needs of "no-asset" consumer debtors) it is important to state the entry criteria for that regime with care.

380 The consolidation of all insolvency provisions into a single statute will have the effect of producing a longer statute which will require more Parliamentary time to pass. However, that disadvantage must be offset against the advantages which flow from greater consistency and the need for officials to ensure compatibility among a variety of legislative provisions introduced to cover particular entities.

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[367] See *Re Samco Sargent Consolidated Ltd* (1977) 1 BCR 112; *Rea v Chix Products* (1986) 3 NZCLC 99,852; *Elders Rural Finance v Galloway* (26 May 1988) unreported, High Court, Tauranga Registry, CP 69/88.

[368] See paras 330-331.

28. A Single Statute?: Conclusions

381 In our view the advantages of enacting a generic statute substantially outweigh the disadvantages. In particular, the three disadvantages which we have been identified should not cause difficulties in practice for the following reasons:

- The first two disadvantages can be overcome by good drafting; we have no doubt that Parliamentary Counsel's Office can perform the drafting task without any residual problems arising;

- In relation to the third disadvantage, our impression is that the benefits of proceeding by a single statute are likely to far exceed the delays which could be expected in the passage of legislation caused by Select Committee and Parliamentary consideration of a Bill. Nevertheless, we immediately recognise that our experience is limited in this area and we would prefer to defer to the Ministry of Economic Development officials in assessing the relative weight to be accorded to this factor.

- It is clear that by far the majority of the receiverships to which the Receiverships Act 1993 applies are commenced by the appointment of an administrative receiver under a debenture. In those circumstances it is appropriate that receivership provisions be dealt with under the generic insolvency statute.

- Fewer difficulties should arise in relation to statutory management issues if our recommendations to deal with those issues are accepted. The remedy will become a mainstream remedy brought into play in a more transparent fashion. If our recommendations are accepted, statutory management will, we believe, have an appropriate place within an insolvency statute.

382 In our view, the reasons in favour of a generic statute are compelling. It is not a case of favouring one statute to make the legislation more aethestically pleasing. Rather there are good reasons to enact a generic statute to improve the insolvency process.

383 A suggested outline for the generic statute follows:

(a) **Part 1**: A general outline of the Act, including a purpose provision, drafted in a similar style to Part 1 of the Personal Property Securities Act 1999;

(b) **Part 2**: Definitions;

(c) **Part 3**: Core provisions affecting all forms of insolvency regime; this would include provisions such as antecedent transactions, claims, priorities and the like.

(d) **Part 4**: Rehabilitation regimes;

(e) **Part 5**: Liquidation regimes for bodies corporate;

(f) **Part 6**: Bankruptcy regimes for individual debtors; including divisions for alternative procedures and partnerships;

(g) **Part 7**: Receiverships (in essence, the current provisions of the Receiverships Act 1993);

(h) **Part 8**: Our revised proposals for statutory management under what is currently the Corporations (Investigation & Management) Act 1989

(i) **Part 9**: Cross-border insolvency (in essence, incorporation of the UNCITRAL Model Law on Cross-Border Insolvency as adapted in the recommendations made by the Commission in its 1999 report).[369]

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369 *Cross Border Insolvency*, above n1.

Appendix A
Letters to Insolvency Practitioners

19 December 2000

Dear Practitioner

LAW COMMISSION INSOLVENCY REVIEW

The Commission has been asked by the Ministry of Economic Development to submit three advisory reports by 28 February 2001 on the following topics:

- The possibility of the enactment of one generic insolvency statute;
- Rehabilitation procedures (including statutory management under the Corporations (Investigation and Management) Act 1989); and
- The Role of the State in insolvency.

I am the Commissioner in charge of preparing the reports. I am writing to you, as a specialist in insolvency issues, to seek some assistance from you on the specific issues set out below. Because of the tight timeframe under which we are working it would be appreciated if you could let me have a response to my queries no later than 17 January 2001. Please feel free, when responding, to raise any other matters you think relevant to the topics the Commission is addressing. In particular, we invite assistance in identifying and defining problems encountered in any of these areas.

My queries are as follows:

Rehabilitation

(a) Have you ever been unable to negotiate a rehabilitation procedure (where there were genuine prospects that the entity could have been saved or, at least, the value of the business preserved for realisation as a going concern) because of the lack of a mandatory stay prohibiting secured creditors from realising securities?

