CORPORATE RESCUE

Report for the Ministry of Economic Development

November 2000

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Introduction

In August 1999 I submitted to the Ministry an Issues Paper as part of the Insolvency Law Review. It was envisaged that a final paper would be submitted in 2000, which, in particular, would take into consideration comments of the Ministry in response to the initial paper. I now submit this final paper, which I understand will form part of the background to further work to be undertaken by the Ministry with the assistance of the Law Commission.

The approach I have adopted is to incorporate large sections of the initial paper, so that it is not necessary to cross-refer to it. In particular, the explanation of the major rescue procedures in other jurisdictions and the background explanation of existing New Zealand procedures, are incorporated into this paper. However, this paper has added new material for the purpose of (a) answering the queries raised by the Ministry in a letter from Lucy Dome dated 28 September 1999 and (b) updating you on developments in policy work and research internationally.

<u>Summary of specific issues raised by the Ministry in response to initial paper</u>

The four points below are summaries of matters raised by the Ministry in response to the initial paper, and will be dealt with at the appropriate points below.

(a) What is the purpose of a voluntary administration regime[1], and what is the gap that such a procedure would fill in New Zealand?
(b) Anecdotally, informal arrangements produce the best return for creditors, so consider the implications of such a regime crowding out informal arrangements
(c) Evaluation of existing regimes elsewhere
(d) New Zealand is pro-creditor, whereas voluntary administration regimes are pro-debtor. Would the introduction of such a regime therefore create 'inconsistencies in the law'.

<u>Need for review</u>

Corporate insolvency law is about regulating and minimising the costs of failure. The principal statutory method by which this is done is by providing for liquidation, in furtherance of the fifth goal in the preamble to the Companies Act 1993, 'to provide straightforward and fair procedures for realising and distributing the assets of insolvent companies'. It is implicit in the objectives behind liquidation that maximisation of returns to creditors and other stakeholders is inherent in this process. However, other expressed objectives in the Preamble are to encourage the taking of business risks, and to allow directors of companies a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against abuse of management power.

A debtor company and its creditors and shareholders (whether the company is solvent or insolvent) are free to reach a contractual compromise amongst themselves without the assistance of any regulatory framework. Such contractual 'rescues' will always happen, notwithstanding the provision of such a framework. Informal rescues may be suited to a variety of situations. Their principal advantage is secrecy, avoiding the stigma of a more public formal procedure (and possibly avoiding investigation and challenge of directors' conduct). Several large group restructurings happen in this way. The second advantage is cost savings and the third is flexibility.

Any statutory rescue procedure should be facilitative, complementing informal rescues. Other means of promoting rescues outside of a legislative framework could take the form of education, exhortation or facilitation through guidelines, usually promoted by a body such as the Reserve Bank or professional bodies such as accountants. (In the UK, Hong Kong and recently several South East Asian jurisdictions, central banks have pioneered rules of conduct to encourage informal rescues in large-scale group failures where major banks are exposed.) The main disadvantages of informal rescues are twofold. First, inability to bind dissenting creditors means there is no legal means to prohibit dissenters from pursuing their legal remedies, including petitioning to liquidate a company. Secondly, there is no moratorium provision preventing them from pursuing such remedies.

The Companies Act 1993 provides mechanisms (in Parts XIV and XV) for restructuring and compromise arrangements to be made between debtors, creditors and shareholders. When applied to insolvent companies, the objective of these procedures is to facilitate a consensual arrangement between debtor and creditors in order to minimise losses by a consensual distribution of net assets. To some extent these provisions enable a company to avoid liquidation by reaching an agreement which is given statutory binding effect, even on dissenting minority creditors or shareholders. However, as presently drafted, the extent to which they provide an effective rescue procedure is limited. Not only do they contain no moratorium to allow a brief 'breathing space' during which a company can formulate a proposal, and its viability can be assessed by professional advisers. They are also not designed to allow either the company or an independent professional to continue to trade while investigating the possibility of selling or restructuring the business or its viable parts.

Many leading world economies with relatively sophisticated corporate insolvency regimes have enacted legislation in the last twenty years providing for a formal corporate rescue procedure, and several other jurisdictions, particularly in the Asia-Pacific region and Eastern Europe, are reforming insolvency law to include one.

In the initial paper it was submitted that it was timely, in August of last year, for New Zealand to review whether it should include such procedure in any package of insolvency reform measures for several reasons:

(i) The issue has been examined in the 1989-1994 period of submissions on insolvency law reform and detailed submissions have been made by the Joint Insolvency Committee and others;

(ii) Any review of statutory management and related procedures should be considered in the context of this issue;

(iii) When considering whether New Zealand should adopt the UNCITRAL cross-border insolvency Model Law, it should be recognised that many of our major trading partners either have such a procedure or are in the process of including one in their statutory provisions, not least the Australian Voluntary Administration procedure. Reciprocity is a factor which will be taken into account under the Model Law or in giving effect to it in signatory countries.

There is a wider point, which relates to the Ministry's policy of providing an infrastructure for overseas investor confidence in New Zealand. Sophisticated business laws are part of that. The most developed insolvency regimes have a corporate rescue procedure and the developing regimes are implementing such procedures.

(iv) Many law reforms in this area (as presently with insolvency law reform in Asia, and with statutory management in New Zealand or examinership procedure in Ireland) are passed as a reaction financial crisis in large companies, or those that threaten the wider financial infrastructure. More considered and less problematic reforms are likely to emerge from review in outside of, but in preparedness for, such crisis.

Since then, the timeliness of the question of whether or not to enact some formal rescue procedure has increased. Indeed, it is not overemphasis to say that New Zealand is in danger of being left behind and categorised as a country with a relatively unsophisticated insolvency system.

Spurred on by the Asian crisis as well as the globalisation of insolvency law and the strengthening of international insolvency bodies such as INSOL and the work of UNCITRAL, most of the world is now in the process of having reviewed or reviewing its insolvency laws, and inclusion of a form of rehabilitation procedure is being regarded as fundamental. It is true that in part, this development has come about because of the unsophisticated state of many jurisdictions' insolvency laws at the time of the Asian financial crisis in 1998, and in many of those jurisdictions reform if being 'forced' upon them by international organisations such as the World Bank, IMF and Asian Development Bank. Nevertheless, out of this crisis has emerged a series of international and regional initiatives which have led to some consensus as to what constitutes the core features of a modern insolvency system, including not only the essential features of core procedures (liquidation and rehabilitation) but also the nature of the court system and professions responsible for administering that system. Ironically, having been given the impetus to embark on insolvency law reform, the Asian region is now in a position to benefit from the wealth of experience of insolvency laws in developed countries, which experience is being harnessed under the aegis of international bodies. The result is that some of the Asian countries will soon have (on paper at least) sophisticated insolvency laws. The danger for New Zealand is that all its major trading partners will soon have insolvency laws which are more sophisticated, and this has wider implications in terms of reciprocity issues and the international reputation of our financial infrastructure. Moreover, Australia has been very active in 'exporting' the services of its policymakers and professionals in shaping the laws and applying the existing laws in the Asia-Pacific region. While one would not wish to undervalue the role and contribution of New Zealand professionals and policymakers in these arenas, it is suggested that the narrowness of the range of procedures which currently exist in New Zealand would affect the perception of New Zealand's authoritativeness to speak on such issues, and the relative marketability of the services of insolvency professionals in this region.

By way of example, the following countries have recently introduced more sophisticated corporate rescue procedures: Thailand, Vietnam, Indonesia. In addition, Hong Kong and Malaysia are well advanced in reform proposals that include reorganisation procedures; Korea has announced a review of insolvency law, and the latest country to announce a thorough overhaul of its antiquated insolvency laws is India. Work has begun on the difficult review of People's Republic of China's insolvency laws. Outside of the Asian region, the opening up of Eastern Europe to the market economy has led to review of insolvency law in many jurisdictions, though in most cases that happened about five years ago. In Africa, the first ever harmonised law for a group of countries, the OHADA project, came into effect in signatory countries[2] in January 1999, and included both a pre-insolvency rescue procedure as well as the possibility for a court-ordered rescue in appropriate cases.

The parties to the North American Free Trade Agreement, Mexico, United States and Canada have recently co-operated on a cross-border insolvency agreement, paving the way for closer co-operation between those important trading partners.

It should also be mentioned that, aside from the rapid emergence of rescue procedures in the Asian region, several key trading nations already have such procedures in place. In particular, Singapore, with whom we have just entered into Closer Economic Relations, have had judicial management, a court-ordered rescue procedure closely modelled on the UK system of administration orders, for several years now. Japan, which already has several different rescue procedures, is undergoing a further review of its insolvency laws in order to improve them in the light of the Asian crisis.

International Initiatives

It is trite to mention the globalisation of business, or even the globalisation of insolvency law. The UNCITRAL cross-border insolvency Model Law, which was by no means the first of such initiatives, illustrates what can be done when there is a commercial need for an international solution and frustration at problems raised by national territorial differences. As stated above, the UNCITRAL Model Law initiative is itself relevant for the debate on Corporate Rescue, given the widespread adoption of such procedures noted above. It should be noted that the UK government will, in a few weeks, pass into law an enabling provision for the UK to incorporate the Model Law, and some Asian jurisdictions are doing the same, for example Hong Kong.

Aside from Cross-Border Insolvency, there have been the following relevant initiatives of which the author is aware. The Asian Development Bank launched its RETA project[3] in 1998 to assist insolvency law reform in Korea, Japan, Taipei, China, Hong Kong, Singapore, Malaysia, Thailand, India, Pakistan and the Philippines. As well as serving to assist in the understanding and derivation of those countries' existing insolvency laws, the Bank has prepared standards of good practice which can be applied to assess a countries' conformity with the essentials of a modern insolvency law, and ways to assist in development of informal workouts. In addition, the ADB has produced a report on the Need for an Integrated Approach to Secured Transactions and Insolvency Law Reforms, prepared by Ron Harmer, lawyer and architect of the Voluntary Administration system in Australia. This report, arising out of the ADB's two day symposium in Manila in October 1999, contains some useful conclusions on how to deal with the problem of secured credit in a reorganisation, which will be discussed below.

In 1999 the IMF[4] Legal Department produced a report entitled 'Orderly and Effective Insolvency Procedures' which contains significant sections on the crucial detail required for an effective rehabilitation procedure, and the relationship between liquidation and rehabilitation.

The IMF has also done work on out of court insolvency workouts or restructurings, as has INSOL (Society of International Insolvency Practitioners), whose Lenders Group has recently produced a draft Statement of Principles for a Global Approach to Multi-Creditor Workouts.[5] In addition the International Insolvency Institute, which works closely with UNCITRAL, has produced a draft Model Voluntary Out of Court Restructuring Statute.[6]

Further reports can be expected in the near future from the World Bank and the OECD.[7] As you will know, the OECD, in conjunction with the World Bank, APEC and Australian Treasury Department, held a symposium in Sydney in September 1999, attended by representatives from the Ministry. This will lead to a report, but a draft World Bank Principles and Guidelines on Building Effective Insolvency Systems is influential in the thinking of how policy makers should approach the design or reform of insolvency laws.

Lastly, the UK Government produced in 1999 a Consultation Paper, A Review of Company Rescue and Business Reconstruction Mechanisms[8] and following public consultation, a final report was published on 2 November this year. [9]This report, which will be subject to a further round of consultation, makes important recommendations and suggestions as to how to improve existing rescue procedures in the UK. The most controversial suggestion is that floating chargeholders should no longer have a veto on the appointment of an administrator. In the meantime, the UK Government has promoted an Insolvency Bill, which improves existing rescue procedures for smaller companies, in particular by providing a 28 day moratorium against action by secured and unsecured creditors (without court involvement), and this will be enacted in the next two months. An earlier proposal in that Bill that a floating chargeholder should have to give notice to the company before appointing an administrative receiver, was removed after it proved controversial among stakeholders and practitioners.

In summary, the international perspective is relevant in two ways. First, it is crucial for New Zealand to have a system in place which inspires confidence overseas, which it will do if it is a relatively sophisticated insolvency system and one which can deal efficiently and fairly with the growing international nature of insolvencies. Secondly, the international organisations and professional bodies have done much work, some of which is overlapping, to identify fundamental building blocks of a modern insolvency system.

It is not suggested that other the insolvency systems and laws of other jurisdictions with inevitably differing economic and cultural histories should simply be transplanted into our system. However, while it is recognised that an examination of the issue of whether we need a rescue procedure and what form it should take, must start from the existing New Zealand structure and take into account the economic, cultural and financial framework in New Zealand, the identification of key objectives and constituent elements of a rescue regime can be done by drawing on these international resources and evaluation of existing systems.

The Evolution of the Rescue Culture

One must always caution against the 'build and they will come' syndrome. The phrase 'rescue culture' has been used frequently over the last ten years, and increasingly so. Cultures cannot be imposed, and take years to evolve. Having said that, it is relevant to point out that the nature of insolvency laws and insolvency work has changed in the last few years. In the past, insolvency was largely cyclical within a domestic economy. When the economy was doing well, insolvency professionals turned their minds to advising businesses how to be more profitable, rather than just dealing with the effects of insolvency. While insolvency always will retain that cyclical element, it is clear that the emphasis of insolvency laws and insolvency work has widened beyond liquidation and receivership, which are both concerned with recovery of the maximum return from the wreck of a clearly insolvent company.

The globalisation of business, hedging against currency fluctuations, and the shock of severe financial crises, have combined to mean that insolvency law and insolvency professionals have to respond with a wider array of tools than those which have served them well in the past. Both at an international and domestic level, insolvency practices are changing their focus. This has been happening for some years, but is now becoming more pronounced. The best way to illustrate it is by reference to the nomenclature of many insolvency organisations and units. Most large worldwide accountancy practices stress the 'rescue' or 'reconstruction' side of their work in the title of their groups, and professional organisations are moving away from the 'insolvency' label. Thus, in the last few months, the major UK professional organisation, which covers lawyers and accountants, the Society of Practitioners of Insolvency, has changed its name to 'R3', which stands for Rescue, Renewal and Reconstruction.[10] In addition, the last two years has seen the emergence of a worldwide movement of turnaround specialists, organised through the Turnaround Management Association, which now has a New Zealand branch. The English organisation is shortly to introduce specialist examinations for turnaround professionals.

Of course, too much emphasis should not be placed on the efforts of professionals to rebrand themselves in the market place or to emphasise the less stigmatised aspects of their work, [11] but the combination of these trends around the world serves to emphasise that what is emerging is a specialist profession who will soon have specialist training in rescue procedures in their home jurisdictions and contribute to the international debate. The idea of 'turnaround' is to deal with the companies who are not insolvent, because they have not yet reached that stage; indeed it can be concerned with solvent companies in a bid to make them more profitable in the long term. But even where it is concerned with companies who are financially distressed, the emphasis is on early diagnosis and treatment. To the extent that rescue procedures, whether formal or informal, will reinforce this culture, they should be encouraged.

Further Research

When considering the appropriateness of overseas approaches to distressed businesses, the extent to which they are relevant or helpful as guides to the direction which New Zealand law should take would be assisted by empirical research into several aspects of the current New Zealand law and practice. In the absence of such evidence, there is a danger that anecdotal evidence and interest-group positions will displace it. (The lack of empirical evidence on insolvency law and practice is a worldwide problem, though where it exists, it has been incorporated into this report.)

