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waterstone INSOLVENCY

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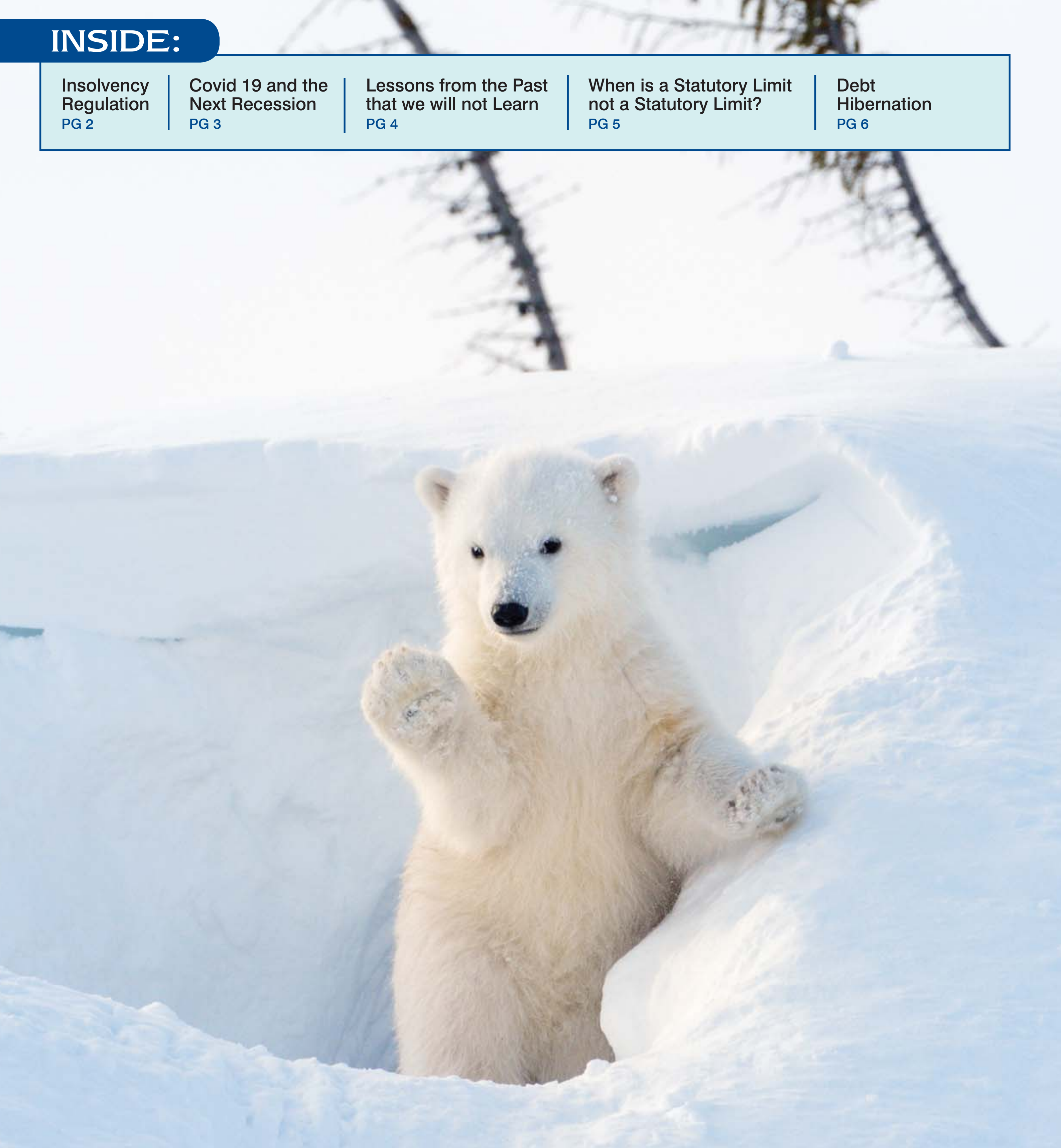


Insolvency Regulation

It has taken a decade to get here. Children born when this process began have already completed five years of primary school. Australia has burned though five prime ministers and half of their native forests in that time. Donald Trump was just a reality star when the first draft bill was put forward and someone called Tony Blair was Prime Minister of the then United Kingdom. Yet. Here we are. What is regulation going to look like?

The New Regime

Parliament has established a co-regulatory regime and has delegated their authority to regulate who can act as an insolvency practitioner to approved third parties. These third parties must be approved by the Ministry of Business, innovation and Employment; MBIE.