(b) If the answer to (a) is yes,

(i) what were the circumstances with which you were faced? and,

(ii) how would the availability of a mandatory stay against secured creditors have improved the chances of rescuing the entity?

(c) Please advise your experiences with the processes set out in Parts XIV and XV Companies Act 1993.

(i) Are these provisions effective rehabilitation regimes? (Please provide reasons for your answer).

(ii) How many cases are you aware of in which these procedures been used in practice?

(iii) In how many of those cases has the rehabilitation been successful? (Please indicate by what standard you gauge success).

Statutory Management

If you have acted either as a statutory manager under the Corporations (Investigation and Management) Act or for a creditor of an entity in statutory management;

(a) what benefits do you think flowed from the use of statutory management as opposed to some other form of insolvency regime?

(b) do you think it is necessary to retain statutory management under the Corporations (Investigation and Management) Act, because the functions imposed on a statutory manager can be performed adequately under other regimes?

(c) if your answer to (b) is yes, would your answer be different if there was a rehabilitation regime providing for a mandatory stay against secured creditors?

If you have any queries about the questions posed, please do not hesitate to contact me to discuss them. I can be contacted at my chambers in Hamilton (07) 8392216 or at the

Commission. In my absence please contact Lucy McGrath, Researcher at the Law Commission, in the first instance.

Thank you in anticipation of your valuable assistance.

Yours sincerely

Paul Heath QC
Commissioner

9 February 2001

Dear Practitioner

Law Commission Insolvency Review

This letter follows on from Paul Heath's letter to you at the end of last year requesting information regarding your experiences with rehabilitation procedures and statutory management. The Commission is very grateful that you took the time to respond to us.

We would appreciate your advice regarding one further query. Can you inform us of the approximate cost of negotiating a Part XIV proposal, assuming that it is fairly straightforward with perhaps 15-20 unsecured creditors and one secured creditor holding a debenture? While we understand that the figure could vary depending on other circumstances, if you could let us know the approximate cost of putting together such a proposal it would be very helpful to us.

If possible we would like a response by the end of next week (Friday 15 February 2001). We apologise for the tight timeframe, but we are due to report to the Ministry of Economic Development by the end of the month.

If you have any queries regarding this letter please don't hesitate to contact myself or Paul Heath at the Commission.

Yours sincerely

Lucy McGrath
Researcher

Appendix B
Responses from practitioners regarding costs of Part XIV scheme

384 We sent the second letter in Appendix A to those insolvency practitioners that responded to the first. We received five responses which contained cost estimates. We consider that the relatively small number of responses may be due in part to the fact that, as set out in chapter 16, Part XIV has received little use.

385 The responses gave the following estimates (with names omitted):

(a) $7 500 to $10 000;

(b) $5 000 to $10 000;

(c) $24 000 to $36 000;

(d) $7 000 to $10 000;

(e) $4 200 to $7 700.

386 Three responses were itemised. The following elements were included in all of the responses:

(a) Meeting proponent;

(b) Discussions/negotiations with creditors;

(c) Preparation and service of documentation;

(d) Receiving and counting votes/attending meeting.

387 None of the responses expressly included figures for assessing the viability of the business prior to the proposal. One (the highest) included an allowance for legal costs,

and for obtaining court consent (which is not a requirement of Part XIV). None of the others included any allowance for any court applications that may follow (for example, an application by a creditor for relief). Only one of the responses (again the highest) included any allowance for the implementation of the proposal.

Appendix C
United Kingdom

PART II INSOLVENCY ACT 1986

C1 Part II of the Insolvency Act 1986 (UK) was enacted as a result of recommendations made by the Insolvency Law Review Committee.[370] The committee considered that the power, normally conferred on floating charge holders, to appoint a receiver "to have been of outstanding benefit to the general public".[371] This was because it enabled an attempt to be made to rescue the company, or, if this was not possible, it enabled parts of the company to be sold as a going concern, resulting in a greater return to creditors.

C2 The committee considered that it would be useful to provide for the appointment of an administrator to cater for situations where creditors had no power to appoint a receiver, or where they were unwilling to do so. The committee further considered that it should be set out that unlike a receiver, administrators were also required to attempt to save the business, if this was possible.

