Insolvency 101

The Fundamentals

waterstone INSOLVENCY

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Introduction

The Media often use the terms Receivership and Liquidation interchangeably and for most practicable purposes the two regimes are identical but there are some important distinctions between them.

It can help to understand how these two regimes have evolved to appreciate their modern distinctions.

Liquidation; A brief history

Companies are creations of statute or royal decree. Prior to companies existing firms were nothing more than individuals pooling their resources and all being personally liable for the debts of the enterprise if it failed. It wasn't until 1855 when the Limited Liability Act was passed, ensuring that investors in English companies could escape the full consequences of their enterprise failing.

Commercial and personal insolvency were and remain very similar regimes. Commercial insolvency can trace its history to the English Joint Stock Companies Winding Up Act 1844 which mandated that the personal bankruptcy regime would be imposed on an insolvent company.

With a personal bankruptcy the commercial life of the person ends but the person does not. Bankruptcy has a body of laws regarding what happens to the person after bankruptcy which liquidation doesn't. Liquidation is the statutory mandated end to the company and the rules around what happens to a company once in liquidation are entirely created by Parliament in the different jurisdictions.

Parliament, through Schedule Seven of the Companies Act 1993, mandated how the assets of a failed company should be divided up and in New Zealand this was as follows;

- Liquidator Fees
- Staff for unpaid wages and holiday pay (Up to $22,160)
- Unpaid GST and PAYE
- Unsecured Creditors
- Shareholders

Receivership; A brief history

Before dealing with receivership it helps to understand the special situation of a secured creditor. This is someone who has advanced money using a specific asset as collateral. The classic example today would be a finance company who advances money for the purchase of a car and takes the car itself as security. If the purchaser defaults, the car can be taken.

This arrangement was very popular historically but as commerce evolved debtors wanted to use intangible assets, like their debtors or their work-in-progress as security. The challenge is that such intangibles change. Debtors pay, new invoices are raised, so the idea of a ‘floating charge’ arose.

Here a secured creditor would enter into a contract with the debtor that said if the debtor defaulted on a loan, the debtor could take over the enterprise, usually a company, and all its assets at the time the charge was enforced, including any outstanding invoices.

The creditor took in effect, a security over the company and they could take possession of it in a way not dissimilar to repossessing a car. A receiver, once appointed, would have whatever rights were negotiated between the parties when the loan and security was agreed.

Receivership evolved as a self-help remedy independent of Parliament and the effect of a receivership was to defeat Parliaments’ wishes because all of the company’s assets went to the secured creditor, leaving nothing for staff and the IRD.

In reaction, Parliament has specified that, unless specifically charged, a company’s accounts receivables and their inventory must be used to pay for unpaid wages, holiday pay, unpaid GST and PAYE.

As a consequence, receivership, has become subject to legislative oversight to align it to liquidation.

All commonwealth jurisdictions now have receivership law to compliment this process but fundamentally receivership is a function of a contract between the debtor and their creditor. Liquidation is a statutory process designed by Parliament.

Liquidation

The Start

Liquidation occurs in two ways. Usually shareholders vote to place the company into liquidation. This requires 75% of all shareholders to vote for liquidation and the resolution must agree on the Liquidator.

In some companies it is possible for the board to trigger a liquidation but this power must be explicitly included in the company's constitution.

Around a third of companies are placed into liquidation by the High Court. This usually follows a simple process;

Step One;	Creditor issues a Statutory Demand
Step Two;	No response from the statutory demand; after 15 days make liquidation application
Step Three;	Serve liquidation application on company. Company has two working days from this notice being served to appoint their own Liquidator
Step Four;	The Court hears the application and if convinced, appoints a Liquidator requested by the petitioning creditor

The Statutory Demand

The statutory demand, often just called the stat demand, is a demand for payment in a specific format as outlined in Section 289 of the Companies Act 1993.

It has several key elements; it must be served on the companies registered address or in some cases a director. It must be for an undisputed debt, be over $1,000 and payment must be made within fifteen working days.

If payment isn't made at the end of the fifteen days the creditor has thirty days to being a liquidation application.