Specific areas in which research would be useful in New Zealand are:

(a)The use of Part XIV Companies Act;
(b) The prevalence of informal workouts, the characteristics of the debtor, and the outcomes of such workouts;
(c) The basis upon which decisions to take security from private companies are made, and the nature of that security in different circumstances;
(d) The basis upon which a decision to appoint a receiver is made, and what steps and practices exist to monitor distressed businesses prior to that point,
(a) Recovery rates for different types of creditor under existing insolvency procedures, and for different business sizes.

Needless to say, there are other specific issues on which evidence would be of assistance, but the important point is to build up an objective picture of the occurrence and characteristics of corporate distress in New Zealand, and the factors which impact on outcomes under current law.

<u>Objectives and reasons for rescue procedures</u>

The issue of whether there should be a formal corporate rescue procedure, and if so in what form, cannot be divorced from wider questions as to the scope and philosophy of corporate insolvency law. The most controversial debates have revolved around whether an objective of corporate insolvency law should be to facilitate rescue or rehabilitation of companies. It is common ground amongst all commentators that a procedure for a fair and orderly realisation and distribution of assets to creditors and other stakeholders, is the minimum objective of corporate insolvency law. Some commentators are of the view that this is the most that it should do, as well as the least. While they may concede that the law should encourage rehabilitation of individual debtors, this is not extended to companies (since they have no soul or body).

Whether the law should facilitate the survival of businesses (as opposed to companies as such) in trouble is keenly debated amongst academics, particularly in the US. At one extreme, the view is taken that rehabilitation of businesses should be an independent goal of corporate insolvency law because of the social or socio-economic costs of business failure, (for example loss of jobs or infrastructure, investment in human capital) and its effect on a local or wider community. At the other extreme, there is a view that businesses should only be assisted to survive if ‘they are worth more alive than dead’, the objective being to maximise returns to creditors. To some extent, these academic standpoints are reflected in different countries’ insolvency laws, though it is difficult to find examples at both extremes. Most practical examples of rescue procedures tend to sit somewhere between these two, insofar as any objectives are expressed or divinable. France is an example of a country where preservation of employment is placed at the forefront of insolvency laws. South Africa, on the other hand, has a procedure which can only be used if a court can be convinced that a business will return to solvency.

Maximisation of creditor returns

Those that propound the view that corporate rescue should not be seen as an independent goal of insolvency law for its own sake usually agree that if, in an appropriate case, a greater maximisation of returns to creditors could be obtained by enabling survival of a business as a going concern, this would be a legitimate goal of insolvency law, and one that creditors would wish to achieve, if possible by agreement. This is the major reason why rescue procedures, both informal and formal, have been promoted and implemented, and why they have received the approval and co-operation of stakeholders in insolvent or distressed businesses.

It is widely accepted that this is the major objective of insolvency systems. Some debate could be conducted about whether it is simply returns to creditors that should be focused on, as opposed to other stakeholders. But given that the edifice of insolvency law is based on credit, and given that a company in distress is unable or may be unable to pay its debts, the return to creditors is a tangible goal which displaces any issue of returns to investors (that is not to say that the latter should be forgotten in any rescue procedure) let alone the intangible interests of the wider community.

Thus there seems little point in disputing that the primary goal of insolvency laws is wealth maximisation, or loss minimisation, in the form of maximising returns to creditors as a class. (This goal says nothing about priority amongst different groups of creditors, which may impact on rescue, and will be mentioned briefly below). Indeed, when one considers that the traditional justification for collective insolvency in the form of liquidation is the inefficiencies of individual creditor behaviour which may deplete the common pool of assets from which claims can be met, collective corporate rescue procedures are simply a natural extension of this to achieve another, sometimes better, way of maximising the value of the debtor's assets for the benefit of creditors.

The limits of liquidation

Liquidation will usually be the most efficient and expeditious method of pursuing that primary goal, where an insolvent business clearly cannot continue trading. A liquidator has powers and duties to act on behalf of all creditors to conduct an orderly realisation of the company's assets, and to distribute them in accordance with statutory and contractual priority rules.

In practice, this will be done by a speedy sale of the company's assets at the best price that can be obtained for them in the circumstances, combined with a disclaimer of unprofitable contracts or leases and clawback of any voidable transactions. If a liquidator trades, it will be a short-term holding position in order to preserve value of assets or fulfil key orders pending break-up of the business and assets.

Liquidation also carries with it a stigma, suggesting terminal illness on the part of the company. It is for this reason that companies often try hard to prevent advertisement of creditors winding up petitions. This will affect the price obtainable by the liquidator for the company's assets, and the perception of those dealing with the company and its business. Indeed, such is the stigma attached to liquidation that in some jurisdictions consideration is being given to whether or not rescue procedures should be removed from Insolvency statutes and relocated in separate statutes. For these reasons, liquidation is not the appropriate procedure within which to attempt to rescue any viable parts of a business, nor is it equipped to do so.

The price available for the assets of a company in liquidation, which will usually have ceased trading, is affected by the fact that the valuation of those assets is done on a 'break up' basis, i.e. as separate assets. In contrast, where a business is continuing to trade, as it may do under a receiver or in a rescue procedure, assets are valued on a going concern basis where it is possible to sell the business as a whole, or at least parts of a business, as an ongoing trading entity, with the added possibility that a bundle of assets essential to the running of the business or part of it by a purchase, can be sold together and thus will attract a greater aggregate value than the sum from the sale of the separate parts.

It is this last factor which means that it is sometimes possible to achieve a greater maximisation of return to creditors through receivership or a rescue procedure. Thus, even if the narrowest objective of a rescue procedure was taken, viz. maximisation of returns to creditors, there are many situations in which use of a rescue procedure will achieve a greater realisation than on a liquidation. Indeed, this is so crucial an aspect of rescue procedures that it is built into many of the purposes of such procedures, such as in Australia and the UK. In one recent UK case the court made an administration order simply because it was shown that the rate of interest obtainable by an administrator from the government's Insolvency Services Account, into which all realisations must be placed, was higher than on a voluntary liquidation. This adopted a wide view of better realisation than on a liquidation.

However, aside from the possibilities of achieving a greater realisation than on a liquidation because of advantages of the rescue procedures and the lack of stigma affecting price of assets, the more important way in which a rescue procedure can achieve a greater realisation for creditors than on liquidation is because in some appropriate cases, the rescue of a business or its viable parts may be possible, under the umbrella of the rescue procedure, either by the sale of the business or parts as a going concern, or by a restructuring of debt and equity by agreement amongst creditors, conducted under the umbrella of a moratorium on creditor action and a framework of legislation which facilitates creditors to reach a consensual solution.

Rescuing Businesses, not Companies

As pointed out by the Cork Committee, society has no interest in rescuing companies, which are mere abstract legal shells. Unlike individual debtors, they have no body and soul. Directors may well have an interest in preserving corporate structures since the dissolution of the company usually coincides with the end of their involvement with the business. Debt restructuring designed to preserve corporate structures does happen, and can be a valuable form of short-term assistance to companies or groups that while not necessarily insolvent, need 'turnaround' treatment. However, it is important to make the distinction between businesses and companies because it is sometimes argued that company law (as opposed to private bargaining) should not get involved in rescue or rehabilitation of insolvent companies. The argument is along the lines that in a market economy, many companies fail. Failure is a fact of business life, and insolvency is a fact stemming from the credit economy. If companies fail, that is generally because they are unviable and therefore it is a good thing that they fail, thereby making way for other, presumably successful and solvent, companies to take their place, and for investors' funds, employment etc. to flow into those latter companies. It is pointed out that many companies become insolvent in the first few years of incorporation, and that this is a method by which weak companies or those with uneconomic ideas are weeded out. This 'Darwinian' view of company and insolvency law finds some support in the academic writings at one extreme of the spectrum of views, in the writings of those such as Douglas Baird.[12]

However, on closer examination it becomes clear that, no matter how true it might be in a market economy that some element of failure is essential to private enterprise, even writers such as Baird have taken on board the distinction made by the Cork Committee between companies and businesses.

So it is largely true that insolvency law should not attempt to rescue insolvent companies, as opposed to businesses. It is not completely true because there are some circumstances where insolvent companies may need to be rescued (at least in the short term) in order to rescue viable businesses. This is particularly likely to be the case with group structures. Since group borrowing facilities are often linked, so that events of default in one company may trigger insolvency of other group companies, or trigger cross guarantee obligations, there are occasions when rescue procedures are necessary for preserving the structure and financing of companies, as opposed to just businesses.

Rescuing Insolvent Businesses

Bearing in mind, then, that the primary objective of collective insolvency proceedings is to maximise creditor returns, and bearing in mind that it is with businesses, not companies, that rescue procedures should be primarily concerned, how is the case for rescue procedures established?

Rescue procedures, and legislative or executive involvement in the facilitation of out of court rescues or restructurings, are justified where they may result in a better maximisation of creditor returns than on liquidation. It is not suggested that rescue procedures should be used for all companies. Clearly the comments above in relation to weeding out unviable entities, apply to businesses. Rescue procedures should not exist to 'prop up' or prolong the life of unviable businesses. To quote from the UK DTI report on Business Rescue:

" Corporate rescue mechanisms are not intended to maintain inefficient firms that are not economically viable, or to protect debtors from creditors except for time-limited and short periods to facilitate the orderly restructuring of the corporate entity and/or its business"[13]

In addition to the wealth- maximisation justification for provision of a rescue procedure to complement existing procedures, there are other justifications.

First, it is often said that directors of companies would like the ability to initiate assistance at an early stage of financial distress, before formal liquidation becomes inevitable. Facilitation of early intervention, and avoidance of formal liquidation in some cases, furthers more than one goal of insolvency law. First, it is likely that in some cases creditor loss will be minimised if directors feel assured that they can trigger formal procedures rather than continue trading to the detriment of, and at the expense of, creditors. Hence, encouraging early 'treatment and prevention' of failure should further the primary goal of creditor wealth- maximisation.

Secondly, it is often claimed to be a goal of insolvency law that the law should encourage, promote and facilitate high standards of integrity and accountability among directors. (The Preamble to the Companies Act 1993 mentions encouraging efficient and responsible management). There are many provisions and mechanisms currently in place in New Zealand which indicate that this is a goal of company and insolvency law. In particular, sections 135 and 136 Companies Act 1993 impose duties upon directors (widened considerably in 1993) which expose directors to liability for incurring obligations or trading beyond the point when they knew or ought to have known that the company could not avoid liquidation and meet its liabilities. It is implicit in these provisions that directors are encouraged to seek advice and take steps to minimise loss to stakeholders, in particular creditors where the company is insolvent or near-insolvent. A formal corporate rescue procedure would allow directors to further minimise loss to creditors by preserving any going concern value in the business, and, by involving outside independent financial assistance or management, this preservation is more likely to be long- term.. Incentives and deterrents can be built into insolvency laws so that directors are encouraged to utilise rescue procedures, even where they may perceive this as relinquishing some control over the company or admitting failure. Insolvent trading liabilities should deter directors from continuing in business past the point where they should have sought early advice, and directors initiation of rescue procedures can be made a defence to insolvent trading allegations, as in Australia.

A third possible goal of corporate insolvency law is to investigate the causes of company failure in a particular case, in order to ascertain what steps, if any, may be taken against those involved in the management of the company. It is implicit in current legislation that this goal exists, given that the statutory management regime includes investigatory powers, and given that there are executive powers to disqualify delinquent and defaulting directors. Just as with liquidation, rescue procedures involving an independent expert afford an opportunity to pursue such inquiries in the interests of the public, creditors and other stakeholders. (This last goal is only relevant if any proposed rescue procedure involves an independent outsider. If all that is proposed is the facilitation of consensual compromise, then no investigatory opportunity arises. Conversely, absence of any outside professional involvement in any rescue procedure may enable directors to avoid investigation or intervention.)

The fourth objective of corporate insolvency law should be to provide a ‘menu’ of procedures from which creditors, directors and others and/or the court, can select. The circumstances of each particular case of financial distress mean that a variety of procedures should exist which can be selected as appropriate. Neither liquidation, receivership nor corporate rescue will be appropriate in every case. Provided that there are adequate checks and balances to ensure that the right selection has been made from the menu[14], and to allow for variation or change of direction if circumstances change or were misjudged, the role of State intervention through provision of an insolvency regime should be largely to facilitate consensual solutions.

Lastly, and related to this, it is important to be clear that any proposal for a formal rescue procedure will not be a ‘cure-all’. First, it is difficult to define and measure ‘rescue’ as a successful outcome within a reasonable timeframe. Secondly, the need to maintain the ‘menu’ approach also involves the need to maintain flexibility so that, for example, conversion between different types of procedure is relatively straightforward. In designing a formal rescue procedure, a decision has to be made as to how far it will facilitate plural objectives, such as an alternative type of liquidation, or how far it should be purely a reorganisation provision. This involves choice as to expressed legislative intent, access criteria and conversion criteria. Those choices should be informed by such empirical research on outcomes as has been done in jurisdictions which already have formal rescue procedures .

Size of businesses

Generalisations are often made about the merits of a variety of insolvency and rescue procedures, without paying sufficient attention to the size of the businesses to which the procedures would apply.

It is now becoming clear, through both policy discussions and empirical research, that size does matter. It would be difficult to design a rescue procedure which is suitable or attractive for all sizes of companies. For example, research has been conducted on informal 'bank' rescues, but this research tends to suggest that while informal rescue arrangements have much merit in multibank cases, the small to medium sized enterprise generally only has one or two financiers and so quasi-informal procedures such as the London approach are not so appropriate. Secondly, the more court-orientated rescue procedures, such as the UK administration order or the US Chapter 11 procedure, seem to produce satisfactory results with large insolvent companies or groups, partly because the assets can absorb the high entry and ongoing costs of such procedures.[15]

There are several recent examples of legislatures recognising the need for different solutions to be available for different sized entities. As mentioned below, in Canada this has led to the legislature reflecting the market view that a more flexible court-driven procedure was more appropriate for larger entities, so that the Companies Creditors Arrangement Act can now only be used for companies with liabilities over Can $5 million. In the UK, the Insolvency Bill is enhancing the Company Voluntary Arrangement procedure with a moratorium, but, whether wisely or not, is limiting this to small to medium sized entities as defined by the UK Companies Act, which uses a mixed test of size, based on turnover, assets and employees. In the United States, there have been calls for a separate Chapter from Chapter 11 to cover small and medium-sized businesses, given that these seem to convert to liquidation far more than in the case of larger corporations under Chapter 11 reorganisation. Of course, there can be problems whenever a restrictive definition is used. Thus, the UK has suddenly realised that this legislative initiative might include some companies in a group but not others, and could give rise to problems for securitisations, which use small Special Purpose Vehicles.

The most important point to bear in mind about size is that the majority of New Zealand companies are small, by any definition. The most important consequence of this is that any rescue procedure has to be accessible to the creditors and the company itself. Costly court-driven procedures, as they have discovered in the UK and Canada, are a major disincentive to debtors to act early to initiate a rescue. Non-court procedures such as the Australian voluntary administration and the Canadian Division 1 BIA reorganisation (see below) are cheaper, and easier to initiate. The Australian system replaces the company management with an independent professional, so is not as cheap as the Canadian system. There is some evidence in Australia that size affects successful outcomes, the larger corporations being more successful, and that direct costs of the administration procedure can have a significant impact on smaller companies' success in administration.[16] However, in a country the size of New Zealand it is debatable whether it would be worth distinguishing separate procedures on a size basis. Given that large companies are rare, it might be more efficient to opt for a procedure that is inexpensive and accessible for all companies and their creditors.