CANZ has been approved as an accredited body, however, there are a large number of non chartered accountants who practice insolvency. To accommodate for these individuals there has been an agreement between CANZ and the Restructuring, Insolvency and Turnaround Association New Zealand, RITANZ.

RITANZ has been established to accredit non chartered accountants who can then gain admission as affiliated members of CANZ and will be covered under CANZ's accreditation.

The regime came into effect on the 1st of September. On this date only those who have been accredited by CANZ are able to take appointments. Those who have existing appointments have twelve months to complete their existing assignments before either striking off their files or resigning them to an accredited practitioner.

What this will achieve?

The first effect of this new regime has been a drop in the number of people taking appointments. A number of individuals have voluntary left the industry and some have been denied admission.

Readers can make their own assessment as to the effectiveness of reputable practitioners from established firms when it comes to investigating their files and holding director's to account. Given the new regime, Waterstone will be subject to the new code of conduct and this specifically prohibits commentary that could discredit RITANZ.

Will this end the 'friendly' liquidator?

A problem, or at least a perceived problem, with the insolvency industry is that most insolvency firms get referrals from a small network. There is an unwritten but not always unspoken expectation that if a lawyer or accountant acting for an insolvent company refers their client to a liquidator that this liquidator will not hammer them.

This places the liquidator in a difficult position. If they do pursue the director they run the risk that the referrer will be reluctant to recommend their next client to that insolvency practitioner. From the perspective of the lawyer or accountant who is acting for their client, often the director as opposed to the company, this isn't unethical. A lawyer has an obligation to act in the best interests of their client. Referring them to an insolvency firm who has a reputation for suing company directors, as opposed to one with a reputation for taking a more passive approach, could be considered negligent.

One of the explicit aims of regulation is to change the behaviour of insolvency practitioners by increasing oversight and obligations on those taking appointments. This will be a significant achievement if successful.

What could have been achieved?

Waterstone petitioned the select committee to dispense with regulation entirely and change the incentive structure of insolvency practitioners by making it easier for creditors to change practitioners at creditor meetings. It is our belief that if we could align the incentives of people who take appointments with the creditors this would do more to encourage insolvency practitioners to take a more aggressive approach.

However, two positive elements of the new insolvency laws that have come into effect is that related parties are now prevented from voting at creditors meeting and shareholders are prevented from appointing a liquidator once they have been served with liquidation proceedings. These measures will go some way to limiting the ability of shareholders to appoint liquidators they perceive to be likely to act in their interests once liquidation proceedings have been served and will make it marginally easier for creditors to replace liquidators that they do not have confidence in.

Our Mascot Prudence, exploring the hinterland of Sri Lanka

Covid 19 and the Next Recession

We're plunging into the biggest period of uncertainty since the GFC, but it isn't 2008 that we should be looking back to. It is 1929.

Where we are now

If the disruption created by the virus was all we had to contend with the prospects of a short period of economic malaise, followed by renewed growth, would be the order of the day. Were we so lucky! To understand the nature of the underlying problems the economy faces let's start with the most important price in the economy; the price of money.

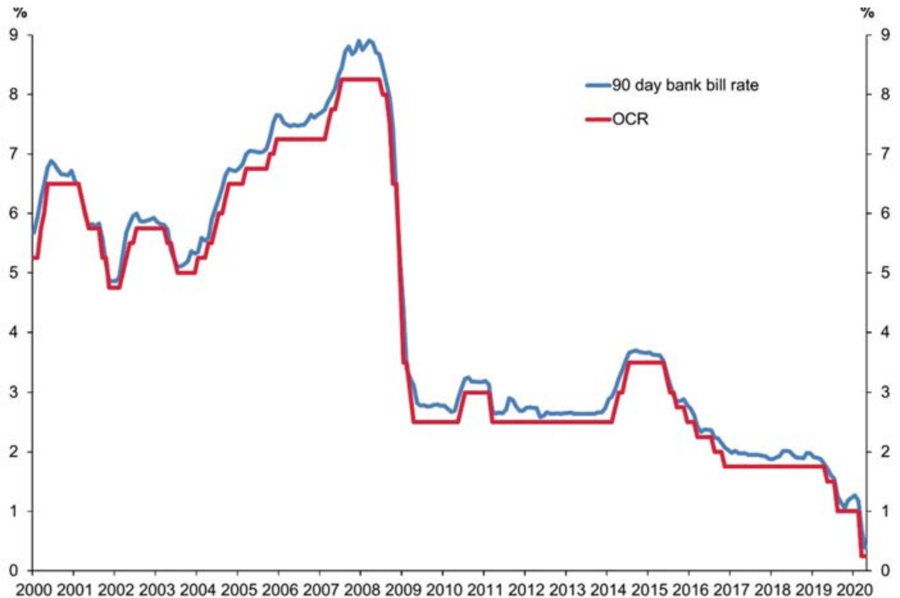
At the time of the GFC the OCR was 8.25%. Wholesale and retail rates were based on this. There was a number of reasons for such a high rate but part of the motivation was to keep our exchange rate high in order to prevent imported inflation and to help keep our inflation rate, that was around three percent, back to the preferred target of 2%.