The most important element of a stat demand is the ten days the debtor has to raise a challenge. Here the debtor must go to court to prove that the debt is either not owed or is disputed. This application is usually called a 290 application, as the process around it is governed by Section 290 of the Companies Act.

The Ten Day Rule

Once a company has been served with a liquidation application they have ten working days to appoint their own Liquidator or Voluntary Administrator. If they do not do so in that time they are unable to do so and must wait until the matter is called before a court and they will usually get a Liquidator appointed by the High Court.

It is customary for the petitioning creditor to make a recommendation to the court as to who the Liquidator should be and the High Court usually follows this request. However, the court is not bound to do this.

The Liquidator

Currently insolvency is an unregulated industry. Any idiot can be a Liquidator and a few are. However, only a very few. Most practicing Liquidators are chartered accountants or professional insolvency practitioners.

A Liquidator cannot have an ongoing commercial relationship with the company they are going to be Liquidator of, including being a director or shareholder in the last two years.

It is also not permitted for a Liquidator to have an ongoing business relationship with the shareholders of the company entering liquidation.

If there is a conflict the Liquidator can make an application to the High Court for a dispensation. This is usually given.

The Creditor's meeting and replacing a Liquidator

In most cases the Liquidator will dispense with a creditor's meeting. However, if a creditor wants one they have ten days from the time that the Liquidator dispenses with the meeting to call one.

This dispensation usually occurs in the Liquidator's first report, which should be sent to all creditors and is available on the company's office website.

The first report should provide a list of all of the failed company's creditors and a creditor who wants to replace a Liquidator can take advantage of this list to call around the creditors and lobby to replace the Liquidator. This sometimes occurs if the Liquidator has been appointed by the shareholders but rarely if appointed by the court.

In order to replace a Liquidator the motion to replace must obtain fifty percent of the creditors by number holding fifty percent of the debt. A resolution that has a majority of the creditors by where these creditors have only 40% of the debt of those voting will be defeated and the incumbent Liquidator will remain in office.

Two other key features of a creditors meeting;

> Proxies must be in two working days before the meeting and sent to the Liquidator. The Liquidator has no discretion in this matter. If the proxy is sent late it cannot be used.
>
> A creditor can arrive at the meeting with a completed proof of debt form and, with the discretion of the Liquidator, be accepted for voting. A creditor that has not completed a proof of debt from cannot vote.

The Creditor's committee

A creditor's committee can be elected at a creditor's meeting and there is a requirement that the committee have three members. The committee has very little real power but can be useful for a Liquidator dealing with a complex liquidation where the views of the creditors need to be canvassed. Usually, however, Liquidators prefer that there isn't a creditor's committee.

Insolvent Transactions

Also often called voidable transitions, these are transactions that occurred in the last two years of a company's life that then Liquidator can seek to set aside. If the company as placed into liquidation by the High Court this two year period begins on the date that application to liquidate was filed at the court.

In almost all cases the only transaction that the Liquidator is seeking to set aside is the payment of money to creditors. The rules for insolvent transactions are tricky but they can be summarised as;

A From the two years before liquidation to the end of the trading relationship the net reduction of debt between the company and the creditor is voidable

Plus;

B Any payment from the company to a creditor that occurred after the trading relationship had ended is voidable.

As an example; A timber supplier was owed $300,000 two years before the shareholders placed the company into liquidation. They traded for another six months and the debt fell to $180,000. At that time they stopped supply and another $40,000 was received after supply was terminated.

The voidable transaction would be A; $120,000 ($300,000 -$180,000) Plus B; $40,000; a total of $160,000.

However, if the creditor can show that they;

Had no knowledge that the company was insolvent ☑

And

Acted in good faith ☑

And

Gave value or altered position ☑

In order to resist the Liquidator's demand the creditor must tick all three boxes. Two out of three isn't enough.

Liquidator's Powers

One of the remarkable features of our insolvency laws is the power of a Liquidator to interview a range of individuals under oath.

This includes not only the company's directors, but their staff, suppliers, accountants, lawyers and bankers. This is defined under Section 261 of the Companies Act and a 261 Notice is a letter sent by a Liquidator requesting information under their powers.

A Liquidator is an agent of the company so they also have the right to request any company documents in the same way that a director would. Usually this is sufficient when a Liquidator is dealing with most enquiries.