The point about size does not just relate to formal rescue. It is sometimes argued that there is a large amount of informal restructuring and 'rescue' that is conducted without publicity or proceedings. However, there is evidence[17] to support the view that while informal rescues are a vital part of the equation in any insolvency system, they tend to favour secured creditors at the expense of unsecured and trade creditors, who do not have the information advantages in an informal situation. This is particularly true in smaller companies dominated by one or two lenders. It would follow that rescue should not just be left to informal bargaining processes because of the imperfect informational position of junior creditors, especially in small firms. In larger firms with more diverse lending and equity structures it may be that junior trade creditors are paid off as a matter of necessity since information is not in the hands of so few stakeholders.

Current New Zealand law in context of rescue

Liquidation

Liquidation is the primary (and strictly speaking the only[18]) collective legislative procedure for dealing with distribution and realisation of assets of an insolvent company.

While a company, through its directors, can initiate a 'voluntary' liquidation, creditors can, by petitioning the court, initiate a compulsory liquidation against the wishes of the company or its directors. The court has discretion to order a liquidation where a company is clearly unable to pay its debts or in certain other 'public interest' situations. A liquidation involves the appointment of an independent professional but the purpose of liquidation is to terminate the company's affairs, collect in and distribute net assets to creditors. It is not a long-term objective of liquidation that a business should continue to trade. Once liquidation (a publicly notified procedure) commences, the value of a company's remaining assets is affected, and a stigma is undoubtedly attached to the company and those associated with it. In addition, liquidation exposes the directors and some creditors to claims which a liquidator has power to bring directly against those directors, as well as exposing them to challenges to voidable transactions which may include transactions between the company and its directors shortly before insolvency, and to investigation by the Companies Office.

Liquidators have power to propose a compromise or arrangement between the company and creditors under Parts XIV or XV, but any such compromise carries with it the weakness of the present Part XIV and (to a lesser extent) Part XV, and would only carry a very limited moratorium against creditor action (only court proceedings are automatically stayed in a liquidation, so secured and other creditors can still take non-court action to enforce their claims). In addition, liquidation is a terminal procedure where liquidators have very limited power to trade or manage a company as a going concern. It is sometimes possible for liquidators to act as facilitators for consensual arrangements among creditors (For example in the recent Voss Construction liquidation, creditors, through the liquidator, agreed to set up new subsidiary companies in order to complete specific building projects which would be of value to the creditors generally). However, generally this sort of arrangement is short-term (designed to complete existing contracts) and difficult to negotiate.

There is some uncertainty amongst the judiciary and practitioners as to the precise inter-relationship between liquidation and compromises under Parts XIV and XV.

Receivership

Receivership is not a collective insolvency process, and is largely contractual, arising out of a charge/security given by a company to a creditor, usually a bank, often over the whole or substantially all of the company's assets. Statute has superimposed limited duties and powers upon receivers under the Receiverships Act 1993 (which is not limited to company receiverships), some of which reflected existing law.

From the point of view of corporate rescue, the advantage of receivership relative to existing alternatives (other than statutory management) is that a receiver has the power to step into the shoes of the directors and continue to manage the business of the company as a going concern, if that is regarded as the appropriate course. For that reason, when in 1982 the UK Cork Committee on Review of Insolvency Law proposed a corporate rescue procedure (the administration order) they stated that it was designed to fill a lacuna where there was no chargeholder in a position to appoint a receiver who would have control over all or most of a company's assets. In other words, receivership was regarded as serving adequately to ensure survival of viable businesses or parts of businesses as going concerns, so that in those situations there would be no justification for a corporate rescue procedure. In addition, the administration order procedure in the UK includes power for such a chargeholder to effectively veto any administration order by appointing a receiver. The reasoning behind this was that the receiver, given similar powers as an administrator, could do everything an administrator could do to 'rescue' a company, so there would be little point appointing an administrator.

However, two main points should be made about that comparison. In the UK, the 1986 legislation identified a new animal, the 'administrative receiver', who was a receiver appointed over all or most of the company's assets and undertaking. Non-administrative receivers still exist, for example if only appointed over one asset or group of assets, or if an administrative receiver is already in place. The new animal was given enhanced powers and duties, effectively putting them in a similar position to an administrator. Thus, with certain court sanctions, they have power to dispose of other secured property without the security holders' consent. Secondly, they have to be licensed insolvency practitioners, and they have certain 'soft' statutory duties to report to unsecured creditors. While in practice much of this is symbolic, the point is that in the UK the position of the receiver appointed under a floating charge is strengthened by statute. Notwithstanding this, the DTI report on Company Rescue has recommended removing the right of the appointor of such a receiver to veto an administration order. The policy debate which is currently being undertaken in the UK and elsewhere (for example Hong Kong) has shifted since the late 1970s, when receivership was seen as sacrosanct. Exposure to other jurisdictions which do not have the concept of receivership and the floating charge (France, the US) has led to a more balanced view of the role of receivership, though few would suggest it has no role.

However, the main disadvantage of receivership as a major corporate rescue procedure is that receivers' primary duties and loyalties are to the secured creditor who appointed them. While statute has overlaid a weak duty to consider other stakeholders on disposal of assets, such as the company itself and other secured creditors who might be affected, ultimately the aim of receivership is to realise the maximum amount in order to repay the secured debt to the chargeholder who appointed the receiver. Unlike liquidation, or corporate rescue procedures operating elsewhere, the receiver is not appointed as an agent of all creditors collectively, in order to maximise returns to creditors collectively. He or she is selected by the chargeholder and reports to the chargeholder. While technically the receiver can propose a compromise under Part XIV Companies Act 1993, it would be rare that this would happen unless the receiver thought it would assist in maximising returns to his appointor (who often has to yield priority to statutory preferential creditors).

While banks and receivers would argue that receivership is a rescue procedure, in that it often results in preservation or sale of viable businesses as a going concern, the limitations have to be acknowledged. First, the receiver is acting for one creditor only and once that creditor has been repaid, (or repaid as much as possible) from charged assets, the receiver has no interest in the fate of the company, business, or other creditors. Secondly, for this reason most receiverships are followed by liquidation, since the liquidator must deal with realisation and distribution of any remaining assets. Cases where receivership results in a return of the company (as opposed to part of its business) to solvency are so rare that they call for special remark. Receivers generally have no duty, power or mandate to take on any of the investigative functions in the public interest which are often incidental to a liquidator 's or administrator's attack on past transactions or directors' conduct. They would often have no incentive to pursue potentially voidable transactions or pursue directors, even though this may maximise returns for all creditors, since their attitude will be to recover as much or all of the secured creditor's debt as quickly and expeditiously as possible at the lowest cost. Therefore, to the extent that receiverships do 'rescue' viable businesses or parts thereof, it is incidental to their main purpose. It is therefore legitimately been claimed that receivership is 'unfair' to preferential and unsecured creditors since there is no incentive to maximise returns to them, and that they therefore bear some of the costs of stemming from the banks' concern to look after its own interests. Clearly banks will not want to be associated with job losses and adverse publicity in some cases, particularly larger ones, but this intangible factor will not usually dictate the outcome of an insolvency once receivership has commenced.

How far does receivership achieve rescue? If rescue in receivership is defined as a going concern sale of the business or a return to its directors, limited research has been done. However, in a study commissioned by the UK DTI by Professor Julian Franks and Oren Sussman,[19] they conclude that 44% of companies in receivership are sold as going concerns, though since the definition of going concern is imprecise, even this should be treated cautiously. But even if it is an overestimate, it does show that some sort of rescue of viable businesses occurs through receivership in the UK, and no doubt in New Zealand too (notwithstanding the slight advantages of the administrative receivership status in the UK). However, what that does not tell us is whether or not more businesses would be rescued through some alternative procedure, and does not tell us whether returns to all creditors, not just the appointing chargeholder, would be greater in alternative procedures. There are so many variables that such statistics would be difficult to produce, and would then not be directly applicable to other jurisdictions.

The behaviour of secured creditors in situations where they do have an option to appoint a receiver notwithstanding an alternative rescue procedure may throw some light on whether an alternative procedure is desirable. In the UK, where chargeholders with a security covering most or all of the company's assets have the option whether or not to appoint a receiver and prevent an administration order proceeding, research by Professor Harry Rajak confirms earlier research that in 50% of administrations and voluntary arrangements, floating charge lenders exist who must have therefore acceded to the rescue procedure being taken out of their control. This confirms the situation in Canada and Australia. In the latter a dubious practice has arisen of chargeholders consenting to the administration proceeding, but only on the basis that they can trigger appointment of a receiver at any stage (the legality of this has not yet been tested, but is quite prevalent since it allows the administration to proceed). However, of 47 companies in administration, Routledge found that administrators responded that 79% were companies where a substantial charge over company assets existed. The main reasons given were that the lenders were adequately secured and that they had confidence in the administrator.

What this indicates is that even where an alternative to receivership exists, which alternative would remove control from the receiver and their appointor, lenders are still prepared to accede to the wider rescue on behalf of all creditors. There may be several reasons for this. In practical terms, in most cases funding during the rescue will be sourced from pre-insolvency lenders and where, as in most cases, there are only one or two principal lenders, they have an ongoing interest in continuing to finance the company during the rescue process, either to realise their investment and/or to continue the banking relationship. Secondly, the independent administrator is likely to be a professional well-known to the bank and thus commanding their confidence that he or she will do their best to maximise returns for all creditors, and act with integrity towards the secured creditors. In terms of outcome, secured creditors in these regimes may now realise the benefits of the collective rescue procedures, which are attended with many statutory advantages in terms of the administrator's powers, so that they expect a greater return through the administration process, and of course avoid absorbing the costs of receivership.

The changing role of secured lending

The above discussion examines the role of receivership as a 'rescue' device, even though it was not designed as such. However, for the same reason that the Cork Committee concluded that administration orders were needed, it should be emphasised that not all company finance presupposes existence of the holder of a charge over all or substantially all of its assets. Two relevant points should be made.

First, personal property security legislation (PPSA) will change the nature of the discussion, so that new terminology would be needed to define the scope of an all-embracing charge over assets and inventory such as to give a receiver control over the business. Secondly, much bank lending, particularly among larger public corporations, does not rely on secured lending or on the taking of a floating charge. Large unsecured overdrafts are quite common for established companies. Thus, receivership cannot perform the entire 'rescue task' even under existing New Zealand law. At present, only the statutory management regime and Part XIV Companies Act would be available to achieve any sort of 'rescue' where there is no principal chargeholder with 'control' over the assets and undertaking.

In addition, there are two further factors which suggest that receivership cannot be relied upon in future to perform the major role in saving viable businesses. First, the nature of corporate finance is evolving, so that new financial security instruments are being utilised, or existing ones are being increasingly used. Thus, asset financing, invoice discounting and factoring are becoming increasingly important. The DTI UK report on Business Rescue states, in respect of the UK sector:

" An increase in the number and diversity of parties holding floating charges and as a consequence with the right to appoint an administrative receiver: this is partly a reflection of the growing diversity and specialisation of business finance, such as the growth in asset-backed lending, factoring and invoice discounting; there is concern that the new diversity of floating chargeholders makes it more difficult to ensure that the appointment of administrative receivers is effectively treated as a last resort by lenders; the diversity is also making it more difficult to rely on self-regulatory measures by creditors such as the banks' Statement of Principles"[20]

Secondly, the Personal Property Securities Act, insofar as it widens the scope of instruments which confer security, and insofar as it expands existing security by recognising a continuous security interest (for example extending into proceeds), may serve to enhance the effectiveness and thus the development of other forms of security over assets and intangibles.[21], One possibility is that the benefits of simplicity, certainty and enforceability, as well as expansion of the security rights recognised under the PPSA, may mean that a traditional bank debenture will no longer cover so much of the assets and undertaking of the company and it will be less possible for a receiver appointed under it to carry out an effective rescue or sale of the business, because the key assets will be fragmented. While it is too early to predict whether the PPSA will have such an impact on traditional secured lending, it may be a potential factor which should tell against relying on traditional receivership under a fixed and floating charge debenture as the major method of business rescue, apart from all the other weaknesses of receivership referred to above.

Lastly, global initiatives such as the UNCITRAL work on cross-border insolvency and possibly on other areas of insolvency in future, mean that the concept of receivership and the floating charge, which is less well-known outside of the English-speaking world,[22] will be difficult to reconcile with collective insolvency procedures at the heart of such global initiatives.

For these reasons, receiverships, though performing a valuable 'incidental' rescue function, cannot be relied upon to do so, and are not possible in all cases. In addition, they are not a collective insolvency process and are not designed to maximise creditor returns generally.

Having said that, all modern corporate rescue procedures give recognition and varying degrees of paramountcy to secured creditor's rights. This is a major issue which has to be addressed in discussion of any rescue procedure and it is the other reason why the legislature in the UK has enabled secured creditors to 'veto' the collective rescue procedure. Established contractual security rights are respected as a given premise in most insolvency regimes. Part XIV of the NZ Companies Act 1993, for example, states that no moratorium imposed by the court can affect secured creditor's rights to enforce security. Whether or not secured creditors should have their enforcement rights postponed in the short term in order to attempt a rescue, is a matter of policy which should be decided in light of such evidence as is available about the behaviour of secured creditors in rescue situations. The role of secured credit in rescues will be discussed below.

Part XIV and Part XV Companies Act 1993

Part XIV Companies Act 1993 (Part VB Companies Act 1955) was passed in 1993 in order to make compromises between a company and its creditors simpler to achieve. Before then, the alternative was to pursue a court-sanctioned compromise or arrangement under section 205 of the 1955 Act. The latter provisions were not designed specifically for insolvent companies, but as part of a package enabling company reconstructions. Such provisions have been in Commonwealth company legislation for many years. They could be and are used by insolvent companies, but the major disadvantage of using them for achieving compromises on insolvency is the cost and inconvenience of court sanction. In addition, as a late inclusion in the legislative and consultative process, what is now Part XV Companies Act 1993 was added, which provides for court-sanctioned amalgamations, not necessarily just on insolvency. There may be some benefit in using Part XV in the insolvency of a complex group structure or to have the court's sanction for 'cramming down', i.e. diluting the rights, of one class of creditors or shareholders where the requisite majorities for Part XIV could not be achieved. (The court may sanction a scheme within Part XV notwithstanding that it could have been proposed under Part XIV). In addition, the potentially wide discretion given to the courts under section 236 means that a wider variety of interests, such as the public interest in preserving a business in the community, have been taken into account, not just creditor views. While the courts have developed a considerable body of jurisprudence as to the test for sanction or refusal of compromises or arrangements, designed to protect minority interests by reference to reasonableness, the Court of Appeal has taken the approach that Part XV does not necessarily dictate application of those tests. In addition, by giving a wide interpretation to the term 'compromise', they have reluctantly acknowledged that it could be used even where there is no consensual agreement amongst a group of creditors and the company, but merely, as in that case, a proposal by the debtor in regard to one creditor's claim. Under Part XV there is no precondition of insolvency, so that theoretically, a company could make a proposal under Part XV where there was an early sense of financial trouble, but short of imminent or actual insolvency. Part XV has no exact equivalent in other jurisdictions. The Court of Appeal has expressed concerns about its justification, its wide discretion given to the court, and its relationship with Parts XIII and XIV of the Act. In addition, the Court acknowledged the difficulty in applying any particular objective standard as to whether it should make the scheme binding on a creditor or creditors. In its decisions in *Suspended Ceilings v CIR*[23], some members of the court expressed unease with the provisions of Part XV, and in particular that it seemed to give much judicial discretion with little legislative guidance, which discretion could be utilised so as to avoid some of the consequences of the voting and other requirements of Part XIV. The courts will continue to be cautious in the exercise of their discretion so that they do not create a conflicting body of jurisprudence as between the two Parts. The courts seem to accept that the creditor voting control inherent in Part XIV should be generally acknowledged when exercising discretion under Part XV. However, it is unfortunate that the court has to be put in that position. In any event, cost means that Part XV applications may be prohibitive for most small and medium sized companies in trouble.