Once the GFC hit the Bank dropped the OCR down to the floor. Critically to this story, by 2013 the economy was back, humming along nicely. Governor Graeme Wheeler sought to push the rates back to a more normal level but, for reasons unclear, the long decent towards 0% began.

During this period cheap money had a number of effects, including a surge in the price of assets, such as housing and equities. Some of this rise in values was driven by fundamentals, but much of it was the result of people seeking an economic return.

When the bank is offering deposits equal to the rate of inflation, shares and rental properties look more attractive.

The long upswing in equities is perfectly captured in this graph, showing a surging New Zealand share market, that increased an incredible thirty percent in 2019, when our underlying economic growth was a tenth of that.



We're all Keynesians now

Standard monetary policy, regardless if you are a follower of Milton Friedman or John Maynard Keynes, is to run loose policy during a slump and tight money supply during a boom. We ran a loose monetary policy during the Rock-Star economy of 2012 to 2019.

One of the effects of this was to drive up consumer and commercial debt. The Key government also plunged into the red for seven straight years, clocking over sixty billion in new Crown debt. The only positive was that the purportingly conservative government inherited a very low level of fiscal debt from Dr Cullen.

Overseas nations weren't so fortunate and have seen their debt to GDP ratios blow out to over 100% in many OECD nations during the last decade. Japan is at 240% debt to GDP, partly as a result of a falling GDP.

During this period the economic expansion of China has added export markets as well as flooding most western nations with cheap consumer and commercial products, that has helped fuel the economic furnace.

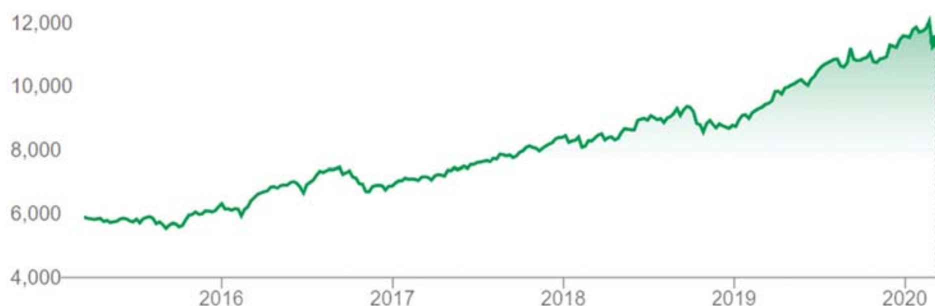
We have built an economy that relies on cheap money, a roaring export market to China and an endless conveyor belt of high quality and low cost Chinese imports.

The Black Swan has Corona Virus

The problem is that even before Wuhan imploded, this economy was unsustainable. Each year the level of debt would increase at a faster rate than economic growth. Most of the lending was being funded by older savers in an endless search for yield above zero.

The only way to avoid this collapsing was for our economic growth to outstrip debt, but for this to happen the level of debt would have to actually stop growing. It never did. Some economists were starting to fret that we were building an economic bubble that was going to collapse with effects well in excess of 2008.

The real challenge facing our economic masters is how to confront one of the most significant downturns in a century without access to the usual stimulatory levers that were available as little as twelve years ago.



Lessons from the Past that we will not Learn

In 1921 there was a similar economic crisis, caused in part to dislocation created by the end of the first world war and, some commentators believe, a rapid rise in interest rates in the months before the July 1920 economic decline.

The US economy declined by as much as 6.9%.

What characterised this downturn, as opposed to those that were to follow, was the lack of government intervention. President Wilson was incapacitated and wasn't replaced by Warren Harding until March 1921, by which time the economy was moving steadily back towards recovery.