C3 The broad objectives of Part II are to enable a company in financial difficulties to trade out of the difficulties, or to facilitate the realisation of the company's assets more advantageously than would occur in a liquidation. Part II attempts to achieve this by providing for an administrator to manage the company, before putting a plan to creditors. During this period there is a moratorium on most claims against the company.

C4 The administration process is commenced by the filing of a petition, which can be done by the company, its directors, or any creditor. The form of the petition is prescribed. One element is that the petition <u>may</u> be accompanied by a report of an independent person that specifies that the appointment of an administrator is expedient and the purposes of the

[370] Cork Report, above n63.

[371] Cork Report, above n63, para 495.

appointment. Although optional, the literature indicates that such a report is expected by the courts in most cases, and is almost always prepared.[372]

C5 In order to prevent creditors taking action prior to the making of an order, a moratorium is placed on proceedings by creditors from the time that the petition is filed. An important exception is that creditors may still appoint receivers; and if this is done prior to the hearing of the petition, then it must be dismissed. Accordingly floating charge holders with the right to appoint a receiver can effectively veto the appointment of an administrator.

C6 Prior to making an order a court must be satisfied that:[373]

(a) The company is, or is likely to become unable to pay its debts;

(b) The making of an order is likely to achieve one of the purposes specified in the Act;

(c) No receiver has already been appointed.

C7 The purposes set out in the Act are the survival of the whole, or a part, of the company, entry into a voluntary arrangement under Part I of the Act, the sanctioning of a section 425 arrangement (a court sanctioned compromise or arrangement), or the more advantageous realisation of the company's assets than would be achieved in a winding up.

C8 The effects of the making of an order include the following:

- The directors are not automatically dismissed. However the administrator assumes the power to manage the company and to remove any director. So the administrator effectively controls the company. The administrator also has various powers/duties of investigation, and powers to set aside certain transactions;

- There is a wide moratorium on the taking of steps by both secured and unsecured creditors, subject to the creditors obtaining consent from the administrator, or the leave of the court;

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372 Dan Prentice, Fedelis Oditah, Nick Segal "Administration: The Insolvency Act 1986, Part II" [1994] LMCLQ 487, 498. A practice note (reported at [1994] 1 All ER 324) has been issued stating that although a report is usually desirable, in "straightforward" cases it may not be necessary, or alternately a brief report may be sufficient.

- Post administration creditors are given priority over both floating charge holders and the expenses of the administrator.

C9 Once an order is made, the administrator has three months to put a proposal to a meeting of creditors detailing how the purpose for which the administration order was made is to be achieved. The proposal must be accepted by a majority in value of the creditors.

PROBLEMS WITH PART II

C10 It is generally accepted in the literature that Part II is not working well.[374] In addition, in comparison to liquidations, the procedure is little used. For example in 1999, in England and Wales, only 440 administrators were appointed compared to 14,280 liquidations and 1618 appointments of receivers. Throughout the 1990s there were typically 150-200 administrators appointed.[375] In Scotland, a jurisdiction more comparable to New Zealand, only three administrators were appointed; from 1994 to 1999, there has not been more than four appointments in one year.

C11 Two main difficulties have been identified. First, significant costs are involved in preparing the petition and the accompanying report, and satisfying the court that an order should be made. This is a clear deterrent to using the procedure, particularly since there is no guarantee that an order will actually be made (taking into account the restrictive grounds upon which orders may be made).

C12 Second, as set out above, orders may only be made in certain prescribed circumstances. This limits the types of case where voluntary administration is appropriate. It also raises difficulties for the applicant in proving to the court that a particular purpose is likely to be achieved.

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373 Insolvency 1986 (UK), s8(1).

374 See for example Ian F Fletcher "Administration Orders under the Insolvency Act 1986 (UK): Results, Reflections and the Prospect for Further Reform" (1994) 2 Insolv LJ 110; John Farrar "Voluntary Administration in Australia and the United Kingdom – A Comparative Study" in Rickett (ed) *Essays on Corporate Restructuring and Insolvency* (Brookers, Wellington, 1996) 68, 84-85.

375 The Insolvency Service *Review of Company Rescue Mechanisms: Consultation Document* (Bloomsbury, September 1999) para 5(a).