The relationship between Part XIV and XV in particular should be examined when reviewing or amending Part XIV.

Part XIV requires that a proponent of a compromise has reason to believe that a company is unable, or will be unable, to pay its debts within section 287 (the liquidation test of insolvency, consisting of rebuttable presumptions). The board of directors, a receiver over all or substantially all assets, a liquidator or (with leave of court) a creditor or shareholder can propose a compromise. The courts have interpreted 'compromise' widely to enable any variation, reduction or cancellation of debts or rights and it is not necessary to point to an existing claim or dispute in order to 'compromise' it. The proponent gives notice in accordance with statutory form and containing details and possible consequences of the compromise, to all known creditors. Where the interests of different creditors are regarded as distinct, it is necessary to have separate voting for each class and there is a presumption that the compromise is conditional on approval of each class. This requirement for class voting is a potential difficulty for proponents, since it has often proved difficult to identify which creditors should be treated as in different classes, and the courts have had difficulty defining this test. This introduces an element of uncertainty and unpredictability into the notice procedure, because a creditor could challenge the compromise on the basis of insufficiently or inappropriately identified classes.

A compromise is binding once approved by creditors or classes of creditors at a meeting held in accordance with the rules for holding of creditors' meetings in liquidation. It is binding on all creditors who received notice of the proposal in accordance with the statutory requirements (this places a heavy burden on proponents of such schemes to discover all possible creditors. – there is no requirement for advertisement of meetings and even where it is done, it may not affect the outcome for those who did not see the advertisement).

It was a major objective of the introduction of Part XIV to reduce the role of the court, and thus the cost and accessibility of the procedure. While that has happened, there is often court involvement, and in some cases, such as where a creditor proposes a scheme, or where powers of management are intended to be reduced, it is a prerequisite. It may still be the case that the degree of court involvement could be further reduced, especially if modifications included some reporting or monitoring requirement by an outside professional.

The court has power on application of the proponent to stay enforcement proceedings or to order a creditor to refrain from taking any other enforcement measure against the company in relation to debts. This stay may imposed from the giving of initial notice until a period ten days after notice of approval of the compromise has been lodged. Thus, it is sufficient to provide a limited moratorium preventing creditors from taking proceedings, and, at the court's insistence, other enforcement steps. However, it is of limited effectiveness in that it is not automatic, as is the case in most rescue procedures, and the only general prohibition is on proceedings in court; other enforcement steps can only be prohibited if specifically requested. Lastly, it may be regarded as a major weakness of Part XIV that neither the scheme nor the court can affect the enforcement rights of secured creditors.

A compromise may continue under Part XIV notwithstanding that the company goes into liquidation. The court may make orders either before or after liquidation about the extent and period of continuation of the compromise after liquidation. This can be seen as an uncertainty in the procedure, or a useful flexibility. In other rescue procedures, there is a more rigid but clearer relationship between the compromise and other insolvency procedures, particularly liquidation. It should also be noted that section 287 Companies Act specifies failure of a Part XIV proposal as a ground for presumption of insolvency, enabling a petition for liquidation to be brought. One question to address when considering any new rescue procedure is how far failure to achieve a consensual compromise should automatically lead to liquidation.

In conclusion, the present Part XIV is an improvement on the available tools for consensual compromise which existed prior to 1993, but its major disadvantages are the lack of an automatic moratorium, and one that binds secured creditors, and secondly, the requirement for class meetings.

If possible, research should be undertaken as to how far Part XIV has actually been used, and to what effect. One suspects that it has been infrequently used due to the problems identified above, and due to uncertainty about its scope and relation to Part XV.

Statutory management

I understand that a review of statutory management under Corporations (Investigation and Management) Act 1989 and related Reserve Bank Act legislation is a specific topic within the review of insolvency law by the Minister and has been referred to the Law Commission. Therefore comments at this stage will be confined to its advantages and disadvantages as a rescue procedure.

The first disadvantage from the point of view of the company and its directors, and from the point of view of rescuing viable businesses, is that the procedure can only be initiated by Order in Council by the Governor-General on advice from a Minister in accordance with recommendation of the Securities Commission. It is not a procedure over which creditors have any direct control or standing. This is also true of the company and its directors. Creditors, the company and its directors are usually the main groups who would initiate insolvency proceedings; while most jurisdictions give standing to an appropriate government minister to initiate proceedings in the public interest, by bringing a petition for liquidation or administration before the court, statutory management goes further. First, *only* the Executive can initiate the procedure; secondly, there is no court hearing at all. The related disadvantage is the cost involved (albeit one that falls on the government) in initiating the procedure. It is normally shareholders and creditors who monitor the performance of the company and it could be argued that the existence of a government power to 'rescue' troubled companies is a disincentive to monitoring and therefore transfers costs to the government. (There is a provision in CIMA designed to avoid this 'moral hazard', since it provides that neither the Registrar-General nor any other person is under a duty to supervise a corporation subjected to statutory management, section 7). (Lastly, statutory management does not show the same deference as is shown in many jurisdictions' corporate rescue procedures to secured creditors' rights to appoint a receiver. While the Securities Commission certainly takes into account whether such a chargeholder exists (see Appendix 1 to report of April 1991 on CIMA) in deciding whether or not to recommend statutory management, no existing liquidator or receiver can remain in office while the statutory management is on foot.)

For this and other reasons, statutory management cannot be regarded as a collective insolvency procedure. There is no requirement of actual or imminent insolvency in order for the procedure to be used, though fraud and public interest are often factors in insolvency. While the creditor's interests are something to which the statutory manager must have regard, so are the interests of members, beneficiaries of any trust and where appropriate, the public interest. There is no suggestion that any one of these interests has primacy and therefore the focus and objectives of the procedure are potentially wider than in most collective insolvency procedures, which are largely creditor-focused.

However, the advantages of statutory management, and the reasons why it has been possible to conduct procedures in relation to relatively large company groups in the 1980s and early 1990s, have been threefold. First, there is an extremely wide moratorium in section 42 prohibiting most types of creditor enforcement steps, including secured creditors, self-help remedies and set-off. This type of wide moratorium is found in the United States Chapter 11 procedure, the moratoria in Australia and England being slightly narrower.

There is no doubt that the moratorium under the C(IM)A, or even a narrower-ranging moratorium, would be a powerful complement to Part XIV, or a good basis for any new rescue procedure.

Secondly, the powers granted to a statutory manager are similar to powers of a receiver of a company, yet wider in that, for example, a statutory manager can disclaim onerous property and sell property subject to security. The powers of a statutory manager to continue running a business, with the benefit of a wide moratorium, put the statutory manager in a very similar position to an English or Australian administrator. Again, if the Ministry chose to enact a rescue procedure which had an independent manager who assumed directors' functions, statutory management would be a possible basis for the powers of such a person. In some respects, a statutory manager has wider powers than any combination of receiver and liquidator , for example the power to suspend payment of (pre-statutory management) debts , or employment or agency contracts, without causing repudiation or breach of any contract (sections 44, 49).

In conclusion, while not wishing to pre-empt either a review of statutory management as a separate topic, or a more detailed review of corporate rescue procedures later in the process, there are some ingredients of the statutory management regime which are central to any separate rescue procedure, principally the wide moratorium, and the powers given to any independent manager who assumes the directors' functions. On more detailed consideration of the nature of any desirable rescue procedure, it would be possible to incorporate or adapt these aspects of statutory management in any new or adapted procedure.

It should be noted that the Securities Commission, in its April 1992 Discussion Paper on CIMA 1989 noted the absence in New Zealand of 'adequate rules of law which provide for corporate moratoria and corporate restructuring on a timely basis' (para 9). The method of initiation of a statutory management (or the related procedures under the Reserve Bank Act) makes it unavailable to creditors or the company as an avenue for rescue. Since arguably the need for any rescue procedure is for a simple and accessible procedure so that a company or its creditors can take prompt and early action of an affordable nature to preserve any viable business, statutory management as presently constituted is not an adequate basis for a rescue procedure.

Systemic Failure

A different question which would have to be addressed if it was decided to introduce a new rescue procedure or adapt an existing one such as Part XIV, is whether there should be some provision giving an appropriate governmental or ministerial body standing to initiate the procedure on public interest grounds, along the lines set out in Corporations (Investigation and Management) Act 1989. In addition, the special position of financial institutions might arguably lead to special standing of an appropriate Minister or official to initiate any new rescue procedure. It might even be a logically consistent step to retain the substance of the Reserve Bank Act statutory management procedure, but not the CIMA corporations procedure:

" In market economies, the liquidation and rescue process should not be the subject of political or government influence or intervention. However, the presence or absence of some exceptional economic, social or other such circumstance might sometimes justify a special process and the involvement or intervention of the government. Typical of such a process is one that might be applied when the banking sector of a country is itself in financial difficulty"[24].

Two of the main purported objectives of statutory management and its predecessor were to deal with fraud and to deal with large group failures. The objectives are broadly stated in section 4 of the Act and elsewhere, and it needs to be shown (except where fraud or recklessness is involved) that a corporation's creditors, members or the public interest cannot be adequately protected under the Companies Act 1993. In relation to group companies, the placing of a corporation into statutory management will automatically extend to its subsidiaries unless they are exempt by order in council. While highly convenient, both these matters can arguably be dealt with by rescue procedures and by liquidation. Corporate rescue procedures in major jurisdictions have been used to deal with large complex group insolvencies such as Maxwell and Polly Peck, often multinationals. These matters would need to be addressed in conjunction with the review of statutory management. In particular the question of how to deal with corporate groups in insolvency and restructuring situations is clearly one which overlaps with other parts of the review of both 'phoenix companies' and statutory management. (Professor Ian Ramsay at Melbourne University , at the request of ASIC, has recently produced a large report purely on the treatment of corporate groups).

Much of the work following on from the Asian Crisis has been in the context of how insolvency systems can be designed to deal with systemic failure, particularly the effect of failure in the financial sector. As a consequence, many countries in that region have passed legislation or established procedures which involve central government, or government agencies, directly in the rescue process. This has been done mainly by one of two routes, or by both routes. The government has either established an entity or bank authority which actually intervenes by trading in distressed debt, as has happened in the complex provisions for the Danharta authority in Malaysia. Alternatively, as in Indonesia and Thailand, attempts have been made to establish a committee or agency which will facilitate rescues or oversee liquidations. To some extent these entities are performing the functions which private insolvency professionals would perform in more developed systems such as New Zealand, and so there is no suggestion that these experiences are relevant here. However, it serves to illustrate that business failures, particularly in the financial sector, can have wider systemic effects and it is a matter of policy whether this is to be left to the usual insolvency procedures, or whether special procedures are necessary to deal with these, such as the powers in the Reserve Bank Act. It is widely acknowledged that excepting banking and insurance companies from the scope of rehabilitation procedures, and subjecting them to more specific procedures, is acceptable. On the other hand, there would have to be clear reasons why certain sectors were not amenable to the mainstream rescue procedure. In the UK, administration procedure was extended to banks in 1989, and has been used successfully. It is also true that in the UK specific pieces of legislation on privatisation of utilities, have devised adapted administration order procedures to deal with these essential services (this has happened with Rail, Gas, Electricity and Water). Largely, however, the structure follows the Insolvency Act 1986 concepts.

In conclusion, statutory management was conceived with broad objectives within an Act some of whose provisions coincide with the usually accepted objectives of corporate rescue on insolvency, and others which are part of the wider role of the State in investigation and regulation of commercial morality, and preservation of the commercial infrastructure and investor confidence. Consequently, aspects of statutory management (and related Reserve Bank Act) procedure could be preserved in any rescue procedure, such as the moratorium and the powers of the manager, but the initiation and termination of the procedure and the complete absence of either debtor or creditor control is virtually unprecedented in the developed world, inconsistent with other corporate provisions and goals in the Companies Act (such as Part XIV itself) and arguably places unnecessary monitoring and regulatory cost on the State and courts, which could be transferred to creditors and other stakeholders.

Whether there is a case for dealing with systemic failure in the financial sector, or specific financial sector failures by separate procedures such as that in the Reserve Bank Act, and aside from any mainstream corporate rescue procedure, can be examined in the review of statutory management. However, it is suggested that the overriding principle should be the need to make out a clear case in the public interest why an executive-initiated and controlled procedure is necessary in preference to the mainstream insolvency regime.

Overseas jurisdictions

<u>Australia</u>

In 1992 as a result of the Harmer report, Australia introduced the Voluntary Administration procedure in its Corporate Law Reform Act 1992, enacting the relevant provisions in Part 5.3A Corporations Law, which is Federal law.

Until 1992 there had been a rescue procedure known as Official Management, which required a high threshold of proof that the company could be rescued (something similar still exists, though is little used, in South Africa).

Clearly it will be necessary to examine how Voluntary Administration has served its purpose of enabling survival of some viable businesses without undue expense or court involvement. If otherwise desirable, there would be incidental advantages in terms of cross-border trade relations, and mutuality in any cross-border insolvency legislation, if New Zealand were to adopt a system similar to Voluntary Administration.

Administration is 'Voluntary' in Australia since it is the company or its directors that usually initiates the procedure, and it does not require any initial court hearing. (Secured creditors with charges over all or substantially all of the assets may initiate appointment of an administrator) An automatic 28-day moratorium is imposed and the company is placed in the hands of a qualified administrator (who must be a registered State-licensed liquidator.) The usual purpose of administration is to attempt to effect a Deed of Company Arrangement, also provided for in Part 5.3A. If this were not possible, the company would go into liquidation. In addition, a liquidator may appoint an administrator, and the liquidation does not necessarily cease.

In terms of use, voluntary administration has rapidly become the most frequently used insolvency procedure, outstripping liquidation. However, the legislation permits an administration to proceed if it would result in a better distribution of assets than a liquidation, so it is not conceived wholly as a device for rescuing businesses. 52% of creditors voluntary liquidations are initiated immediately after a voluntary administration. [25]The proportion of businesses actually rescued to those which go into some form of liquidation eventually, is about 20%. [26] However, Routledge examined 45 companies in administration through questionnaires and found that average returns were 37 cents in the dollar compared with an estimated 7 cents in liquidation.[27] However, this was qualified by the statements that in some cases, the return stipulated in the Deed of Company Arrangement did not eventuate, and that the returns did not factor in the time value of money. Lastly, the questionnaire requested practitioners to select 'successful' administrations.

Although there is no initial application to court, thus making it cheaper and more attractive to directors, there have been areas of uncertainty in the legislation which have led to judicial activity, revealing that the courts have wide discretion in some areas where the legislature has not provided definitions. Thus the overall cost of voluntary administration should be examined including court and professional costs.

