waterline

waterstone INSOLVENCY

EDITION 1

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IS VOLUNTARY ADMINISTRATION THE WAY OUT?

Northern Energy lights up the Voluntary Administration Regime

Voluntary Administration became a new insolvency option for companies in November 2007. To date there has been less than a dozen companies who have entered Voluntary Administration and only two, Northern Energy on the 14th of March, and Phoenix Building on the 27th of March, who emerged successfully. Northern Energy was the first company to emerge from Voluntary Administration:

The Company

Northern Energy was a medium sized electrical contracting company that was set up in 2003 to do contract work for Siemens Energy. In 2007 Siemens Energy brought the business back in house and Northern Energy was left holding the costs for a large infrastructure. The two owners quickly went back on the tools to try and generate revenue, and did so with some success, but they were faced with legacy debt of $168k.

To compound their problems, they had a undeclared dividend, meaning they each had a $40k current account debt owed to the company.

When they came to our door Northern Energy had $168k in debt, with less than $25k in assets, and most of that was vehicles and debtors. They were concerned about trading whilst insolvent and were exploring their options. They went into Voluntary Administration on the 14th of February.

Entering Administration

As Administrators, Waterstone ran the business, reviewed quotes, cancelled their lease and collected their debtors. We ran a small marketing campaign for them. We discussed various options with the creditors, the directors, and ran the numbers to try and find a solution.

The Deed of Company Arrangement (DOCA)

After five weeks we proposed a Deed of Company Arrangement at the watershed meeting, held on the 14th of March. The creditors would get $6k immediately (about 5c in the dollar), half the settlement of a dispute with Siemens (about another 5c), and after a ninety day moratorium they would receive $1,000 a month for 24 months.

In total, the creditors would receive 30c in the dollar. In liquidation the creditors would receive almost nothing. The creditors voted to accept the proposal. It was New Zealand's first Deed of Company Arrangement.

Other DOCA Options

The Northern Energy agreement is one example of a DOCA arrangement. The Phoenix Building arrangement was more successful for creditors, where the firm is aiming to pay back 100% of the debt over 36 months. The administrators, BDO Spicers in Christchurch, are taking a larger role in the administration than we are in the ongoing case of Northern Energy.

The legislation provides for enormous flexibility in DOCA options. The alternatives are limited only by the imagination of the creditors and the company involved in the transaction. The most important piece of advice we have for companies or their advisers considering Voluntary Administration is not to hold on for too long. Nothing destroys creditor goodwill faster than unkept promises from a company director trying desperately to hold their business together.

Damien Grant, (Waterstone) Stu Fraser and Tim Donaldson (Northern Energy), Steven Khov (Waterstone), Ross Dillon (Gaze Burt). Participants in New Zealand's first watershed meeting to pass a DOCA.

The numbers tell the story:

Northern Energy	Before DOCA	After DOCA
Current Assets		
Bank	-	9,000
Debtors	15,000	5,500
Vehicles	10,000	10,000
Total	**25,000**	**24,500**
Current Liabilities		
Creditors	168,000	-
Total	**168,000**	**-**
Current Position	**-143,000**	**24,500**
Long Term Assets		
Current Accounts	80,000	80,000
Total	**80,000**	**80,000**
Long Term Liabilities		
Creditors	-	24,000
Bank	30,000	30,000
Total	**30,000**	**54,000**
Net Position	**- 93,000**	**50,500**