A Liquidator's powers of interrogation are frightening.

Reckless Trading

Few topics create as much excitement as reckless trading. However, actions for reckless trading in New Zealand are very rare. Less than a dozen judgements a year are obtained and most Liquidators currently active have never obtained a judgement against a director for reckless trading.

In general courts are very reluctant to hold a director liable for the losses of their company. At the heart of company law is the concept of the Corporate Veil.

A company is a separate legal entity from its directors and shareholders and directors are not liable for the debts of the companies that they manage.

Navigating through stormy waters can take its toll.

However, a director has specific obligations to the company that they are in control of and if they breach those duties then the door is opened for the company, through it's Liquidator, to hold the director personally liable.

Those duties include;

To act in the best interest of the company

To keep proper accounting records

Not to incur a debt on behalf of the company without a reasonable belief that the company can meet that obligation

Not to trade the business in a reckless manner

A Liquidator must prove that the director breached these obligations and once that has been successfully done the High Court must then be convinced that it should exercise its discretion to make the director pay for some or all of the company's losses.

This is often difficult and the courts are especially reluctant to compensate the companies for the time and legal costs of the Liquidator in taking this exercise. As a result, even if the Liquidator is successful, there is invariably never a result for the unsecured creditors.

Director's Current Account and Section 161

In many cases a director will not take a salary from the company but will prefer to take drawings. This makes sense if the company is losing money because there is no PAYE on the income taken. However, if the company then fails the Liquidator will treat any overdrawn current account as an asset and demand it from the director.

This demand can be very difficult to resist legally.

However, often overlooked is Section 161 of the Company's Act that specifies that any income, even a salary that a director wishes to take from the company must first be approved by the board and that such a resolution, when passed, should be fair to the company.

A director who takes a salary but omits to obtain a 161 resolution can find themselves on the receiving end of a Liquidator's demand for repayment of their salary.

Secured Creditors

If a creditor has a security this remains unaffected by the liquidation. There are five types of securities that are relevant;

GSA	A General Security Agreement is a security over all of the company and its assets and usually includes the right to appoint a receiver. However, the law allows that any debtors and stock that the company has at the time of liquidation must first be used to pay staff their holiday pay and the IRD for unpaid GST and PAYE.
PMSI	A Purchase Money Security interest is a charge over a specific asset where the creditor lent the money to the debtor to buy the specific asset secured. This can include a supplier who gave credit to allow the debtor to buy their product. A PMSI is registered on the PPSR.
Romalpa	A retention of title contract, often called a Romalpha clause, is an agreement that says if goods are not paid for title shall remain with the supplier.
Factoring	A factoring agreement is where the creditor lends money using a specific debtor as security. In this case the creditor, usually a factoring company, owns the right to a specific debt. In the event of a liquidation the debt is owed to the factoring company and not the company in liquidation.
Secured	A creditor may have a security over a specific asset that is not a PMSI, or the company may have used other assets, such as land, to raise debt and a mortgage will exist over that land.

In the event of a liquidation there can be complex priority arrangements that the Liquidator will need to resolve.

Funding Creditors

The Companies Act allows for a creditor who wishes to fund some recovery action to receive a super priority over other creditors. A typical action would be a legal action to sue a director but it can be any form of recovery.

If the company owns a boat that is moored in Fiji and the Liquidator needs to bring it back to New Zealand, an unsecured creditor can pay to bring the boat back and when the boat is sold is entitled to any recovery.

The funding creditor is entitled to be paid the cost of any recovery action plus the value of the unsecured debt. The rest will then go back into the general pool of creditors.

What a Liquidator does

Once appointed the role of a Liquidator is dependent on the type of company. In most cases the firm has long since ceased trading and all that remains to be done is clean up any remaining assets, collect any debts owing to the company and investigate the books to see what if any legal action can be taken against the directors.

However, in some cases the company will be trading when the Liquidator is appointed. There is no requirement on the Liquidator to cease the operation. The default option, in practical terms, will be for the Liquidator to see if they can sell the business as a going concern.

If this is possible the Liquidator will usually fire all of the staff and put them on temporary contracts, followed by making temporary arrangements with key suppliers, including the landlord, in order to keep the business intact for as long as necessary to see if a sale can be achieved.