Secured creditors with charges extending to all or substantially all of the company's assets are given a ten-day decision period during which they can appoint a receiver, but if they do not do so, the administrator retains control and management functions. (However, there is some anecdotal evidence to suggest that banks are making it a condition of consenting to the administration, that they can continue to have the right to exercise remedies at any time during the administration.)

Once administration commences, there is a 28 -day moratorium, extendable on application to the court.

There is also some suggestion that voluntary administration is open to abuse and has been abused. While abuse involving administrators seems unlikely to go undetected or unremedied, two criticisms are made of the procedure . First, directors favour voluntary administration since once they appoint an administrator, they can escape some scrutiny of their conduct. Indeed, it is a statutory ameliorating factor in reckless trading legislation in Australia that the director filed for administration (see also section 288FGA referred to below). The answer to this criticism might be to ensure that administrators have sufficient powers and duties to investigate and report wrongful conduct- even in Australia where the profession is formally regulated, administrators have been reluctant to 'bite the hand' that appointed them, namely the directors. The Australians are currently in the process of tightening up reporting requirements in voluntary administration and professional bodies have recently issued codes of conduct.

The second criticism is that though directors initiate the procedure, it then allows creditors to decide the fate of the company, usually by a deed of company arrangement. Creditors have no concern with what happens to the company after such an arrangement unless they are to receive further payments, and so creditors can sanction a return of the company to its directors without any assurance that it is now solvent. However, such criticism of creditor control would seem to advocate a wider role for state or practitioner control in the public interest which would have to be justified by statistics as to the level of harm against the cost of more intense regulation, and in any event there can be few cases where there is much left to return to the directors.

Prima facie the suggestions of abuse do not seem borne out by statistical evidence and when seen in light of the wide use of voluntary administration, and the fact that it is in the hands of professional administrators regulated by their professional bodies and licensed by the State, there seems little cause for concern about the Australian procedure. However, the role of secured creditors, both at the time of and after initiation, needs to be addressed in establishing such a procedure (as also does the width of definition of secured creditors).

United Kingdom

In 1985 the UK made provision for two forms of rescue procedure, which are interrelated. Following the Cork Report in 1982, an administration order was conceived as filling the gap where there was no secured creditor with power to appoint a receiver over all or most of the company's undertaking. As stated above, receivers were seen to be doing a good job in ensuring survival or sale of viable businesses as going concerns, though the duties of such receivers were slightly increased in 1985 to make them appear more accountable to general creditors. The administration order is a court order which can be made on various grounds, by petition of the directors, the company or creditors (in most cases). In addition to satisfying the court that the company is, or is nearly, insolvent, it has to be shown that one or more of four purposes would be served by the order. One purpose relates to the other new procedure introduced in 1985, the Company Voluntary Arrangement. This was conceived as a simple form of compromise procedure whereby a debtor company could put a proposal to creditors, supervised by an independent practitioner who would report to court on the viability of the proposal. It is very similar to Part XIV Companies Act 1993 (NZ) though without the need for class meetings. However, unlike the procedure introduced at the same time for individuals in the UK, the CVA did not have a moratorium against creditor action attached to it. The administration order does effect a moratorium of a wide-ranging nature, and for that reason, CVAs have largely only been used under the umbrella of an administration order. The other purposes of an administration order are the survival of the company as a going concern, an 'old-style' court sanctioned composition or arrangement, and lastly if it can be shown that there is likely to be a better realisation of assets than if a liquidation occurred.

The court has a discretion whether or not to make an administration order, and will expect a report by an independent insolvency practitioner (usually the proposed administrator) to be filed.

A person entitled to appoint a receiver who would have control over all or most of the company' s assets can effectively 'veto' the administrator's appointment by appointing a receiver in a five-day decision period, similar to the ten day period in Australia. This reflects the Cork Committee's view that as long as someone independent from the company was in control and management, it did not matter whether it was an administrator (acting on behalf of all creditors) or a receiver (acting primarily for one creditor). However, if a receiver is not appointed in that period, a secured creditor would have to seek leave in order to enforce security.

The moratorium imposed from the time of an administration petition is quite wide compared to that on liquidation, extending to all proceedings, enforcement of security and other legal process. It is not as wide as the moratorium in the United States, or under statutory management in New Zealand.

Despite the reasonably sophisticated system which has been established in the United Kingdom, the procedure has been relatively little used when compared to other jurisdictions. Administration orders have rarely risen annually above 250. It has been used in some high-profile cases, such as Maxwell and Polly Peck, and has been successful in these cases. The UK Government has bowed to pressure over the last five years to introduce a simpler, cheaper system alongside administration orders. The disadvantages of administration orders are that there is a relatively high level of court involvement, as well as professional involvement in preparing reports for the court. There may be further court applications during the administration. In order to effect a Company Voluntary Arrangement with the protection of a moratorium from creditor action, directors need to petition for administration, unlike the position in the US, Canada and Australia.

As a consequence, the government, after two consultation papers from the Department of Trade and Industry in 1993 and 1995, has introduced into Parliament a Bill for a simpler, cheaper company voluntary arrangement whereby directors may file for a 28-day moratorium during which they can put together a proposal, with the assistance of an independent professional. However, this is only applicable to small to medium sized enterprises,[28] on the basis that it is smaller companies who can ill afford the court-driven administration procedure.

One aspect of the UK procedure which has proved beneficial is the body of judicial precedent that has built up, with court understanding of the 'spirit' of the legislation. Indeed, in the area of protection of secured creditors as against protection of the debtor company, English Court of Appeal cases have been referred to in Australia where there was little statutory or judicial guidance prior to 1996.

In conclusion, despite the enthusiasm of the English courts to support the so-called 'rescue culture' heralded by the 1986 reforms, the actual usage of these procedures has been generally restricted to larger companies and groups, or more unusual types of business such as football clubs and media companies.
The main reason for lack of usage is the cost of court and professional involvement. The Government has itself acknowledged this, and is introducing a parallel procedure which will reduce costs and be more attractive for small and medium sized companies. This reflects the procedures in Australia and Canada which were introduced after the UK procedure. Meanwhile, the recent report of the DTI on Business Rescue contains some important suggestions as to how the administration order and CVA procedures can be made more attractive, and how practitioners and government agencies can do more to improve the rescue culture.

(It should be noted that Singapore has a replica of the UK administration procedure in its judicial management procedure, which was used in the Barings case. Ireland has a similar procedure, introduced hurriedly in 1990, but the threshold for application to court is higher than in the UK, it being necessary to show a real prospect of business survival, rather than the alternative of better result than on liquidation.)

United States

The United States formal rescue procedure contained in Chapter 11 of the Federal US Bankruptcy Code is now notorious. It is the oldest of the formal rescue regimes mentioned in this document, being enacted in 1978. It has now become the major formal insolvency procedure in preference to Chapter 7 liquidation (there are various specific procedures under other Chapters for agricultural industry and municipalities for example. In addition, the mainstream Chapters do not cover banks and insurance companies). It should be noted that much of US Bankruptcy legislation is harmonised as between procedures for companies and individuals. Thus, the word 'bankruptcy' and Chapters 7 and 11 themselves, apply to both (with necessary modifications). In addition, it should also be noted that Chapter 11 filings at court, to trigger an extremely wide automatic stay under section 362 of the Code may be voluntary debtor's petitions or involuntary, i.e. filings by creditors. In addition, the conversion process between reorganisation and liquidation proceedings is relatively straightforward, unlike in jurisdictions such as the United Kingdom. In practice, most Chapter 11 filings are voluntary.

As is notorious, the distinguishing feature of Chapter 11 over many English-speaking jurisdictions' procedures other than Canada is that there is no automatic appointment of a professional 'outsider' to any management role. The concept of the 'debtor in possession' has become a technical one but broadly means that the company retains control and management functions, subject to a raft of duties and powers which distinguish it from the corporate entity pre-filing, and to the roles of creditor and the court. The powers include the ability to challenge preferences and unperfected security interests. The duties are fiduciary in nature. The court must sanction any disposals outside the ordinary course of business. In addition, there is provision for the appointment of a trustee and/or an Examiner by the court, but this is rare, such as in cases of fraud. The Examiner would usually be appointed at the request of creditor to conduct an investigation as to the viability of reorganisation, or where the assets are over $5 million, but the functions of the Examiner are largely at the discretion of the court.

There is no requirement that an entity be insolvent for Chapter 11 to be initiated, so that the automatic moratorium triggered purely by filing can be used tactically, as witnessed in litigation concerning Texaco and Dow Corning (silicone breast implants). (This has been criticised as an 'abuse' of Chapter 11, which it may be. However, it has to be borne in mind that in some cases filing for reorganisation may be a genuine attempt to deal with anticipated insolvency that might follow from a major class action going against a debtor.) In addition, the cultural and philosophical commitment to the concept of 'fresh start' which seems to extend to corporate as well as individual debtors, and to pre-date the 1978 reforms, means that once a debtor files, the wide moratorium protects the debtor from almost any creditor action for a relatively lengthy 'exclusivity period' of 120 days during which the debtor is supposed to put together a reorganisation plan. It is this combination of the moratorium, the exclusivity period and the debtor in possession that has led to notorious charges of abuse. In addition, the court often extends the exclusivity period.

The debtor must put any reorganisation proposal to class meetings of creditors, so that all classes of creditors whose rights have been impaired by the proposal get a chance to vote. The debtor generally has at least 60 days after the 120 day period in which to negotiate. Dissenting classes can be 'crammed down', in other words bound by the scheme despite voting against it. This happens rarely in practice. The circumstances in which that may happen are complex, as are the voting rules generally, but broadly the legislation envisages a scheme whereby the hierarchy of pre-filing security and other priority interests will be reflected in the proposal. In addition, the plan has to be confirmed by the court, which applies a number of fairness criteria and has to be satisfied that the scheme is 'feasible', and that individuals who dissent will receive at least as much as they would on a liquidation.

Useful provisions assisting in formulation of a plan are that post-petition funding will attach super-priority, sometimes over secured creditors if necessary to the success of the scheme; in addition the debtor in possession has the ability to reject or confirm contracts and thus either leave a counterparty to an unsecured claim, or bind in a party or assign a contract against the counterparty's wishes.

The allegations that Chapter 11 is open to abuse need to be seen in the light of the checks and balances in the Code. First, filings should be made in good faith and for the purposes of reorganisation, and creditors may apply to court to challenge filings on this basis. This presents an opportunity for creditors and the court to filter out bad faith filings. In addition, there are various fee penalties at the discretion of the court to prevent attorneys from filing unviable or bad faith plans on behalf of debtors. Secondly, although a wide moratorium is in place, creditors can apply for the stay to be lifted. The court has developed a considerable body of jurisprudence as to the circumstances when this can happen, but two points can be made here. First, there is a test of 'adequate protection' which is similar to principles developed in UK and referred to in the Australian regime. Secured creditors cannot usually have the stay lifted in order that they can enforce remedies if the debtor has ensured that their security or some substitute equivalent is protected. Secondly, since applications to lift the stay often present as the first opportunity to litigate on the merits of the filing, such applications have become a crucial forum for attacking the viability of any reorganisation prospect. A frequent outcome of such applications is therefore dismissal of the Chapter 11 procedure or its conversion to liquidation.

A frequent criticism of Chapter 11 is that it allows existing management, who may have been responsible for the company's parlous state, to stay in office. This is a misunderstanding of the concept of 'debtor in possession', which refers to the corporate entity, not the individual directors or managers. Research shows that in fact old management is usually replaced early in the proceedings, as a condition of creditor approval for most plans.[29]

Another different feature of Chapter 11 compared with other rescue procedures is the role of the creditors, and in particular the creditors' committee. Such a committee is invariably appointed in Chapter 11, and has wider powers than in other jurisdictions where the role is largely consultative. In larger cases, however, the cost of the committee and its advisers may be paid out of the estate and thus add to the costs of rescue. There may be more than one creditors' committee in some cases.

Secondly, despite the absence of an initial court hearing to trigger the start of the moratorium, the degree of court involvement, and accompanying court discretion, is much more marked in the US than elsewhere. Most importantly, any plan is subject to court confirmation. The existence of a dedicated body of Bankruptcy Judges in the District and Circuit courts no doubt streamlines judicial involvement, but the cost of court and creditor committee involvement, even in cases where no examiner or trustee is involved, often reduce returns to creditors. In addition there is an office called the US Trustee which is a relatively new post in each State, and is involved in the appointment of trustees, examiners and the creditors committee.

Additional checks on the debtor in possession are that the court must approve payment out of any pre-petition unsecured creditors, there are restrictions on the use of secured book debts without court approval, and regular reporting requirements both to the court and creditors committee. There is a timetable of filing financial statements from soon after initial filing of the petition, and then court approval is required for remuneration of advisers and any compromises of existing litigation.

As stated above, at the termination of Chapter 11 there can be a relatively easy conversion to liquidation. Alternatively, if the plan is confirmed, the remaining assets re-vest in the pre-filing debtor once the plan is effected. However, it is important to point out two characteristics of Chapter 11 as a rescue procedure. Many plans contemplate liquidation, and indeed 90% of confirmed plans result in liquidation rather than reorganisation. Even in those cases where a plan is dismissed by the court or rejected by impaired creditors, there is nothing to stop the debtor filing for Chapter 11 again, or amending their existing proposal. This contrasts starkly with the Canadian procedure and that currently under discussion in the UK. There is also some evidence that there is a higher correlation between smaller or medium sized firms liquidating after or within Chapter 11 than is the case with larger firms. Indeed there have been legislative proposals for a separate, more streamlined procedure for such firms (a separate Chapter 13 exists for smaller estates of individual bankrupts) but to date nothing has been enacted.

In conclusion, Chapter 11 is a well-established procedure which is undoubtedly pro-debtor. It has received criticism has open to abuse by retention of existing management in control in most cases. While that is true, and while the checks and balances mentioned above cannot be seen to counter that criticism in their entirety, it is also true that the power of creditors means that often, existing management are dismissed as a condition of a successful plan. The delay involved in Chapter 11 proceedings is both inherent in the timetable (the 120 day exclusivity period followed by a period of negotiation) and in judicial extensions beyond that, and the delay causes real prejudice to undersecured creditors who do not receive interest on their claims from date of filing. Certainly the evidence suggests that Chapter 11 is an effective rescue procedure in larger cases, and that it is an effective formal procedure which facilitates bargaining among creditors. Secured creditors are adequately protected by several safeguards built into the law.

The Canadian BIA procedure can be seen as an improvement on its North American neighbour since there is a more rigid timetable, and reduced court involvement and discretion. Even with time limits in Chapter 11 legislation, the court clearly extends them in many cases, and the degree of discretion given to the court is probably unacceptable in terms of cost and predictability.

The ease of conversion to liquidation can be seen as an advantage, since it accords with reality, but the fact that there is no check on the number of refilings for Chapter 11 is open to abuse.

Canada

Along with Australia, Canada has passed the most sophisticated, balanced and potentially effective reorganisation legislation, avoiding most of the problems of delay and abuse possible under Chapter XI in the United States, yet avoiding the costs involved in the United Kingdom and to a lesser extent, Australia.