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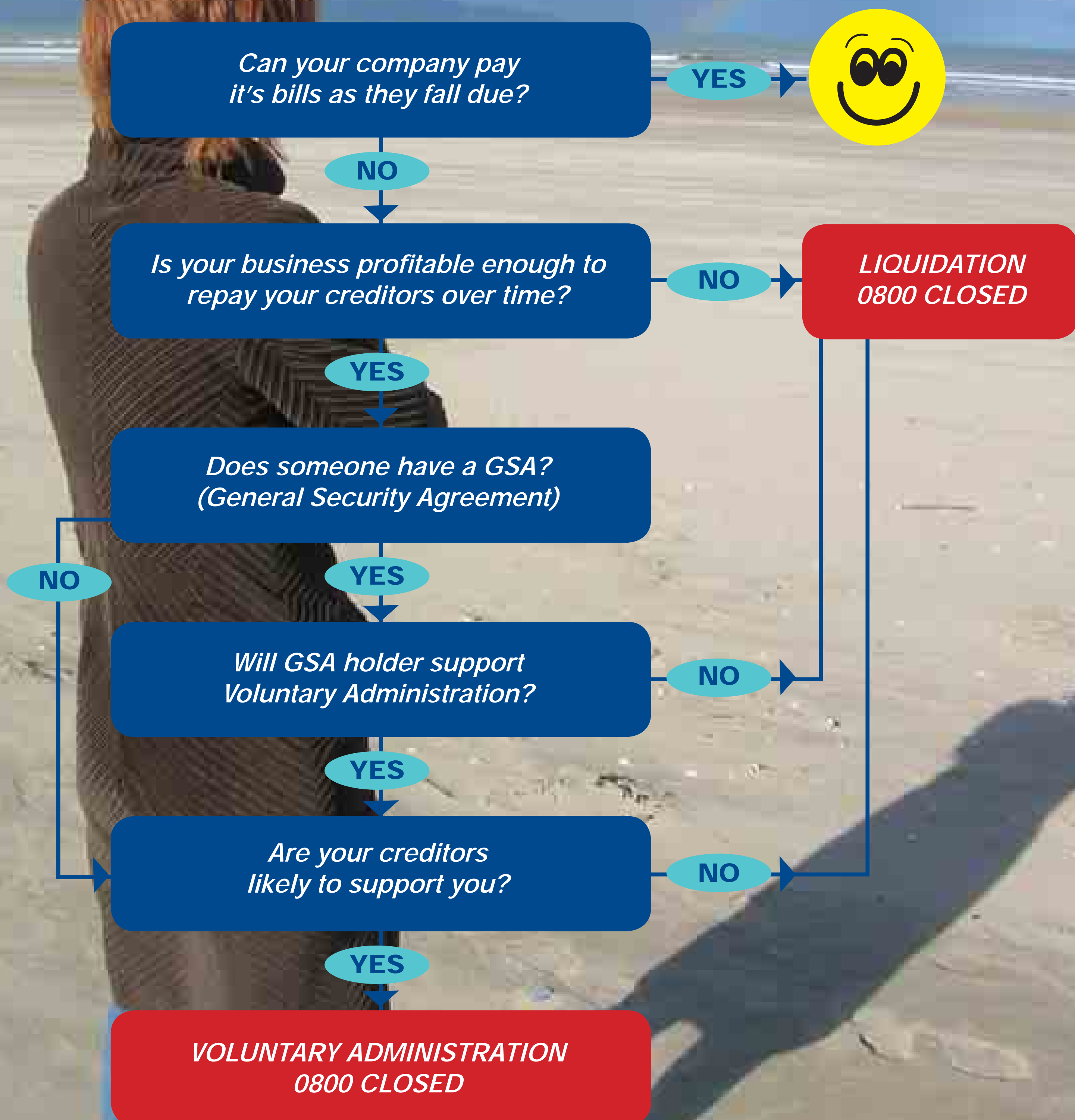
Is Voluntary Administration right for your business?



Receivership: A Case Study

We are seeing an increasing use of Receiverships as the economy tightens and lines of credit are reined in. Below is an example of an unorthodox use of receivership to take control of an asset, a farm in South Canterbury.

The Farm

Lone Arrow Stud was a stud farm, in a small town called Cave, twenty minutes drive from Timaru.

The farm was based on breeding descendants of the thoroughbred horse Lone Arrow. The land was owed by a trust, which leased the land to Lone Arrow Stud Limited. The owner of the trust has lent money to Lone Arrow Stud. This loan was in default and the owner wanted possession of the farm.

The Company

The owner of the company was not inclined to walk off the land, and was adamant that, as a beneficiary of the trust that owned the land, she would not be moving. However, as she was a bankrupt, the decision of what to do with her equity of the land rested with the Official Assignee, who had not made a determination.