INSOLVENCY AMENDMENT ACT 2000

C13 Partly in response to the above criticisms, a simplified procedure has recently been introduced to the United Kingdom, which is to operate alongside Part II. The essential features of the procedure are:

- A company proposing to enter into voluntary arrangements under Part 1 of the Act can obtain an automatic 28 day moratorium upon filing certain prescribed documents in court. Prior to obtaining the moratorium the directors must first obtain a statement from a nominee that he is satisfied as to certain matters, including that the proposal has a reasonable prospect of success;

- During the moratorium the directors remain in control of the business, however the nominee will oversee the moratorium;

- The creditors must meet within 28 days to decide whether to approve the arrangement, or the moratorium will end (although the period may be extended);

- The procedure is only available for small companies (defined as any two of the following: turnover less than 2.8m pounds, balance sheet total less than 1.4 m pounds, less than 50 employees).

C14 The Insolvency Service of the Department of Trade and Industry has also recently released a report,[376] which includes a recommendation that a floating charge holder should lose its right to veto a voluntary administration by appointing a receiver. This recommendation is largely premised upon the view that the administration process has advantages over a private receivership.

[376] The Insolvency Service *Review of Company Rescue and Business Reconstruction Mechanisms: Report* (Bloomsbury, May 2000).

Appendix D
Australia

SUMMARY OF LEGISLATION

D1 The Australian voluntary administration scheme, contained in Part 5.3A of the Corporations Law, has the same objects as the United Kingdom model; namely to maximise the chance of a company staying in existence, or to provide a better return to the company's creditors than would be possible in a liquidation. The report on which the legislation is based however, also emphasised that the procedure should be:[377]

(i) capable of swift implementation;

(ii) as uncomplicated and inexpensive as possible; and

(iii) flexible, providing alternative forms of dealing with the financial affairs of the company.

D2 In line with these aims, Part 5.3A does not require a court order for a company to enter voluntary administration. An administrator may be appointed either by the company, its liquidator, or a creditor entitled to exercise a charge over the whole, or substantially the whole, of the company's property. With respect to an appointment by the company, the appointment is made by the directors in writing under the company's common seal, having previously resolved that the company is, or is likely to become, insolvent. A liquidator need only make an appointment in writing (having reached an opinion as to insolvency). A chargeholder is entitled to appoint an administrator when his charge becomes enforceable. Upon any of the above methods of appointment occurring, the administration commences immediately.

D3 The consequences of administration include the following:

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377 Harmer Report, above n64, para54.

- Directors retain their positions, but are unable to exercise any of their powers without the written consent of the administrator;

- Any transaction affecting the company's property is void unless made with the consent of the administrator, or with leave of the court;

- A moratorium is placed on the rights of owners, or lessors of, property in possession of the company;

- Secured lenders with charges over the whole or substantially the whole of the company's property have 10 business days to appoint a receiver. If they do so the administration is not terminated, but the administrator's powers are subject to those of the receiver. If they fail to do so then they are bound by the moratorium. There is also a moratorium on other secured lenders enforcing their security;

- There is a moratorium on all proceedings against the company. Creditors can however resolve to liquidate the company;

- The administrator takes over the management and control of the company and, amongst other powers, may carry on or terminate the business, dispose of the company's property, and remove directors;

- The administrator may also sell property subject to a charge, if this is done in the ordinary course of business, or with leave of the court.

D4 The administrator is required within five business days of his appointment to hold a meeting of creditors. At the meeting the creditors may vote to remove the administrator. They will also consider whether to appoint a committee of creditors.

D5 As soon as practicable after appointment, the administrator must investigate the affairs of the company so as to form an opinion on whether the creditors should execute a deed of arrangement, terminate the administration, or wind up the company. The administrator is also required to lodge a report as to any offences or misconduct by officers or former officers of the company.

D6 Following the investigation, and within 21 days of his appointment (subject to any extension), the administrator is required to convene a meeting of creditors, inform them as to the affairs of the company, and give his opinion as to which of the three options above should be selected. The meeting must be held within five business days after the convening period, but may be adjourned for up to 60 days from the first day of the meeting. At the meeting the creditors will vote on which of the three options to adopt. This will terminate the administration.