The main features of the Bankruptcy and Insolvency Act procedure are that a debtor may file either a proposal for a reorganisation (for example if the company is already in receivership), or a notice of mere intention to file one. (Creditors cannot file for a debtor's reorganisation, unlike in United Kingdom and Australia) . A wide moratorium against creditor action is triggered for an initial 30-day period. However, a trustee has to attest to creditors the accuracy of the debtor's cash flow projections. The trustee's role is deliberately 'light-handed', though he must report to the Official Receiver any 'material adverse change' since the original filing. The court is not involved in initiation of the procedure, but where more than light monitoring is required, may be involved in defining the trustee's powers which could be quite wide. There is a very strict timetable during which the debtor must effect a proposal and, if it is not approved by creditors, automatic liquidation follows. While there is some judicial flexibility for extensions of the moratorium period, there is a maximum cumulative period beyond which the court cannot go under any circumstances.

Unlike the situation in Hong Kong, United Kingdom and Australia, in Canada a secured creditor who wishes to appoint a receiver over all or most of the company's business and assets, must give the debtor company ten days notice, during which time the company can file for protection. If the chargeholder is genuinely worried that assets may disappear in this time, it can apply to court for appointment of an interim receiver to safeguard the assets.

In addition to this reorganisation procedure in the Bankruptcy and Insolvency Act, as amended in 1992, there is an older rescue procedure available in the Creditors Companies and Arrangements Act, dating from the 1930s but revived by practitioners and the courts in the 1980s recession. This Act, which in 1997 was amended and doubled in length, has become the preferred vehicle for rescuing larger corporations, even thought it leaves considerable discretion to the courts. A classic example is the Olympia & York group, whose UK subsidiary went into simulataneous administration. The CCAA flexibility is preferred by stakeholders concerned with larger corporations, so that in reviewing the progress of the new insolvency legislation, the Federal government decided to retain the CCAA provisions, but to amend them, in particular by limiting them to companies or groups with minimum of $5 million outstanding liabilities.

While the BIA reorganisation procedure is relatively new, there is some empirical evidence now available as to its success. Emeritus Professor Jacob Ziegel, a recent visitor to the New Zealand Law Commission, and a colleague, undertook a study of all reorganisation filings (148) in the Toronto bankruptcy office between November `992 and December 31 1996, as well as interviewing stakeholders about the results of that study. While this is a limited local study, Toronto is of course the principal commercial centre of Canada. The new procedure certainly seems to have been popular. Since 1993 when it was introduced, there has been a 49% increase in corporate debtors filing for insolvency. Even if this cannot be entirely attributed to the new procedure, it certainly suggests that the more rescue-orientated regime has encouraged corporate debtors to initiate reorganisation proceedings. As one would expect, the majority (84%) of debtor filings are through the notice of intention to file route, since this is the simplest and buys the company time to formulate a proposal. As Ziegel and Sahni conclude, this explains the increase in filings since debtors have 'little to lose'[30] Of the 148 debtors who initiated reorganisation, only 78% proceeded to proposal stage. 33% of the 148 resulted in a proposal which was accepted by creditors and the court, and was fully implemented, and a further 6% were being implemented at the time of publication.

Thus, if one was looking for a 'success rate' for the BIA procedure, this limited survey would put it at 39%. However, the other aspect of 'success' is whether or not creditors were better off under the reorganisation than they would have been on liquidation. The survey concludes that the average estimated realisation rate for unsecured creditors under reorganisations studied was 44.65% as against 6.89% in bankruptcy. However, it also stated that the average of unencumbered assets as a percentage of total assets was 8.6% and in most cases, there were no unencumbered assets.

On important aspect of the BIA procedure which is highlighted by this research is that secured creditors do not have to be included within the reorganisation proposal. In only 24% of cases were they included. Given that in most Canadian insolvencies there are on average 4 secured creditors, who have charges over most or all of the debtor's assets, this means that the success of many of these proposals is dependent on the informal agreement of the debtor and key secured creditors, which agreement is no doubt secured at an early stage, so that unsecured creditors may not know the terms of such agreement when they vote on the proposals. 76% of the files indicated such arrangements outside of the terms of the proposal. The authors point out that although the extension of the moratorium to cover secured creditors in 1992 would prima facie seem a likely candidate to explain the increased popularity of the BIA reorganisation procedure between 1993 and 1996, this is countered by the fact that secured creditors have generally acquiesced in reorganisation proceedings and supported them through informal arrangements with debtors. Reasons why this might be so include that they may be well secured, that the general moratorium may improve the debtor's cash flow and thus returns to the secured creditor, and the cost of appointing a receiver as against leaving the debtor in possession under the eye of a trustee.

Ziegel and Sahni, while acknowledging that the increase in filings for reorganisation by debtors is largely attributable to the 'little to lose' explanation, state that trustees and insolvency lawyers whom they interviewed supported the retention of the notice of intention to file procedure. So long as the larger number of reorganisation filings exceeds the higher failure rate induced by the notice of intention facility, unsecured creditors, they conclude, would be better off with this option being available to debtors. There is certainly no evidence that unsecured creditors have widely exercised their rights to initiate a termination of the reorganisation prior to seeing the debtor's proposal.[31]

However, there is no doubt that a regime such as this which allows debtors to initiate a blanket moratorium covering secured and unsecured creditors, will lead to some abuse. Under this system, there is no guarantee, once the moratorium has been triggered, that any proposal will emerge. At present there is an 'erosion' rate of about 22% of cases where no proposal eventuates. This is the 'downside' risk of such a regime, but as stated above, the question would be (a) whether anything can be done to reduce that erosion rate by way of monitoring by the trustee and (b) whether this is a fair price to pay if it results in a greater number of business rescues than would exist if the notice of intention procedure was not an option. The Canadian system already includes provision for the trustee to monitor the procedure, as mentioned above. However, Ziegel and Sahni question whether the trustee can currently be an effective gatekeeper, and suggest that there may be a need for a practitioner who is independent of the filing process, to actually certify whether or not the debtor may be able to make a viable proposal. On the other hand, in 74% of cases, debtors proceeded to file proposals with creditors within the initial 30-day period, so creditors got a chance to vote on the viability of the proposal without any outside assistance.

Hong Kong

A proposal for provisional supervision made in a Hong Kong review in 1996 is near to implementation. It is modelled closely on a combination of the Australian and UK position, and in fact is similar to what is being proposed as a new procedure in the UK at present. Thus there would be a 'voluntary' debtor filing for a 28-day moratorium during which time a proposal can be put forward, but there is to be an independent professional, the supervisor who would oversee what is intended to be a short term procedure. One key controversial feature of the Hong Kong proposal is that secured creditors with a charge or charges over all or most of the company's assets and undertaking, can 'opt out' of the supervision regime and continue to enforce their usual security rights. This is not so significant in Hong Kong where the lending pattern is not as traditional as in the UK. Hong Kong has wisely not retained any distinction here between fixed and floating charge, so provides a model of what such a provision might look like in a post - Personal Property Securities Act environment.

South-East Asian nations

The 1998 financial crisis in South-East Asia has, with the insistence or encouragement of organisations such as the World Bank and Asian Development Bank, triggered a review or insolvency laws in many jurisdictions. Almost without exception, the insolvency laws of Asian nations derive from their European colonisers . However, the regimes have not been changed much since their enactment as colonial legislation. As noted above, Singapore already had a formal rescue procedure modelled closely on the UK administration order , and Hong Kong initiated a review in 1995 which will shortly lead to legislation. Japan also has rescue procedures, though they are in the process of reform. Many jurisdictions had provision for a court-ordered composition, with or without some moratorium effect. In the last two years in response to the crisis in the region, countries such as Malaysia, Thailand, Korea, Vietnam and Indonesia have legislated, or are in the process of legislating for, a more formal rescue procedure. Others such as the Phillippines have some way to go in modernising their insolvency regimes.

In ascertaining whether the development of rescue procedures in this region can inform debate in New Zealand, several points can be made.

First, while fundamental issues such as who has control during the rescue process, who can initiate it, how will funding be dealt with and what rights should secured creditors have, arise in these jurisdictions as much as elsewhere, a number of differences can be noted which constrain law reformers there.

Cultural factors affect the use of insolvency regimes that do exist, and may shape reform initiatives. First, the stigma of failure permeates corporate insolvency in the Asian region to a greater extent than it does elsewhere, where family companies play a larger role. For this reason, existence of rescue procedures will only assist if directors can be encouraged to initiate or participate. The stigma factor which may be present in personal insolvency in New Zealand and elsewhere, does not permeate corporate insolvency to the same extent.

Secondly, this stigma and reluctance to use formal insolvency has meant that existing procedures such as liquidation and court composition have been little used, but that there has been a greater willingness in this part of the world to embrace negotiation, arbitration and informal work-outs. The latter has been taken further in the Asian financial crisis by development of Guidelines, usually with the assistance of a country's central bank, and these have been implemented in Hong Kong, Indonesia and Malaysia , Korea and Singapore in the last two years. In some cases, these have been confined to rescues of banks and financial institutions, in others they extend to all corporate debtors. This aspect of the developments in South-East Asia (which had also been seen in the Bank of England's London Rules) seems one that should be investigated.

Thirdly, one of the major obstacles which exist in some jurisdictions such as Indonesia relates to the infrastructure of the legal system and professions. There is not only corruption, but lack of education and training among those administering insolvency regimes in the courts and the private sector.

Lastly, there is a degree of political and executive control over formal rescue procedures in some jurisdictions such as Pakistan and Philippines, which may be evident through quasi-judicial processes or central agencies initiating the process or retaining control.

Some of the jurisdictions have formal rescue procedures reserved for public or other large companies only.

In conclusion, it is unsurprising to find that the insolvency regimes of Singapore and Japan are already well advanced and comparable to major Western nations, and that Hong Kong, Malaysia are in the process of discussing corporate rescue regimes (Thailand enacted a court-ordered rescue procedure along the lines of the UK system for larger companies, in 1998 which has been used in some major insolvencies).

Specific issues for consideration in any new or revised procedure

Cost/entry

In order to make the procedure accessible to directors of small and medium sized companies, it should not involve overly costly reporting requirements or court applications. The need for both a court order and a detailed independent report accompanying the application have proved fatal to its use in the United Kingdom.

If it is deemed necessary to have a professional report on the company's financial state and viability and genuineness of any proposal, it should not be so detailed as to be financially prohibitive for a company or a creditor (with appropriate assistance) to prepare. It is suggested that the Canadian approach under the BIA (see above) provides nearly the right balance between the need for a cheap process which directors will feel comfortable with and the need for a monitoring by a professional.

There are choices to be made as to the balance here. Canada is unique in having a non-court debtor initiated moratorium which is automatic (initially) without having to evidence a viable reorganisation proposal. This clearly solves the problem of making directors feel comfortable with the procedure, but as discussed above, the Canadian procedure may have gone too far, and some independent attestation of the prospect of a viable proposal might be needed at this initial stage, or at least within a very short timeframe of weeks.

Entry into the procedure should not be premised on proof of insolvency. In some jurisdictions an alternative is that the company is likely to be unable to pay its debts in future. Where there is a procedure with no court hearing, the matter is left to the veracity of directors and the professionalism of advisers or trustees appointed to supervise or monitor the debtor, as in Canada. However, the important point is that there is a need to encourage debtors to address financial difficulties as early as possible, and if an insolvency precondition is insisted upon, there is a danger that any new procedure becomes stigmatised as an insolvency procedure and thus avoided by directors. Therefore the choice for debtor initiation is between an open-ended entry, or a condition that the debtor believes it is insolvent or likely to become so in future.

In the case of creditor initiation, the same test should not be applied. Clearly it would be unfair (and impractical, given informational disadvantages for most creditors) if a company was involuntarily placed into any sort of formal procedure unless creditors could show that their rights were at risk due to insolvency or imminent insolvency. The same test should apply as on liquidation, if it is decided that creditors should be able to initiate a rescue procedure.

Who can initiate the process?

Should creditors, as well as directors/the company, be able to apply/file? In some jurisdictions, creditors can only apply by court order. If court proceedings and independent reports are involved, some creditors may not have access to sufficient financial information for any application to be successful. If no court proceedings are involved, should only major secured creditors be able to apply, as in Australia? (It is not known at this stage if many do so there – it was intended to encourage them to embrace the concept of administration and feel in control of its initiation, but there are other incentives that could be given to secured creditors, such as superpriority for post –initiation lending, or a generous discretion in ensuring adequate protection of their interests.). In principle, subject to the point in the previous paragraph about the insolvency threshold, there is no reason why creditors should not be able to initiate a rescue procedure. Indeed, they should be encouraged to view such procedure as an opportunity to enhance their returns. In the UK, creditors can petition for administration orders, but there has been only one or two cases, usually secured creditors, where this has actually happened. Therefore, the problem may be more theoretical than real.

Court involvement (related to cost)

Court control over initiation, as in the United Kingdom or Ireland, does provide a check against hopeless proposals, and enables creditors' views as to alternatives such as liquidation to be weighed at the initial stage. However, creditors can be placed in control of the proposal from an early stage after initiation so that check could be provided other than through routine court involvement.

Aside from the time of initiation of proceedings, court involvement during an administration can vary. Interested stakeholders should be able to come to court for rulings and to apply for leave to enforce their usual creditors' rights. However, in establishing such a system, experience in Australia and the United Kingdom, and especially in United States, has shown that insufficiently delineated powers and duties in legislation means that courts have more discretion, thus encouraging more applications to court during proceedings.

Who is in control?

The two traditional choices are the appointment of an outside professional 'administrator' who replaces the management functions of directors (possibly leaving their residual duties) and replaces any receiver over any company assets, or leaving control in the hands of the directors, as in Chapter 11 in the United States. (A third possibility is a high degree of creditor control through a committee of creditors representing the majority of creditors' interests, or at least a committee which has an important role in directing the other controllers). This polarised debate is one of the most controversial in the field of corporate rescue. In caricature, the existing management are portrayed as responsible for the company's existing dire straits, so that they must be removed immediately from control and an objective third party professional installed. On the other hand, the view in the United States is that the existing directors may have invested skills, time and money in the enterprise over many years, and there should be no presumption that their removal is essential to any rescue- that decision can be left to the creditors when voting on reorganisation proposals. As pointed out above, this is a misconceived debate since it is the abstract concept of the 'debtor in possession' which is created under US Chapter 11, and this means the corporate entity, not necessarily the management.

However, there is a spectrum of possibility. For example, while under Chapter 11 the 'debtor in possession' is the company during the procedure, so that directors may retain control, two further possibilities are that the court could appoint an Examiner to oversee the debtor in possession, with such functions as the court orders; secondly, more frequently the management that was responsible for the company's parlous state is quickly superseded as part of reorganisation proposals or creditor pressure, so that it would be rare for Chapter 11 to actually result in old management retaining control.

At the other end of the spectrum, though an administrator in Australia or the United Kingdom may replace management, it is not envisaged in either procedure that the administrator would be in that position for long, and the administrator can employ existing management to assist if necessary. The United Kingdom Insolvency Bill provides for a procedure whereby management does stay in control for a short stay during which a proposal can be put to creditors.

One approach to this issue is to recognise that unless there is any suggestion of malpractice, incompetence or other default, it is more efficient and cost-effective for existing management to continue in control of a company, with or without outside assistance or monitoring. Clearly the professional costs of a team of qualified managers and the cost of their time on the learning curve should only be incurred if necessary to protect further loss to creditors. It should not be assumed that there will be widespread abuse simply because no outside professional takes control. While that may be one outcome, the other checks and balances within a system would have to be taken into account, such as the role played by creditors (and the court) in the particular process.