The Demand and Receivership

A demand under the terms of the GSA had been made and un-remedied. We were appointed on the Thursday night, April 2008.

Day One: Forty-five minutes in: The local constabulary are called onsite.

A weekend in Cave

On the farm we found twenty six horses, seven cows, three sheep (one with only three legs) a couple from Australia who passed themselves off as horse whispers and a property manager. We spent the weekend in Cave managing the removal of all of the livestock, hay, and finally on the Sunday night we resorted to changing the locks and calling up the local constabulary to clear the site.

Receivership: Not just for companies

In this case the GSA was held by a trust over a company, but a receivership is not just for use against companies. In many cases in New Zealand land is owned by a trust. Under the receivership legislation there is provisions for trusts to grant a GSA. The PPSR website allows for GSA securities to be registered against trusts.

Damien Grant and a worried looking horse.

This means a receiver can be appointed over a trust and not just a company, although the overwhelming number of receiverships in New Zealand are against companies. A receiver can also be appointed just over a piece of land or other property. Where a receiver is appointed over an entity that is not a company, notice of the appointment must be published in the normal way (ie: the gazette and local papers).

Steven Khov shows his horse whispering talents.

The Ten Day rule kicks (like a mule) into effect.

Firms that receive notice that a creditor has began legal action against them have ten working days to appoint their own liquidator or administrator.

This is a little noticed change that came into force with the other changes to the Companies Act last year.

It is starting to have an impact as we see company directors coming to us wanting to liquidate their firms ahead of a court call. These companies are unable to appoint their own liquidators and their firms must live on waiting for the court to appoint a liquidator.

Indeed, at Waterstone we have seen and aware of a number of such companies, where the court dates are months away. We call them Zombie firms.

There are two interesting issues: what if a liquidator takes an appointment despite the ten days rule, and can a director be held liable for reckless trading during the period their firm was reduced to a zombie like state by the new changes?

The courts appear to have resolved the first issue. The courts in two cases, TMP Quality Fixing Limited and London Traders Limited have replaced the shareholder appointed liquidators and replaced them with liquidators requested by the petitioning creditors.

The implication is, and is reported on the Companies Office website as such, that the liquidation began at the time of the shareholder resolution, in apparent contravention of the act which clearly states that the shareholders cannot, in fact, pass such a resolution.

Our belief is that, where the shareholder appointed liquidators become aware of the legal action that made their appointment invalid, they should approach the petitioning creditor and resign in favour of the liquidators preferred by the creditors. This appointment can then be validated by the court.

The second issue is more complex. There are so few reckless trading convictions in New Zealand this issue is more likely to be an academic exercise. However, with the funding creditor provisions now in force, we can expect to see more reckless trading prosecutions, and to this end the liability of the directors during this Zombie period may become relevant.

Voidable Transactions

Voidable Transactions
Voidable Transactions are one of the most controversial areas of insolvency. A voidable Transaction (or an insolvent transaction under the current terminology), is one where the liquidator can compel a creditor who has received a payment to pay it back to the company.

This is a large topic. Please see our website; www.waterstone.co.nz/voidable for a more detailed examination of the issue.

The New Rules
The rules have changed, and so have some of the terms. Insolvent transaction has replaced Voidable Transaction, and a new concept of a Running Account has been introduced.

An insolvent transaction is defined as:
1) The company was insolvent at the time the transaction was made
2) The transaction enables one creditor to receive a greater reduction of debt than they would have received in the course of a liquidation

Importantly:
- If the transaction was in the last six months of the company's life the company was deemed to be insolvent,
- If the transactions were between six and twenty four months prior to liquidation the burden of proof of insolvency lies with the liquidator.

A running account?
Using Australian guidelines, a running account is one where new debts are being created, as opposed to one where debt is simply being reduced.

A wholesaler providing building equipment to a builder would have a running account. A finance company (who holds a personal guarantee from the director) that receives a large cash payment in the months leading to liquidation, would not be seen to be holding a running account.

Why is a running account important?
If an insolvent company makes a payment to a creditor in the last six months of its life, the liquidator can recall the payment. If the creditor can show that it had a 'running account' with the insolvent company and that its level of exposure did not materially change over a longer period, this is a defence to the liquidator, (this defence essentially replaces the 'ordinary course of business' defence).