D7 If it is decided to agree to a deed of arrangement, Part 5.3A contains detailed requirements. Unless the deed provides otherwise, the directors will then resume their powers. The deed will bind all necessary parties except for secured creditors. They will only be bound if they voted in favour of the deed, or if the court makes such an order (in which case their interests must be "adequately protected").

PROBLEMS WITH PART 5.3A

D8 The general perception we gain from the literature is that Part 5.3A has been better received than its United Kingdom equivalent. Two difficulties have however been highlighted:

- The Harmer committee contemplated that courts would be given a general supervisory role during the administration period,[378] and have a broad power to ensure that the scheme operates effectively.[379] Andrew Keay however argues that the courts have been given few guidelines as to how to exercise these powers.[380] He says that this has led to inconsistent decisions and general uncertainty.

  Plainly this is undesirable, since uncertainty will lead to more matters being litigated, and therefore higher costs for the parties. In the case of secured lenders it means that their property rights are dependent upon the uncertain exercise of the court's discretion.

- Michael Rose and Larelle Law point out that practitioners have found the timetable to be too tight.[381] In respect of the first meeting, they say that it is unrealistic in such a short time to expect the administrator to provide any useful information. O'Donovan makes similar comments in respect of the second meeting:[382] "[s]ave in

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378 Harmer Report, above n64, paragraphs 56 and 62.

379 Harmer,Report, above n64, para 62.

380 Andrew Keay "Court Involvement in Voluntary Administrations and Deeds of Company Arrangement: Powers, Problems and Prognoses" (1995) 13 Comp & Sec LJ 157.

381 Michael Rose and Larelle Law "Voluntary Administrations: Will They Work?" (1995) 3 Insolv LJ 11, 12-17.

382 O'Donovan "Voluntary Administration and Deeds of Company Arrangement Under Part 5.3A of the Corporations Law" (1994) 12 Comp & Sec LJ 71,95.

the case of a very simple administration, it is unlikely that an administrator would be able to complete his investigation and compile a report as to the affairs of the company within the prescribed convening period".

D9 In addition, commentators have argued that certain aspects of the legislation could be improved. Rose and Law point to two areas:

- They consider that all creditors should be able to apply to the court for an appointment of an administrator.[383] This is because they consider that cases may arise where a company is insolvent, and the appointment of an administrator would be advantageous, but the directors are unwilling to take the step (due to self interest);

- They consider that in many cases it is unnecessary for the administrator to take over the management of the company, and in these cases it may be preferable for the administrator simply to oversee the management of the company.[384]

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383 Rose and Law, above n381, 24.

384 Rose and Law, above n 381, 26-28.

Appendix E
Canada

E1 There are in fact two procedures for voluntary administration in Canada. Prior to 1992 the Companies Creditors Arrangement Act[385] (the CCAA) was the only viable procedure. In 1992 amendments were made to the Bankruptcy Act (renamed the Bankruptcy and Insolvency Act (the BIA)) to introduce a new procedure. We will just consider that procedure in this paper; however the CCAA remains in force (with some additional limitations).

E2 The main features of the BIA are that, as in Australia, no court order is needed to commence the process. However, unlike in Australia, an administrator does not necessarily take over the management of the company. Another significant feature is that secured creditors must give 10 days notice before enforcing a security over all or substantially all of the debtor's property. This will enable the company to initiate the administration procedure before the 10 days expires. Accordingly, unlike in the United Kingdom or Australia, secured lenders are not able to veto the process; in fact, enforcing their securities may lead to the initiation of the process.

E3 A proposal under the BIA may be made by a receiver, liquidator, trustee, or the "insolvent person". An initial stay of 30 days, in order to make a proposal, may be obtained by filing a notice of intention to make a proposal. At that time the company must nominate a licensed practitioner to act as a trustee. Within 10 days the company must then file financial information and the trustee must report on the reasonableness of the company's cash flow projections. At this stage the directors remain in control of the company, subject to monitoring by the trustee. The time limits are strict, and, if there is a failure to comply, then the company is automatically put into liquidation. Extensions of up to six months may however be obtained in order to make the proposal.

385 RSC C-25 (1985).

E4 The stay is wide and applies to both secured and unsecured creditors. They are however able to apply to have the stay lifted upon the grounds of material prejudice, or that it is equitable to do so.

E5 During this period the trustee is under a continuing obligation to report on the financial state of the company, and must report any "material adverse change" to the Official Receiver. He must also report to the court upon request.