Powers and duties of administrator

Where any independent administrator is given powers of management (rather than an independent professional with powers of monitoring and reporting but with the debtor remaining in control) those powers should be at least as wide as a combination of a receiver and liquidators' current contractual and statutory powers. This would enable the administrator or practitioner to maximise objectives of survival or sale as a going concern, compromise or at least a better result than on a liquidation. (It is recognised that corporate rescue procedures should not, where possible, be protracted, and are designed to be short-term procedures. However, whether or not some of these 'liquidation' powers would be frequently used, their inclusion would be prudent). In order to counter any possible self-interested choices by directors, administrators should be given the same investigative and reporting powers as liquidators, and equal ability to challenge voidable transactions or directors' reckless or wrongful trading conduct. While it may be possible to give directors incentives, through statutory defences and possibly costs priority mentioned below, to seek help at an appropriate early stage, the ability of an administrator to report, investigate and challenge unlawful conduct or suspect transactions would act as a deterrent to directors and their associates against viewing administration as a 'soft option'. This suggestion is an improvement upon the current Australian and Canadian systems, though it is understood that there have been calls to tighten up reporting of directors' default in both Canada and the UK.

The powers of an administrator should be at least as wide, but also wider, given that they should have the benefit of a moratorium as well as powers in some circumstances to dispose of secured property without consent. Under such a scheme, directors will still need incentives to prefer administration rather than liquidation, and these will be a combination of defences to wrongful trading and other liability, as well as the prospect of survival of their business.

Duration of moratorium

There is little point in having an initial moratorium from creditor action for so short a period that it does not enable genuine negotiations to take place with a view to a viable reorganisation proposal. The minimum automatic period, on notice of intention to file as in Canada, should be around 21 days, 28 days being more usual.

It is then necessary to have ability to extend this, usually on application to court. The onus of proof should then be on the debtor, with independent corroboration through a professional report on viability, to convince the court that a viable proposal is likely within any extended moratorium period.

The remaining question would be whether there should be a maximum period of six months or a year after which no further extension should be granted.

A related question would then be what would happen at the end of that period. Would it be possible, as in the United States, to file for further protection and submit a new plan, and if so, how many times? Or should liquidation automatically ensue as in Canada? In the UK it has been proposed that no filing will be allowed if there has been a previous one by that debtor within 12 months.

Width of moratorium and court power to modify

Section 42 Companies (Investigation and Management) Act 1989 contains a good example of a relatively wide moratorium. The narrowest form would prohibit winding up resolutions and all other proceedings against a company. A wider form would include other forms of legal process, execution and attachment, forfeiture and distress. Wider still would include contractual termination notices, and all forms of set-off. Lastly, of course, it is necessary to have a moratorium which prevents secured creditors from enforcing security (and the definition of secured creditors is important here- recent problems have been caused in the UK when forfeiture by peaceable re-entry was held to be outside of the moratorium, and this is now being altered by Parliament).

It should be a fundamental principle with all such moratoria (including Part XIV Companies Act 1993 and statutory management) that they do not remove rights and remedies, but merely prohibit them for the duration of the moratorium (though in practice, depreciation of value of enforcement rights is inevitable in some cases.

It is necessary to give discretion to an administrator and the court, preferably with some statutory guidelines (these have been lacking in Australia) to allow the moratorium to be lifted in favour of some creditors, particular secured creditors. This involves balancing the interests of all creditors that the rescue attempt or compromise proposal continue, for which purpose it may be necessary to prevent a creditor exercising rights or remedies in relation to a particular asset or bundle of assets, against the individual creditor's pre-insolvency contractual rights, particularly secured creditors where the argument is that they have bargained on the strength of security rights and remedies.

It is axiomatic that any moratorium in a rescue procedure extends to secured creditors. To leave secured creditors outside of the procedure and able to continue to exercise contractual remedies is to fail to recognise that the collective insolvency procedure is wealth-maximising for all creditors including secured creditors. It is equally important that secured creditors receive 'adequate protection' for their security during an administration or reorganisation proposal process.

Where property owned or hired out by a creditor is vital to the continuation of the rescue attempt, principles can be developed to ensure that the value to the owner /lessor is preserved, for example by agreeing that rental payments during the insolvency will be a priority expense.

In cases not involving owners or secured creditors, a more finer balancing exercise has to take place, for example whether a personal grievance litigation can be continued during the administration. This is more likely to turn on the inconvenience and cost to the administrator and company in having to deal with the claim, balanced against the individual's loss and hardship if the claim cannot be continued (for example, if a limitation period may expire if the claim cannot be continued).

<u>Rights of secured creditors (and meaning of secured creditor)</u>

Should certain secured creditors (those who could normally appoint a receiver to control the business on debtor default) be able to 'veto' the insolvency rescue from continuation? It has been seen that in some jurisdictions chargeholders are given a period during which to decide whether or not to appoint a receiver, after which in theory they are bound by the moratorium, (though they may or may not be able to vote at creditors' meetings). In other jurisdictions such as Canada (and proposed in the UK) the opposite is true, the chargeholders must give notice to the company, during which time the company can file for protection. This latter is far more controversial and is seen as a dilution of secured creditor's bargained-for pre-insolvency rights.

In those jurisdictions where certain secured creditors can 'veto' the continuation of a rescue attempt, only those creditors who can control all or substantially all of the business and undertaking of the company can 'veto' the procedure, since the argument is that (a) rescue procedures are sometimes used because no receiver is in control (or none can be appointed and (b) secured creditors' contractual rights should be treated as paramount.

The first of these is arguable and subject to statistical verification; the second is cultural and political, and finds favour in systems where secured creditors' rights have always been given precedence (as they have in New Zealand to date). In New Zealand the terminology would have to be considered in the light of the Personal Property Securities legislation. The Law Commission in its recent advisory report to you on Priority Debts has recommended that there be harmonisation of the definition of 'secured creditor', especially in the light of the Personal Property Securities Act definition.

Those that support the view that secured creditors should be able to continue to enforce their security and have a veto on the successful continuation of any rescue procedure, would argue that the idea has emerged from the function of receivers appointed under all-embracing fixed and floating charges. It is fundamentally an issue of control. From a 'rights' point of view, the secured creditor might argue that the right to take control of the business through a receiver is a bargained-for part of its security. From an outcomes point of view, they might argue that administrators or other rescue procedures are not necessary where there is such a chargeholder, since the receiver can effectively rescue any business worth rescuing. The answer in both these cases is to refer back to the section on Receivership in this paper, where it is pointed out that receivers do not owe real duties to anyone except their appointor, and do not concern themselves with the maximisation of returns to other creditors; secondly, the view that receivers will rescue all businesses which are worth rescuing is challenged on the empirical evidence available. In any event, the evidence in countries such as the UK and Australia shows that secured creditors are often quite content to allow a trusted professional to act as administrator, even if not appointed by them.

Secondly, what rights should secured creditors have during the moratorium, particularly with regard to exercising their remedies with leave of court or consent of debtor or administrator, and how should 'secured creditors' be defined for this purpose and for voting purposes. For example, should it include lessors forfeiting a lease? Personal Property Securities legislation will avoid many of the definitional problems that have arisen elsewhere (such as having to extend the definition to cover retention of title claims or finance leases). Which type of secured creditors should have the value of their security safeguarded if the debtor/administrator is given power to dispose of property as if it was not subject to the security (this is a usual and valuable power enabling extraction of optimum going concern or break-up value from a business or bundle of assets).

Just as it is crucial that secured creditors be included within the scope of a moratorium against creditor action, it is equally important that secured creditors rights are not diluted, but merely postponed. While this can be achieved by provisions that enable secured creditors to come to court at any stage when they feel their interests are being prejudiced, it can also be built into reorganisation plan rules, so that secured creditors will receive 'adequate protection' in the form of e valuation of their collateral so that its priority (for capital and interest) is preserved in any plan, or for example, that they will be compensated for any depreciation in the cash value of their collateral during the reorganisation. The courts in the UK and Australia have managed to devise discretionary guidelines along these lines, in the absence of compliance with which the stay will be lifted against secured creditors, whereas the US has strict rules built into the Code. It should be stressed that the postponement of secured creditors rights through a moratorium needs to be balanced by this protection, the ability to apply to court for relief from the moratorium, and preferably by strict time limits for the continuation of the moratorium. With these safeguards in place, it should counter any suggestion that a reorganisation is being continued 'at the expense' of secured creditors or that their security is slipping away in the meantime.

Voting procedures

A variety of combinations of voting procedures exist, for example whether proposals should pass by a clear majority in number, a three-quarters or two-thirds majority in value, or combinations of value and number voting. An important factor is how far votes of connected persons should be discounted, if at all. In addition, consideration should be given to whether secured creditors should be able to vote, or whether they should only be able to vote to the extent of any unsecured portion of their claim. If secured creditors (and priority creditors) are able to enforce their claims or are given priority notwithstanding the compromise of unsecured claims, then there is no need for them to vote. On the other hand, in jurisdictions such as the UK where this is the case, debate has revolved around whether in fact it is better to allow secured and priority creditors to vote and thereby be bound by a proposal, either because it is necessary to use secured property or because some compromise of their absolute claims is desirable.

Adequate precedents already exist in Part XIV and the Seventh Schedule to the Companies Act 1993, though it should be pointed out that one of the major impediments to the use of compromise schemes is the need for separate class voting, which is often seen as unnecessarily complex. It may be that this is one reason for the lack of use of Part XIV (if indeed it is been infrequently used, as one suspects).

Unnecessarily complex class voting procedures may be counterproductive in terms of attracting debtors to use the procedure. It is suggested that for most small to medium sized companies, class-voting procedures (especially for unsecured creditors) are unnecessary, potentially litigious, and may be detrimental to the success of some rescues.

Procedure on failure and relationship to other procedures

As stated above, the question may need to be addressed what should happen if a rescue procedure fails. Should automatic liquidation ensue, and should future rescue attempts in relation to that company (perhaps if by directors only) be banned for a certain time; if so, how long?

Secondly, the relationship between current procedures such as liquidation, Part XIV and/or any new procedure which may be recommended, must be addressed. At present the relationship between liquidation and Parts XIV and XV are unclear, and leave something to court discretion.

Thirdly, if a relatively accessible procedure is recommended without undue court involvement, as in Australia, should it be equally without court involvement at the termination point. It does not necessarily follow that it should. In Australia, creditors determine the outcome of an administration and any deed of company arrangement within it. In the UK, no administration order can terminate without a court order discharging or varying the original court order. Some thought will need to be given to whether ease of termination as well as ease of initiation might encourage bad faith filings. In the United States it is certainly arguable that there are insufficient checks on access and continuation of Chapter 11 filings, and no penalties for repeat filings. However, there is no independent administrator in that jurisdiction. Where there is an independent administrator, particularly with a licensed insolvency profession, as in the UK, much emphasis can be placed on the view of that professional as to the stage that the company has reached. In Canada, the strict statutory timetable under the BIA Division 1 procedure seems to mitigate against abuse of reorganisation procedure, since there will be an automatic conversion to liquidation if no proposal has been filed within a certain timescale, or if creditors reject it. Presumably it would be necessary to allow for modifications of the original proposal, within a strict timescale. This could be combined with a rule prohibiting new reorganisation filings within, say, 12 months. Any longer may inhibit genuine repeat filings.

It is important to have a flexible 'menu' of procedures available, with relatively quick and easy conversion from administration to liquidation, but also the reverse. While in some jurisdictions there has been discussion of one 'gateway' procedure, so that it is left to a court to decide whether liquidation or rescue should be attempted, in most jurisdictions where there is the more attractive twin track or multi track approach, it should be possible for stakeholders to apply to terminate the existing direction of the procedure and substitute another. If, for example, a liquidator formed the view that the company could be rescued or was susceptible to a compromise scheme if there was an adequate moratorium protecting it, she should be able to apply to convert the proceeding into a rescue procedure.

Encouragement of informal workouts

Informal workouts will always happen. Given that they promote the objective of early 'treatment' of financial problems, the issue is whether steps should be taken to investigate whether New Zealand could benefit from following the route taken in other jurisdictions, usually through their central bank, to promote and encourage informal workouts by issuing guidelines on protocol covering such matters as an informal moratorium, appointment of a lead bank and provision of ongoing finance. Clearly these informal rules are playing an important role in Asia, largely due to cultural factors. However, the UK has successfully developed the London Rules and INSOL, the international insolvency body, is investigating a more global accord. Clearly such protocols are more suitable to large or significant restructuring attempts and may not necessarily be adopted for all jurisdictions. There is some evidence that the London Rules are founded on traditional London clearing bank practice and will be less adaptable to a changing lending culture, or other jurisdictions (Other than through existing legislation, I am not aware of what informal procedures exist for identifying or limiting New Zealand financial sector's exposure to corporate financial failure in this and other ways.).

However, it should be stressed that informal arrangements are not inconsistent with formal rescue procedures. Indeed, it is well recognised that informal workouts take place 'in the shadow of the law', and therefore the parties' minds will be focused by the alternative formal structures that await them if the informal rescue fails. Providing for a formal rescue procedure will not necessarily lead to a large fall in informal workouts, since whatever the rules for formal rescue procedures, there will always be cost and secrecy attractions of the informal route. To the extent that there is a fall in informal rescues, this might not necessarily be detrimental, given that some of these workouts will not necessarily be maximising the returns to all creditors (in addition, they may have the effect of concealing director delinquency).

Funding for reorganisations

As with informal workouts or statutory compromises, funding for ongoing trading, either in the immediate moratorium period or the medium term, can be left to consensual arrangements. Usually, it is provided by existing lenders to the company. Alternatively, provision can be made for a market, as exists in some jurisdictions, for insolvent debt, and secondly a market for special provision of finance to distressed companies. [32]If there is not such a market it may evolve naturally, but it could also be created by intervention in the market, as an objective of insolvency and finance law. Thus, in Thailand and Malaysia, State organisations have been created to deal in non-performing loans and return proceeds to creditors, reportedly with limited success.

However, the more usual method of legislative encouragement is (a) to ensure that funding arrangements are part of any proposal and attested by a professional or the court to be viable (as in Canada or the US) and (b) to give superpriority to 'post-petition lending', i.e. to give secured or other creditors priority over existing preferential creditors, and even over pre-insolvency secured creditors. (I note that the Law Commission did not raise this issue in its paper on preferential debts, since there is no such superpriority at present and it only arises in relation to a rescue procedure). In the United States Chapter 11 procedure there is also provision for compulsion in use of book debts and other collateral by the debtor without the permission of the secured creditor, with appropriate safeguards. The UK DTI report on Business Rescue also raises this issue of ability to use book debts while trading.

Lastly, tax incentives could be provided to financiers of companies trading during rescue.

Could Part XIV be modified sufficiently?

Without pre-empting any final report on whether a new or revised procedure should be adopted, and if so with what features, the issue of whether Part XIV Companies Act could be modified sufficiently to achieve the objectives of a simple, cheap and accessible rescue procedure which would obviate the need for a major procedure such as voluntary administration is one that has been canvassed amongst commentators.

In order to modify Part XIV , an automatic wide moratorium against creditor action would be needed. Arguably, the need for separate classes of creditors to be identified should also be removed.