An Australian Example :
Compass Airlines was required to pay AirServices Limited for aviation services. They paid $10m and were billed $18m. The liquidators of Compass tried to recover the most recent payments from Compass Airlines to AirServices.

The Australian Courts took the following view:

> *"If at the end of a series of dealings, the creditor has supplied goods to a greater value than the payments made to it during that period, the general body of creditors are not disadvantaged by that transaction – they may even be better off. The supplying creditor, therefore, has received no preference."*

In the case the Liquidators of Compass were unsuccessful in recalling the money.

But:

If AirServices had ceased supplying services to Compass Airlines, all payments received by AirServices from the moment they ceased supply would have been called back by the liquidator.

Protecting yourself from an Insolvent Transaction

If supply has ceased, all payments received by an insolvent firm should be considered to be voidable and liable to be recalled by a liquidator.

If supply is continuing, but net indebtedness is reducing, the amount that the debt is reducing is liable to recalled by a liquidator.

The simple answer is not to supply to an insolvent company, and if you suspect that you are trading with an insolvent company look for some form of security.

Specifically:

- *Personal Guarantees*
- *PPSR Security over specific assets*

The act, Section 296(3) gives one very specific defence:

> *"The person from whom recovery is sought received the property in good faith and has altered their position in the reasonably held belief that the transfer to that person was validly made and would not be set aside. "*

When does the running account start?
This is going to be a much litigated area over the next few years. Australian law is unclear, and the New Zealand parliament did not codify when it should start.

Three schools of thought:

Peak indebtedness.
The running account should start at the high point of the creditors debt with the company. This position is favoured by Liquidators and hotly disputed by creditors. It means the peak indebtedness can be measured from a point before the company became insolvent.

At the point of insolvency.
Favoured by academics, the argument is that at the time the company becomes insolvent is the time that the liquidator should take a snapshot of the creditors account and look at the difference in indebtedness between that point and liquidation. Fine in principle. Completely impossible to determine in almost all liquidations.

Six to twenty four months prior to failure.
Favoured by creditors, this follows the legislation. The liquidator can look at the six months prior to liquidation as the start of the running account. If the liquidator wants to go back further the burden of proof falls on the liquidator.

Our mascot, Prudence, in Bagan, Burma.

Funding Creditors: A new way forward

Parliament has made a small change in the all important Schedule Seven of the Companies Act.

Schedule Seven determines the order in which creditors receive funding from the proceeds of unencumbered assets.

Schedule Seven:
A summary of the distribution:

Secured Assets Distribution
Money received from secured assets (ie: a vehicle with finance on it), the money goes to the secured creditor first. If they are paid off, the balance is available to the unsecured creditors, otherwise, the balance of their debt becomes unsecured.

Liquidator's expenses
These include any costs incurred by the liquidator in continuing to run a business in liquidation, including all liquidation fees.

Staff wages
Limited to the last four months wages, all holiday pay, time in lieu, up to a specified maximum $16,420. (excludes directors).

The IRD
Next, all outstanding GST and PAYE must be paid. This is usually where most distributions cease. It is common for a firm in trouble to cease paying the IRD, and the IRD is a preferential creditor ahead of all other unsecured creditors.

All unsecured creditors
Unsecured creditors receive a distribution according to the percentage of total debt they are owed.

Shareholders
If a liquidator was successful in paying all unsecured creditors, any remaining distribution would be receipted back to the shareholders.

The change.
The wording of the change is thus:

To any creditor who protects, preserves the value of, or recovers assets of the company for the benefit of the company's creditors by the payment of money or the giving of an indemnity-

The amount received by the liquidator by the realisation of those assets, up to the value of the creditors unsecured debt.

The amount of costs incurred by that creditor in protecting, preserving the value of, or recovering those assets.

The Impact
This is very positive news for creditors in a liquidation, and very bad for directors guilty of reckless trading.

Already: Waterstone is involved in two cases where creditors have chosen to fund a liquidation. The cases are very different.