E6 Once a proposal is filed the trustee must call a creditor's meeting within 21 days of the filing of the proposal. At the meeting creditors are divided into classes. A proposal is accepted by a class if half in number and two thirds in value vote in favour. Proposals are binding on those classes of unsecured creditors that accept them (but not on those classes that do not). Secured creditors are only bound if they voted in favour of the proposal.

E7 If a proposal is accepted by creditors, then the trustee must within five days apply for court approval, and file a report 10 days prior to the hearing. The court has a discretion as to whether to approve a proposal and may decline to do so if the terms of the proposal are unreasonable, or if it is not beneficial to the general body of creditors. If either the creditors or the court reject a proposal, then the company is automatically placed into liquidation.

E8 There appears to be little literature (at least outside Canada) on whether the procedure in the BIA is working effectively. On its face however, the procedure does appear to overcome many of the disadvantages of the United Kingdom, Australian and United States models.

Appendix F
United States

F1 The United States procedure for voluntary administration is contained in chapter 11 of its Bankruptcy Code. Like the Canadian BIA, it provides for a stay, without application to the court, while still allowing the existing management to stay in control. The basic principle of the legislation is[386] "it is generally preferable to enable a debtor to continue to operate and to reorganize its business rather than simply to liquidate." Unlike either the BIA, or Part 5.3A of the Australian procedure however, it does not provide for a tight timetable. Further it requires significant involvement by professionals and the court.

F2 The procedure may either be commenced by the company filing a petition, or by a creditor obtaining a court order. Upon commencement, a stay automatically comes into effect in respect of all claims by secured and unsecured creditors. A secured creditor may obtain relief from the stay if the company fails to provide it with "adequate protection" for its interest.

F3 The company's previous management remain in control of the company, and retain their previous powers (subject to certain exceptions, such as taking action outside the ordinary course of business, or utilising secured property). The company is required to file monthly reports with the United States trustee, containing financial statements and a statement of intended actions.

F4 The court may appoint a trustee to take over the management and control of the company where there has been fraud, dishonesty or incompetence by the previous management, or if such an appointment is in the interests of the creditors and shareholders. The court may also appoint an examiner to conduct an investigation into any allegations of fraud, dishonesty, incompetence, or mismanagement, by the current or former management of the company.

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386 7 *Collier on Bankruptcy* (15th ed Revised, Matthew Bender & Co Inc) para 1100.01.

F5 Chapter 11 also provides for the appointment of committees to represent the various interested groups (for example, unsecured creditors). The basic roles of the committees are intended to be to negotiate on behalf of the group, and to monitor the case.

F6 The company has 120 days following commencement to file a plan. It may then seek approval of the plan within 180 days after commencement. Both of these periods may be extended by court order, and commonly are. At the expiry of the 120 days, if the company has not filed a plan, then other creditors may do so. When soliciting acceptances from creditors, the company must provide a statement to the creditors containing detailed information about the plan and the company. The statement must have been previously approved by the court.

F7 In voting on the plan the creditors are divided into classes. A plan is accepted by a class if two thirds in value and half in number of the class vote in favour. The plan must also be confirmed by the court. As long as at least one class accepts the plan, then the court may confirm it (which means that it will be binding on all creditors). In deciding whether to confirm a plan which has not been accepted by all classes the court will consider whether the plan is "fair and equitable" to the dissenting classes. This involves consideration of the absolute priority rule:[387]

> Under the absolute priority rule, if a senior class of creditors rejects a reorganization plan, a junior class cannot "receive or retain ... on account of [their] interest" a distribution under a plan unless senior classes are paid in full under the plan. If a junior class dissents, that class must receive under the plan its full allowed claim, or no class junior to it may receive anything. As a practical matter, the absolute priority rule means that, if all creditors' claims are not paid in full, equity interests must be eliminated before a reorganization plan not accepted by all classes of creditor may be confirmed.

F8 If the court declines to approve a plan, it may direct that the process convert to one of liquidation. It is also possible for the company to file a fresh chapter 11 proceeding (and so continue to frustrate its creditors).

F9 There is considerable literature on the chapter 11 proceeding. We have not reviewed it in detail at this stage, since we perceive that a similar procedure is likely to be regarded as inappropriate for New Zealand. Common criticisms of the procedure are:

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387 *Collier's International Business Insolvency Guide* (Matthew Bender & Co Inc) para 5.10(4)(a).