A minority of commentators, this author included, believe that it was this very lack of government activity that allowed the normal process of creative destruction, liquidation of unsustainable financial positions and the price mechanism to work so quickly to bring the US economy back into positive economic growth.

The Great Depression and the New Deal

Contrast this with the response by the Hoover and Roosevelt administrations after the 1929 stock market crash. Hoover began an aggressive government intervention through half a billion, (in 1929 dollars) into agricultural subsidies, massive tariff restrictions in the Smoot-Hawley law of 1930, bailouts to banks via the Reconstruction Finance Corporation and a further two billion (again, 1929 dollars) in public works and finally the Glass-Steagall Act of 1932 that allowed the Federal Reserve to inflate the money supply.

This was at a time when the US GDP was less than one hundred billion in 1929 dollars.

Not only did these measures fail, the tariffs actually stifled a nascent recovery and plunged the economy further into an economic malaise. Hoover was booted out of office in 1933 and Roosevelt embarked on his even more expansionary New Deal.

The New Deal, often praised by contemporary economists, failed to revive America's fortunes and there was a further contraction in 1937. Contrary to almost universal opinion the expansionary policies of Hoover and Roosevelt didn't end the Great Depression. They exacerbated it.

Didn't the War end the Depression?

Some of the same people who argue that the New Deal ended the Depression also maintain that it was the war that did the same thing. Certainly placing a country on a war footing and drafting twelve percent of the population is going to remove any slack in an economy.

Yet it is hard to argue that stripping some of the most productive members from your workforce and diverting resources into making tanks is in anyway increasing the productive capacity of a country.

The lesson, which we will fail to learn, is that a market economy, left to its own devices, is perfectly capable of reallocating resources quickly and efficiently. Well meaning attempts by the state often do little but delay the inevitable reconstruction and holds in place companies that should have been mothballed, sold off, or closed down, freeing capital and individuals to be re-allocated to more productive enterprises.

Of course, we are an insolvency firm, so, you can probably discount our perspectives as self-serving and perhaps we are guilty of seeking out opinions that serve our own interests. It can be hard to test your own objectivity.

When is a Statutory Limit not a Statutory Limit?

90 Nine is a debt buying company based in the semi-industrial wastelands of Rosedale. Luxury Rentals NZ Limited owed $1,000 to Pure SEO Limited. This debt was disputed and Pure SEO took the issue to the Disputes Tribunal and obtained a judgement for the $1,000.

As Luxury Rentals didn't pay it, Pure SEO sold it to 90 Nine.

Being a good debt buying company they issued a statutory demand against Luxury Rentals.

As many readers will be aware, a statutory demand is a mechanism to prove insolvency under Section 289 of the Companies Act. If the debtor does not pay or dispute the debt, they can be placed into liquidation.

Section 241 is the mechanism that give the High Court the discretion to place a company into liquidation. The court isn't, however, obligated to do so even if all of the requirements for doing so are met.

Section 287 outlines one of those requirements, that a company is unable to pay its debts. One of the pieces of evidence that can be used to demonstrate that a company has failed to pay or dispute a statutory demand, issued pursuant to Section 289 of the Companies Act.

Section 289 mandates a Prescribed Amount, the amount of which Parliament delegated to the Executive Council to set, and the current Prescribed Amount, under Regulation Five of the often overlooked Liquidation Regulations, is $1,000.

When the issue came before the High Court the Associate Judge demurred. He felt that the cost of a liquidation, rarely under $5,000, was disproportionate given a $1,000 debt, and the judge decided that "I regard liquidation as disproportionate given the indebtedness. I dismiss the application. The plaintiff should take other steps to recover the debt."

This placed 90 Nine in a bind. What other steps could be taken? Any other action would require using their judgement, as a Disputes Tribunal is as good legally as a District Court judgement, to try and seize the debtor's assets, get an order of examination of the company, ask politely for the money?

None of these options are commercially viable. The effect of this judgement was that debts for a thousand dollars would not be enforced. Worse, no new limit was set, so creditors would be going to court with unsatisfied statutory demands uncertain if they would be able to get a liquidation order.

90 Nine isn't a timid outfit. They took the issue to the Court of Appeal, appealing not on the economics of the case but, as Director Brent Norling made clear, a point of principle.

Norling was also the lawyer who argued the case. It was in the public interest that insolvent companies be removed from trading, he pointed out to the Court of Appeal. While it was true liquidator's fees may be disproportionate given the debt, liquidators often worked for free if there wasn't any recovery.