Eventmakers
We believe this is an egregious example of reckless trading. Here two directors have used multiple companies to defeat their creditors and hide behind the thinnest of corporate veils. The creditors have established a fund to engage the services of a lawyer to pursue the directors.

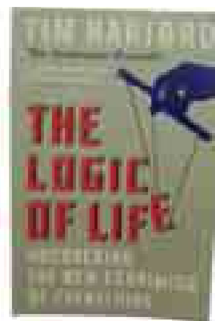
Because of the funding creditors legislation, only the creditors who put into the fund will receive a distribution, unless they are all paid out on their unsecured claim.

Under the old rules this would not have been possible, as any money recovered would have been distributed pari passu to all unsecured creditors, reducing the incentive to participate in such an arrangement.

Black Magazine
Black Light Publishing was put into liquidation by their printer, see the story of this liquidation on the opposite page.

When we arrived we found edition eight ready to be published, and with $60k of advertising revenue already sold. We approached the printer; they quoted a price to print the magazine. We signed a funding creditor's arrangement that specified that in return for protecting the value of the asset (the masthead) by printing the magazine, any proceeds from the sale of the magazine as a going concern will go repay their unsecured debt ahead of any other creditor, secured or unsecured, including the IRD, staff wages, etc.

Book Reviews



The Logic of Life
Tim Harford

Why should short fat men persist in speed dating? It is not the sort of question you expect an economist to address but Tim Harford delves into this and other questionable areas. Why do sex workers risk aids for $100 and why do firms over-pay ineffective managers? This book will give you the answers.

This book weaves the authors thesis into a series of ripping yarns. You will come away informed and entertained. The best book of its genre I have read to date.

Private Receivers of Companies in New Zealand
Peter Blanchard
Michael Gedye

The latest tome from Blanchard and Gedye does not, however, have the same easy flow as that by Tim Harford.

The authors update their decade old work in the same area but depart from it in significant ways, reflecting the rapidly changed legislative environment. The book focuses on the issues around receivership and the conflicting issues facing receivers, especially those dealing with the sometimes conflicting PPSR, Receivership and Companies Act legislation.

Sometimes the greatest challenge facing a receiver is the complexities of resolving competing security issues, and here Blanchard and Gedye offer an invaluable guide.

Receiverships in New Zealand can cover trusts and other entities, and not merely limited liability companies. This, and our PPSR regime puts New Zealand on a different path from the Australians, even as we move towards them by embracing Voluntary Administration.

$175+gst Lexis Nexus

It's good to be (Conrad) Black.

Of all the career options outlined to young graduates being a liquidator, (or an Insolvency Practitioner as some prefer) is not on the list. And perhaps that is a good thing. Insolvency work is like working in a prison. Those who are most keen to do the work are usually the worst people to have in the role. And to be frank, it is mostly unthankful, often goes unrewarded, and occasionally some idiot takes a swing at you.

We have a saying at Waterstone: "Those who can do, do. Those who cannot become Liquidators."

However, every once in a while a liquidation falls into our lap and reminds us why we chose this profession. Black Light Publishing is just such a liquidation.

The appointment

We were appointed by the courts on the application of our client, McCollum's, who were the magazine's publishers. When we arrived in the afternoon of our appointment we found a dejected Black Light team. They had been expecting the axe to fall and were not surprised, (or pleased) to see us.

The business

There is no value in sugar-coating it. Black Light Publishing had made some terrible business decisions. The company had a respectable inner city fringe office with substantial unpaid rent, a nice car with unpaid lease costs, and the director was drawing a stipend.

In their defence they were not living 'a lifestyle' as we often find when we liquidate companies. Had they been doing so we would have been much less sympathetic than we have been to date. The directors were passionate about their product and were desperate to keep the magazine alive.

We think that the directors were running very close to reckless trading. They certainly had a reckless disregard to the interests of their creditors and their plans to turn a profit and pay their bills seemed more fanciful that real to us.

Maybe it was the fabulous Indian Summer we had been enjoying at the time. Maybe it was the same hubris that gets so many magazines into trouble, but we decided to investigate the possibility of publishing the magazine in liquidation. We were certain that the assets of the business totalled less than the cost of advertising the liquidation in the gazette so the only way to realise value would require a more creative approach.