This would be an improvement on the current situation, but even with a wide judicial interpretation of 'compromise', it would not provide a mechanism such as exists in Australia or the United Kingdom whereby an independent person can replace management and can continue trading the company as a going concern for a period of time. Of course, it might be possible for the company to continue trading within the terms of the Part XIV arrangement, but the company directors would not be protected from potential liability for insolvent trading. Although the United Kingdom government is reforming the law because of the lack of a moratorium of a relatively short time while the existing or new management is in control, they are not proposing to abolish administration orders, so it is acknowledged that at least for larger companies, the advantages of an independent professional representing all creditors, with full management powers and the protection of a moratorium, is valuable.

Two aspects of modification of Part XIV which were addressed by the Joint Insolvency Committee in 1994 and which are still relevant are:

(a) the need for an independent report,
(b the need for an independent supervisor or monitor of the arrangement.

In the United Kingdom the government has recommended the second of these in order to counter allegations that it is proposing a Chapter 11 style charter for bad management to stay in control. Only in the United States can a Chapter 11 procedure be commenced without any professional report testifying as to its viability (there are other checks in that system, but most involve court applications). Two points should be made at this stage. The higher the level of professional reporting and monitoring, the higher the cost, thus making it proportionately less attractive to companies. Secondly, there is at present no regulated insolvency profession in New Zealand, whereas that is not the case in Australia, Canada and the United Kingdom. Higher levels of professional endorsement or certification of the viability and genuineness of rescue proposals puts higher emphasis on integrity, judgment and qualifications of those professionals.

Related areas for review and impact

A review of corporate rescue impacts on other areas of insolvency law or related law, most of which have been proposed for review by the Ministry.

<u>Cross-Border Insolvency</u>

The UNCITRAL Model Law examined by the Law Commission gives scope for signatory jurisdictions to select all or part of the Model Law, and to recognise compatible aspects of another jurisdiction's legislative code. The Model Law encompasses reorganisation procedures such as voluntary administration, administration orders (UK) or Chapter 11. In addition to the Trans-Tasman situation, the

Pacific Rim jurisdictions are enacting reorganisation or rescue procedures. While the Model Law eschews any attempt at harmonisation of the world's insolvency laws, a closer approximation of the laws of key trading partners would certainly make cross-border insolvencies more manageable and at lower cost to creditors.

Statutory management

Any review of statutory management must work closely with the examination of corporate rescue generally. Comment has already been made above.

Group companies

If any recommendations are made elsewhere in the Review in relation to treatment of corporate groups and insolvency, it may be necessary to ensure that the provisions are consistent with any recommended rescue procedure. In addition it will be necessary to consider how far the objectives of Corporations (Investigation and Management) Act 1989 in relation to complex group structures and financial failure can and should be met within existing or proposed schemes, and how far this gives rise to discrete insolvency, as opposed to regulatory, issues.

Netting

The recently enacted Companies (Amendment) Act 1999 (and related amendments to Reserve Bank Act and CIMA) provide for special provisions in relation to netting in financial markets on liquidation. It would be logical to extend these provisions to any recommended corporate rescue procedure, as happens in the United Kingdom and elsewhere.

Tax

Provisions of the Income Tax Act 1976 which provide for an 'accruals' basis of assessment will have to be reconsidered in the context of a business survival objective, and group taxation issues will need to be similarly reconsidered in the light of any new proposals in relation to group insolvencies or group structures.

Secondly, one method of dealing with financing of business rescues may be to provide tax incentives for lenders to companies in distress.

Priority debts

Since this is the subject of a separate Law Commission paper and separate paper from the Ministry is in process, little need be said. However, it is worth pointing out that in any discussion of whether businesses can be more effectively rescued, so that returns to creditors are maximised, the issue of which creditors benefit from any rescue is relevant. In the recent UK report on Business Rescue, an entire chapter was devoted to the position of the Crown as a preferential creditor. There were two strands to the discussion. First, abolition of some or all of the Crown's priority claims on insolvency would enhance the available unsecured assets for other creditors, thereby making them more inclined to support voluntary arrangements which need creditor approval. Secondly, the attitude of the UK IR and Customs and Excise to companies in distress, and Company Voluntary Arrangements, was described by consultees as 'uncommercial', with the agencies adopting a blanket approach rather than looking at the merits of individual compromise proposals. Recommendations were made that the Crown agencies should improve their practice and attitude towards companies in difficulty, given that the size of preferential Crown claims in the UK was in the order of 60-90 million pounds sterling per annum. In response to the report the agencies simultaneously published proposals for adopting a more commercial attitude in the light of their power as preferential creditors, and other powers. In addition they agreed to publish criteria against which rescue proposals would be assessed, agreed to give reasons for rejecting proposals, and agreed to establish an ongoing forum for discussion with insolvency practitioners.[33]

Any reforms proposed in the Review for other reasons, which have the effect of reducing Crown priority on insolvency, and encouraging the IRD to embrace the concept of corporate rescue in a practical way, will be a welcome contribution to business rescue in New Zealand.

Priority payment for costs of rescue?

The Law Commission in its recent report to the Minister entitled *Priority Debts in the Distribution of Insolvent Estates* refers to the current provisions, in section 234 of that Act, which ensure that some of the costs of an attempted compromise, at least the costs of convening creditors' meetings, will be paid in priority to unsecured creditors in any eventual liquidation.

Where a receiver or (in other jurisdictions) an administrator is engaged in performing his functions, remuneration and expenses are a priority payment in any subsequent liquidation; similarly where a liquidator is engaged in functions including compromising any of the company's debts and calling meetings of creditors, properly incurred costs will form part of the 'liquidation expenses' which will have statutory priority under existing legislation. Indeed, in some jurisdictions such as the United Kingdom the court, when refusing a petition for administration, has discretion to order the costs of that petition to be costs of the winding-up, and where the petitioners presented the petition in good faith the court has allowed directors' costs of a failed attempt at rescue in this way. Where a rescue procedure is not court-initiated, the problem is how to ensure the good faith element, where costs are incurred for which directors or creditors know they will have priority on any liquidation.

Where a compromise is attempted under Part XIV (or any other provision) which is ultimately unsuccessful, the issue is whether, in order to encourage such compromise attempts, the costs of attempting them should receive priority treatment in any subsequent liquidation. As the Law Commission points out at paragraph 199 of the Report, it is arguable that the present section 234 is limited to initial costs of holding meetings, not any further costs such as the fees of professional advisors.

The Law Commission recommends empirical research be undertaken into whether it would be desirable to provide for such a priority. The Commission refers to the need to ascertain the economic impact of any such new priority.

It is noted that this proposal first arose in the context of Committee J of the International Bar Association suggestion that priority be given where debts were contracted within the context of 'some kind of official management or supervision if the debt is contracted with the approval of the appointed management/supervision'. (the Committee may or may not have had in mind such procedures as the old Australian or South African Official Management which are court-controlled). This context may provide an appropriate safeguard against unnecessarily incurred costs on hopeless reorganisation attempts. However, it is suggested that the Law Commission is right to be cautious before recommending such priority. While on the one hand it may provide directors with more incentive to take steps to avert failure at an earlier stage, it may also, especially in the absence of a regulated insolvency profession, be a license for practitioners to encourage fruitless rescue attempts at the expense of available funds for unsecured creditors.

Before recommending empirical research, the Law Commission should be asked what questions that research should address, and how such research is feasible. If the research is to be aimed at ascertaining whether current law on priorities provides a disincentive amongst creditors, the company and its directors, to take steps towards a compromise or rescue, it will be difficult to research. As the Commission suggests, there are a number of other factors which may affect directors' perception, such as the inadequacy of current rescue procedures, fear of investigation of their conduct. A more easily researched question (albeit one to which an intuitive answer is apparent) would be whether professionals are discouraged from 'rescue' work by the fear of non-recovery of their fees, or whether they regard such work as potentially leading to long-term remunerative work if successful, or as part of a longer term relationship with banks and other clients.

As the Law Commission indicates, the need for a new priority for costs incurred by rescue proponents outside of receivership, liquidation or the company itself, can only really be addressed in the context of whether any new rescue procedure should be introduced, whether or not building upon Part XIV.

The related issue of whether such a priority would be more justified were the Crown to be given powers to recoup payments from directors along the lines of section 588FGA Corporations Law (Australia) is removed from the subject of this paper – those powers are in the context of voidable preference clawbacks by liquidators against the Revenue authorities. However, the defence provided to directors against the Crown under that provision extends to the court taking into consideration whether or not the director took steps to put the company into formal insolvency (voluntary administration). This ties in with 'Directors' Duties' below, but if a new procedure such as voluntary administration or a revised Part XIV is forthcoming in New Zealand, any statutory defence to directors' liability for reckless or insolvent trading could also logically extend to covering the costs of directors taking steps to initiate rescue procedures.

Voidable transactions

An issue may arise as to whether an administrator in any new procedure should have power to challenge voidable transactions. In the United States, for example, the 'debtor in possession' has such power through the so-called 'strong-arm' provisions, and administrators in the UK can also challenge voidable transactions.

Directors Duties

Two issues arise in relation to statutory provisions in Companies Act 1993, particularly sections 135 and 136. Should any administrator have standing to bring proceedings against directors on behalf of the company?

Secondly, should it be an ameliorating factor, as in Australia, that a director facing liability for wrongful or reckless trading, was party to placing the company in administration to avoid further losses to creditors? The two issues are related, since in the absence of powers for administrators to challenge directors' conduct, provision of such a 'defence' may simply mean that a rescue procedure is popular with directors for the wrong reasons, that is, it may enable them to avoid liability or investigation.

The link between voluntary administration, and directors' liability for wrongful or reckless trading is an important one. It emphasises how a balance has to be struck between encouraging voluntary initiation of administration yet preventing directors from being 'let off the hook' through administration.

Regulation of Insolvency Profession

When considering the introduction of a rescue procedure involving (if it is recommended) the possible continuation of an ailing company in business, under the guidance or control of a professional outsider, who not only attests to the viability of the initial rescue proposal but also may have wide powers of management going beyond directors' normal powers (for example to override secured creditors' rights), it should be recognised that in most of the major jurisdictions where such a professional is involved to such a degree in the affairs of a company, the professional is licensed by or through the State, and has to show that by reason of education and/or practical experience he or she is qualified for the specialist task of rescue. While liquidators and receivers in New Zealand are also part of an unregulated profession, liquidators do not generally manage or trade a business, but merely wind it up; receivers manage and sell businesses but are largely answerable to their appointor, not to a wider body of creditors. Having said that, administrators in the United Kingdom and Australia are answerable to creditors for their acts and omissions and can be challenged in court for their conduct of the company's affairs. If new procedures are introduced in New Zealand, it is essential that the insolvency profession and other stakeholders, particularly company directors, are given sufficient lead time and training to familiarise themselves with them. Arguably, there is a strong case that formal rescue procedures work best where the insolvency profession is subject to some form of licensing, self-regulation and training regimes.

Personal Insolvency – Proposals

Part XIV Companies Act 1993 was clearly intended to reflect the procedure in Part XIV Insolvency Act 1967 (Proposals). However, that did not happen. If the Insolvency Review has an objective of, where possible, achieving harmony between corporate and personal insolvency, harmonising rescue procedures between individual and corporate insolvency would seem desirable as far as possible. A relatively high degree of harmony and terminology has been achieved in England, and in the United States, Chapter 11 of the US Bankruptcy Code applies to corporate and individual debtors. The subject is also under examination in Australia.

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(Footnotes)

[1] This is the name given to the main Australian rescue procedure

[2] Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comores, Congo, Equatorial Guinea, Gabon, Guinea, Guinea-Bissau, Ivory Coast, Mali, Niger, Senegal and Togo.

[3] Regional Technical Assistance for Insolvency Law Reform

[4] with the benefit of input from a number of other world organisations including the World Bank, OECD and INSOL, and with the assistance of leading international experts such as Manfred Balz (architect of the recently enacted German insolvency code), Professor Jay Westbrook of the University of Texas, Richard Gitlin, leading US insolvency attorney and past president of INSOL, and Phillip Wood, a UK lawyer and expert on international insolvency . The IMF paper is available at www.imf.org/external/pubs/ft/orderly/index.htm

[5] May 2000, INSOL Lenders Sub-Committee, unpublished draft paper passed to Law Commission

[6] September 2000, sent to the Ministry and the author in confidence by Paul Heath, Law Commission

[7] Some of the current initiatives are sumnarised in the UNCITRAL Working Paper 50 distributed by Paul Heath subsequent to the UNCITRAL meeting in Vienna, December 1999

[8] The Insolvency Service, 1999

[9] Rview of Company Rescue and Business Reconstruction Mechanisms, 2 November 2000, DTI, London, www.insolvency.gov.uk

[10] The formal name is now Association of Business Recovery Professionals.

[11] The UK DTI report points out that the profession should ensure that the name-change will be matched by a positive approach to companies in difficulty, p30, para.112

[12] Baird "A world without bankruptcy" Ch. 4 in *Corporate Bankruptcy* (ed Bhandari and Weiss)

[13] page 10, para.24

[14] whether the selection is made by debtors, creditors, officials or the court, is a matter for debate

[15] Several pieces of research in the US have correlated successful plan confirmation and outcome to size of business, see Jensen-Conklin (1992) 97(3) Commercial Law Journal " Do Confirmed Chapter 11 Plans Consummate?"; See also Lo Pucki "The Debtor in Full Control – Systems Failure under Chapter 11" (1983) 57 American Bankruptcy Law Journal 99

[16] Routledge's study of 45 companies in administration " An Exploratory Empirical Analysis of Part 5.3A Corporations Law" (1998)CSLJ 4, 8

[17] Franks and Sussman " The Cycle of Corporate Distress, Rescue and Dissolution: A study of small and medium sized UK companies" Institute of Finance and Administration, London Business School, April 2000

[18] Receivership is an important method of dealing with insolvency and of saving businesses, but it is not strictly an insolvency procedure, since it is not collective, being controlled and for the benefit of one creditor, the secured creditor

who appointed the receiver
[19] n 17 above
[20] Business Rescue, Page 16, para 51
[21]See Armstrong, "Return to First Principles" in New Zealand: Charges over Book Debts [2000] 3 Insolvency Lawyer 102
[22] Sweden is a rare example of a European country with a statutory floating charge
[23] (1997)8 NZCLC 261,318; [1995]3 NZLR 143
[24] Insolvency Law Reform in the Asian Pacific Region (Asian Development Bank Report, April 1999), page 13, n12
[25] ASC Research Paper 98/01: A study of Voluntary Administrations in NSW, ASC, Sydney, 1998
[26] Hodson and McEvoy 'Voluntary Administrations- Are they Really Working'(Coopers and Lybrand, 1995)
[27] "An Exploratory Empirical Analysis of Part 5.3A of the Corporations Law" (1998)CSLJ 4, 7
[28] as defined in the UK Companies Act 1985
[29] Warren " The Untenable Case for Repeal of Chapter 11" (1992)102 Yale LJ 437 at 449; see also LoPucki and Whitford " Corporate Governance in the Bankruptcy Reorganisation of Large Publicly Held Companies" (1993) 141 U. Pa. L Rev. 669
[30] p37
[31] page 38
[32] See for example, the Loan Market Association www.loan-market-assoc.com

[33] These proposals are available on the internet at www.inlandrevenue.gov.uk, and http://213.38.88.195/coi/coipress.nsf Press releases dated 2 November 2000