His submission was quoted in the judgement:

"The prospect of liquidation acts as a sword of Damocles with the consequences that the issue of a statutory demand is an effective debt collection tool in New Zealand. The reality of that remedy would be substantially undermined if the perception in the market was that notwithstanding a failure to comply with the demand a liquidation order might be declined."

The Court of Appeal agreed with Norling's submissions and the case was referred back to the High Court for a liquidation order. 90 Nine, to make the point that this was an issue of principle and not economics, allowed the case to lapse.

This case is important not only in restricting the High Court's discretion in issuing a liquidation order, it puts a permanent nail in the coffin on the old canard that a statutory demand cannot be used as a debt collection tool.

It is, it can be, and we have 90 Nine and Brent Norling for resolving this issue in perpetuity.

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Debt Hibernation

A number of legislative changes have occurred as a result of the economic impact of the Covid19 pandemic and one of the most significant for the insolvency industry has been the Covid Debt Hibernation regime.

This is quite a complex process. It allows companies to place their debts into hibernation for as long as seven months; but there are a number of key steps to this regime.

Director's Statutory Declaration

Before a board can enter the regime eighty percent of the board must sign a statutory declaration stating that the company was able to pay it's due debts at the 31st of December 2019, will fall into insolvency as a result of Covid19, and will be able to pay its debts by September 2021.

Few companies will actually meet that threshold.

Once the board passes the required resolution, a notice is given to the Registrar of Companies, via form on the Companies Office Website. This begins the process.

Protections

As soon as the notice is given all enforcement against the company ceases; this includes the rights of secured creditors to recover their assets and even to appoint a receiver. Personal guarantees are unable to be enforced.

Landlords are unable to evict tenants and it is not possible for creditors to issue statutory demands, or at least enforce or rely on them. All court action is suspended. This even applies to action that was commenced ten days before the Notice was given to the companies office. Presumably, although the legislation is a little vague, receivers appointed in the ten days before the Notice was given will not be removed as a result.

The initial protection period lasts for one month once the Notice has been sent. If the compromise proposal is passed, the protection will last for six months once the board has certified that the proposal has passed.

Critically, once the proposal has been passed, or has failed, or the first month has passed with no proposal being submitted, a GSA holder is once again free to appoint a receiver.

Creditors

The Debt Hibernation regime covers a wider set of creditors than other insolvency restructuring options, such as the Part XIV Compromise and Voluntary Administration. There are no classes of creditors and all secured creditors are covered and can vote, including GSA holders.

Excluded however, are related party creditors, the IRD for unpaid PAYE and staff for unpaid holiday pay.

The Proposal

Once the Notice has been sent, the company must send a proposal to all their creditors. At the most aggressive the proposal can be for no debts to be paid for the full six months. There appears to be nothing that would prevent the proposal preferring some creditors over others. However, the court may rule that a creditor need not be bound by the proposal if that creditor has voted against the proposal and "…the arrangement is unfairly prejudicial to the creditor."

In most cases we expect to see proposals that offer to pay creditors a monthly portion of the debt and to pay each of them equally; say ten percent of their debt, once a month for six months, with a balloon payment of forty percent at the end of the process.

Creditors Support

Creditors must support the process by a majority in number and dollar value. This means if most of the creditors support the proposal, but one large creditor holding over half of the total debt votes no, then the proposal will fail.

Clooney

Clooney Restaurant was a fixture of Auckland's fine dining scene for thirteen years, before shutting its doors for good last year. Its legacy, however, will be more than over a decade's worth of wonderful meals in opulent surroundings.

Behind every restaurant is a financial structure and Clooney's was a bit more complex than most. However, by 2010 he sole shareholder and director was the restaurateur Antony Stewart.

However, the restaurant was falling behind in its tax obligations, which had reached $384k in 2014. Mr Stewart then did what many have done before him, he did a Hive Down. He established a new company, Clooney Restaurant Limited, as separate from the initial company.

The old company then sold to the new company the assets of the restaurant, which were on the books for $411k. In consideration the new company agreed to take on debts worth $408k, the three thousand dollar balance was left unpaid.

Before the sale:

Old Clooney Company		*New Clooney Company*	
Assets	$411k		
Creditors	$408k		
IRD Debt	$384k		

After the sale (Assuming creditors paid)**:**

Old Clooney Company		*New Clooney Company*	
Assets	$0k	Assets	$411k
Bank	$3k	Bank	$3k
Creditors	$0k	Creditors	$408k
IRD Debt	$384k		

The idea was straight forward; move the assets across to the new company and get the new company to pay for the creditors, other than the IRD. The old company was then left high and dry. Mr Stewart was the director and shareholder of both entities.