- It has been abused; in particular it has been used to protect solvent companies from court actions;

- Creditors' funds are tied up for a lengthy period of time for the purpose of rescuing the company. Often these funds may be further diminished during the chapter 11 process;

- It is a costly process due to the extensive court involvement, the detailed documentation that must be filed, and the length of time that the process takes.

Appendix G
Summary of Recommendations of Securities Commission (April 1992)

G1 The summary of recommendations is taken verbatim from the Securities Commission's report. For ease of reference however, we have numbered the paragraphs (in the format G2, G3 etc).

G2 **Should there be a statutory management regime?**

We recommend that:

(a) The statutory management regime be retained.

(b) The Act be amended at an early date in order to incorporate the amendments that we recommend later in this report.

(c) A further review be undertaken in the course of a comprehensive review of the law dealing with insolvent and at risk corporations.

G3 **The grounds for applying statutory management**

We recommend that section 4 of the Act be amended to state that the grounds referred to under both paragraphs (a) and (b) of that section apply only where the affairs of the corporation cannot adequately be dealt with under the Companies Act or in any other lawful way.

G4 **Period of statutory management**

We recommend that the following amendments be made to the Act:

(a) The notice placing a corporation into statutory management should state the term of the statutory management and that period should be no more than six months;

(b) Prior to expiry of the term of statutory management, the statutory management should be required to report to an independent body summarising the results of his or her investigation and giving details concerning the conduct of the statutory management. Recommendations as to whether the statutory management should be continued or discontinued should be made. Those proposals should be discussed with the Advisory Committee and comments of the Advisory Committee should be contained in the report.

(c) Publicity should be given to the preparation of that report and interested parties should be entitled to receive copies and to make written submissions to the Commission within a period specified by the Securities Commission.

(d) The Commission should be required to make a decision after the final date for submissions, either –

- not extending the statutory management;
- extending it for a specified period; or
- extending it for a specified period subject to terms and conditions.

(e) The Commission should have power to hear from the statutory manager and the Advisory Committee in confidence, and may at its entire discretion hear from any other party.

(f) Subject to compliance with the foregoing procedures, the Commission shall have power to extend the term for a further period.

G5 General Duties Of The Statutory Manager

We recommended that the Act be amended by inserting a further section following s 41 which would cover the matters provided for in ss 148 and 149 of the Companies (Ancillary Provisions) Bill insofar as they are application to a corporation under statutory management.

G6 **The role of the courts?**

(a) The courts should not be charged with the decision to place a corporation in statutory management;

(b) There should be no express right to apply to the court for the review of the Commission's decision to place a corporation in statutory management;

(c) If the period of a statutory management is extended beyond its initial term, any interested party should be entitled to apply to the court for relief on the grounds that a corporation's affairs are being or have been managed in a manner which is oppressive and unfairly discriminatory to that party. Appropriate safeguards would include:

- requiring the court to reject frivolous or vexatious applications; and

- requiring an undertaking to the court from each applicant stating that it will meet the reasonable costs of the statutory manager incurred in defending the application if the application is declined by the court.

G7 **Extent of the moratorium**

We recommend that:

(a) In each case the term of the moratorium should be co-extensive with the initial term of the statutory management set in the notice of appointment;

(b) Section 42 should be retained in its current form for the initial term of a statutory management, but subject to a stand still period of 28 days the statutory managers should be prevented from accessing funds subject to contractual rights of set-off, to a banker's right to combine accounts, and to rights of set-off on the part of a futures clearing house;

(c) Notwithstanding the moratorium, where a secured creditor is expressly entitled to an assignment of rentals in relation to a specific mortgage security or in relation to a specific charged property with an assignment of rentals, that the statutory manager be required to accumulate the rentals received during the initial period of statutory management subject only to the right to take costs and expenses in accordance with a costs scheme settled on the basis of the recommendation made in paragraph 130 below. On the expiry of the initial period the secured creditor should be entitled to apply to the statutory manager for release of the net accumulated rentals and "good reason" would have to be shown if the statutory manager is to retain the rentals, with the right to have that decision reviewed by the Court.