Black Magazine is now for sale.
Contact Waterstone 0800 CLOSED.

The magazine

All we can say about the magazine is that we are not the target demographic and leave it at that. No one wants to know the creative opinions of Insolvency Practitioners so we will not offer them.

When we arrived the autumn edition was almost ready and there were enough advertising sales to cover the cost of printing the magazine plus pay for some disbursements like the graphic designer.

Funding Creditors Agreement

Once we were ready, we approached McCollum's and outlined our plan. We wanted to print the next edition, and in return for McCollum's taking the credit risk on the printing cost, they would receive a share of the profits from the sale of the masthead.

Magazine Anyone?

We went to print, and the end result is in a bookshop near you.

The magazine business is not for the faint hearted and it would go best with someone who has a stable of other publications, or someone who can afford to fund a magazine for the sheer pleasure of owning a magazine. (Owning a magazine carries much more cachet that a boat, especially in Auckland. Everyone has a boat! And if you own the magazine at least you can guarantee you will never simply be a visitor from the Hawke's Bay in your own society pages.)

Offers over $100k will be looked at, vendor finance also considered.

How bad is it? Conflicting evidence from the front lines

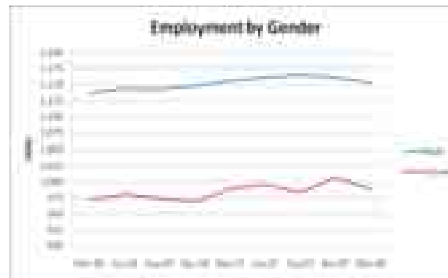
The credit issues flowing out from the United States hit parts of the New Zealand economy quickly. The failure of a dozen finance companies and rising interest rates hit quickly. Employment, however, remained stubbornly high, evidently defying the crumbling fundamentals.

We do not lay claim to any economic insight but we can report from the front lines of insolvency many business owners are using some creative methods to cover their overheads. Faced with falling sales and fixed overheads like staff and rent, business owners are choosing to fund the shortfall by:

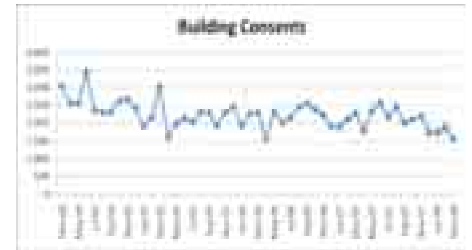
Not paying the IRD
Extending creditor's terms
Increased debt on the family home

These measures have proved effective at keeping employment high, but as the graph below shows, this strategy is running its course. Businesses are finally laying off staff, and this has caused a drop in the total number employed.

A closer examination, however, shows that women have taken the brunt of this downturn. It is reasonable to assume that this reflects businesses shedding auxiliary staff. A law firm facing a downturn in work is likely to let their (mostly female) legal executives and admin staff go, while keeping hold of their lawyers. Looking at the steady increase in employment rates over the last two years, especially in female employment, probably reflects a booming, labour hungry economy, attracting with high wage rates those who would not normally participate in the labour force.



The recent decline, therefore, need not be the harbinger of a wider economic downturn, but only the cooling off an overheated labour market. The dramatic headlines in the mainstream press are not borne out in the numbers. All we are seeing is the return to the numbers of twelve months ago.



Of more concern is the building consent numbers. Building consent numbers are important because of the critical part the building industry plays in the wider economy. Each new house is $200k to $400k worth of investment, all funded with (mostly overseas) borrowed funds, flowing into the economy. A decline in new buildings reflects a decline in real economic activity. Less income to tradesmen, real estate commissions, margin for building suppliers, advertising revenue, etc. The decline of building consent numbers show a steady decline from 2,500 a month to 1,500 a month.

In our opinion, the economy is very weak and is being supported by business owners propping up their business. Over the next twelve months we expect to see many of these businesses fail, and these failures will have a compounding ripple effect on increasingly distressed firms. A domino effect.

Reference: Statistics NZ

IN RECEIVERSHIP - MUST BE SOLD

Instructions Clear - All 4 Must Be Sold

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