The shareholder then appointed his own liquidator, who for reasons that are not explained but can be inferred, resigned in favour of David Levin of Deloitte.

Mr Levin took the director to court on three grounds;

Section 348 of the Property Law Act

The disposition of property from the old company to the new one was a "disposition of property to defeat creditors"; specifically, the $384k owed to the Commissioner. If the court finds that the disposition was done with this purpose in mind, then they can order the party that received the assets to compensate the party that was dispossessed.

The court did find that the transfer of assets, excluding the IRD debt, was done to defeat the IRD and ordered the new company to pay the $384k back to the now liquidated old company.

Breach of Directors' Duties

The liquidator alleged that this transfer was a breach of the duties of the director. This, on the surface, seems harsh. If we take the transfer at face-value, the fit-out was sold for consideration equal to the book value of the fit-out. By contrast, if the transfer had been for cash, and the money paid to the creditors but not the IRD, these payments would have been voidable, but there may not have been any breach of director's duties.

However, as the consideration was only for the promise to pay the creditors and the actual asset was transferred, the claim of a breach of duties looks more reasonable. The judge found that directors' duties had been breached and the director was held personally liable for the total of the IRD debt.

Phoenix Company

However, there was a third cause of action. Because the new company was a Phoenix, as per Section 386A of the Companies Act, the director could be held personally liable for all the debts of the Phoenix Company.

A Phoenix Company exists if the director of the new company was also the director of another company with a same or similar name that had been placed into liquidation. Once the court finds that the new company is a Phoenix, then the director is personally liable for the new company's debts.

This is what happened. In this case the unfortunate Mr Stewart was held liable for a further $201k, which was the outstanding tax obligations of the new company.

Critically, had Mr Stewart taken advice before his ill-fated restructure, he could have avoided this outcome. The Phoenix Company sections of the Companies Act allow for a director to set up a Phoenix Company legally. They must first liquidate the old company, buy all or substantially all of the assets off the old company and write to the creditors of the old company to explain their role in both entities. Mr Stewart did not do this, and now faces over half a million in judgement debt as a consequence.

Introducing Greg Sherriff

Waterstone is delighted to introduce our latest team member; Greg Sherriff. Greg's insolvency career began in South Africa where he ran his own practice before moving to New Zealand with his family to take up employment with McCallum Petterson prior to and through its merger with Deloitte.

He then spent nearly eight years at Grant Thornton before working with Auckland insolvency practitioner Digby Noyce. Prior to starting with Waterstone Greg also spent two years as a director of a Waterstone sister company, a debt collection and credit reporting business.

Helpfully for us at Waterstone, Greg is accredited! He is also a former board member of the regulatory body, RITANZ, and was involved in setting up the current regulatory regime.

In his insolvency career in New Zealand Greg has been appointed to a number of iconic firms, most notably Video Ezy, that Greg described as a 'fascinating and challenging file'.

Waterstone thus enters the new regulatory world with confidence and experience. Greg can be contacted at:
greg@waterstone.co.nz

The Auckland Shot Tower

We get a few interesting files, here at Waterstone, but this one is proving a real challenge. Stuck on a landlock sliver of land at the back of a Mt Eden residential development sits the Auckland Shot tower.

The Colonial Ammunition Company was a successor of Whitney and Sons, an ammunition manufacturer that was founded in 1885. In 1916 the company built the Shot Tower in Boston Road Mt Eden. This structure was used to drop molten lead pellets thirty meters to make the perfect round balls for shot. It is the only one remaining in New Zealand.

According to a news story in the NZ Herald, the tower was still operational in 1982!

As part of a residential development a tiny section of land was carved off onto its own title and apartments built around the tower, where it now remains, landlocked and unloved.

Unfortunately, the company that owned the land, which was set up by the property developer, didn't pay either the rates nor made any attempt to maintain the site, which has a Heritage Category One status.

Waterstone was appointed by the Auckland Council over unpaid rates. We are exploring options.

Now; we like to think were pretty good as solving even the most complex problems, but this one has us stumped. We tried tickling the interests of a mobile telco, an outdoor advertising firm, even Tower Insurance. So far, no luck, but we will keep you posted. We are open to offers!

Then.

Now.