(d) Where on the commencement of the statutory management a corporation is entitled to hold assets which are likely to substantially depreciate during the initial period of statutory management, any creditor who holds security over those assets or claims ownership in them (for example under a hire purchase agreement or lease) may give notice to the statutory manager requiring the statutory manager to elect within a period of 28 days from the date of service of the notice whether to retain the asset and accept ongoing responsibility for any payments due to the creditor, or release the asset to the creditor.

(e) If the term of a statutory management is extended, Section 42 should continue in force, but secured creditors should be entitled to require the statutory manager to lift the moratorium in their favour under section 42(3) unless "good reason" exists for refusing to do so. "Good reason" should be defined by reference to the factors referred to in paragraph 110 above.

G8 Costs of a statutory management

We recommend that:

(a) Statutory managers be expressly empowered to devise and apply (subject to the approval of the Advisory Committee) a scheme imposing a levy upon the companies in statutory management to meet the costs of the statutory management. If agreement cannot be reached with the Advisory Committee, the statutory manager should have the right to apply to the Court for directions.

(b) In devising a scheme a statutory manager should be required to have regard to the factors specified in paragraph 125 of this Report;

(c) Creditors should be entitled to apply to the Court seeking the review of the scheme if the statutory management is extended beyond its initial term.

G9 **Advisory committee**

We recommend that:

(a) The appointment of an advisory committee should be mandatory each time the statutory management procedure is invoked;

(b) The Commission should be empowered after consultation with the Registrar of Companies to appoint the members of each advisory committee;

(c) The committee should have at least two and no more than five members, at least one of whom should be a representative of creditors and at least one who should have no financial interest in the statutory management;

(d) The role of the committee should be that set out in paragraphs 139 and 140 of Report.

(e) The initial fees of the advisory committee should be fixed by the Commission in consultation with the Registrar of Companies, and should thereafter be fixed by the Registrar for payment by the company.

G10 **Reporting**

We recommend that:

(a) A statutory manger should be required to report to the advisory committee one month after a corporation is placed in statutory management, addressing the matters referred to in paragraph 152 of this Report.

(b) A statutory manager should be required to provide a second report to the advisory committee before the expiry of the (initial) term of the statutory management, disclosing the results of their investigation into the corporation's affairs (addressing the relevant items referred to in clause 153 of the Companies (Ancillary Provisions) Bill, their recommendations on the continuation or termination of the statutory management and where continuation is recommended, the statutory manager's proposals for the future conduct of the statutory management;

(c) If the term of a statutory management is extended, a statutory manager should be required to provide a six monthly report to the advisory committee, addressing the relevant items in clause 154 of the Companies (Ancillary Provisions) Bill:

(d) The following additional reporting requirements should apply:

(i) the provision of reports to secured creditors at least quarterly concerning the status of their securities;

(ii) Each statutory report by a statutory manager to the advisory committee should be filed with the Registrar of Companies and placed on a public file for the statutory management.

(iii) Each statutory report completed by a statutory manager should be provided to any claimant on request without charge;

(iv) Where a statutory manager considers that reporting to a particular class of secured creditors under (a) or claimants under (c) is futile (perhaps because that class has no real financial interest in the outcome of the statutory management), the statutory managers may cease to report to that group after ensuring that reasonable publicity is given to that decision.

G11 The role of the Minister of Justice and the Securities Commission

We recommend that:

(a) The current responsibilities of the Minister under Part 11 of the Act be conferred upon the Securities Commission;

(a) The initial application to place a corporation in statutory management should be made to the Registrar of Companies, who should then refer the application, together with a report on the corporation and the nomination of any persons for the proposed appointment as statutory managers, to the

Securities Commission for its decision on whether or not the application should be granted and on what terms and conditions.

(b) (c) That apart from our specific recommendations elsewhere in the report, there be no general increase in the Commission's involvement in the statutory management process.

G12 **Rights of a fixed charge holder in relation to preferential creditors**

That s.51(2) of the Act be amended in order to provide that a floating charge may be postponed to preferential payments made under s.308 of the Companies Act.

G13 **Application of Companies Act provisions in relation to a winding up**

That s.55 of the Act be amended in order to make it clear that the sections of the Companies Act 1955 which are referred to in this section do not further apply to a corporation in the event of that corporation continuing to be in statutory management at the time that any order may later be made for the winding up of that corporation.

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