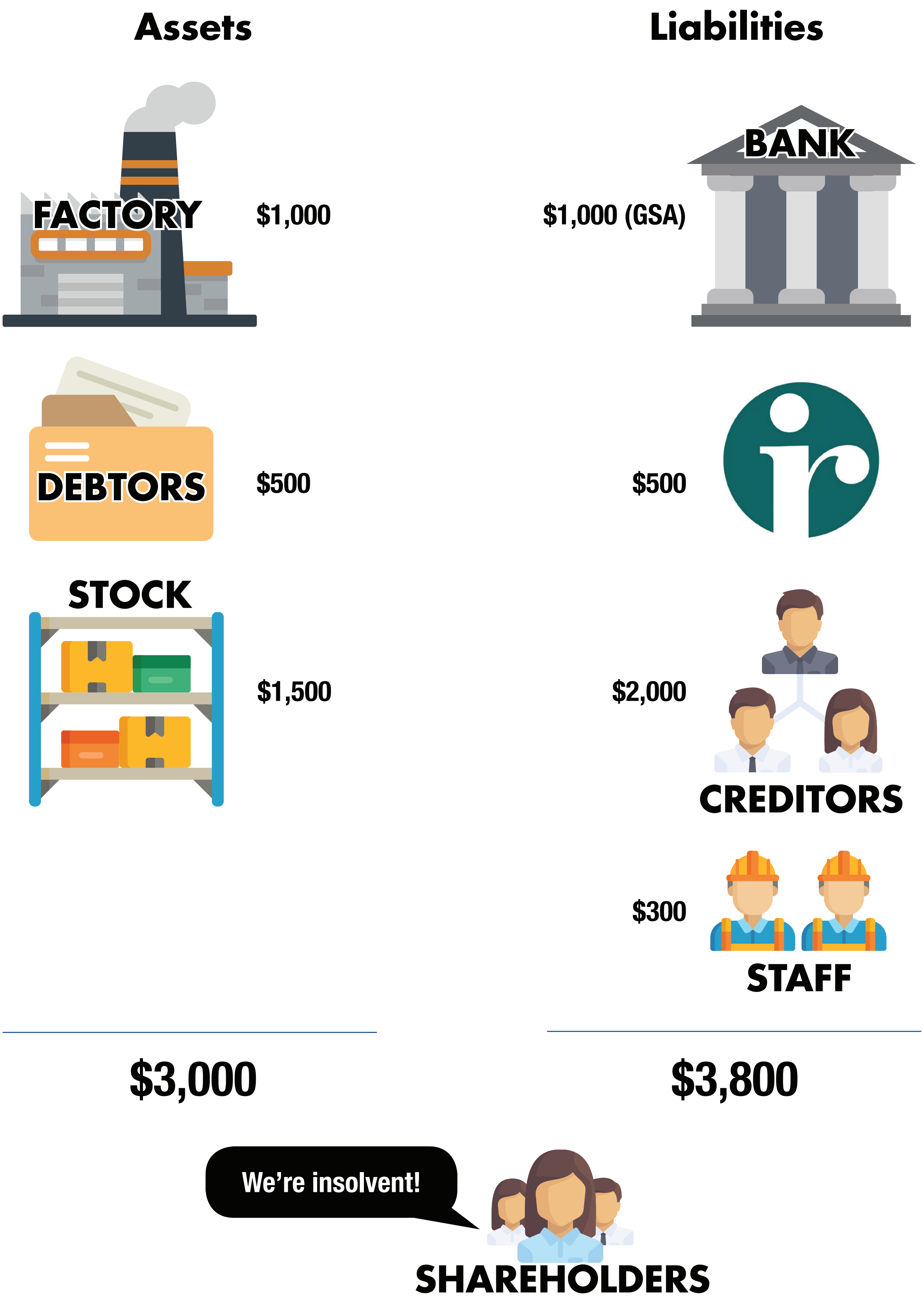
The Liquidator will be able to sell any stock or other assets that are not secured in order to fund this activity and in the case of a retail store it might be more profitable for the Liquidator to keep the doors open and sell the stock to the general public than close the doors and try and sell whatever assets the company has on a wholesale basis.

End of Liquidation

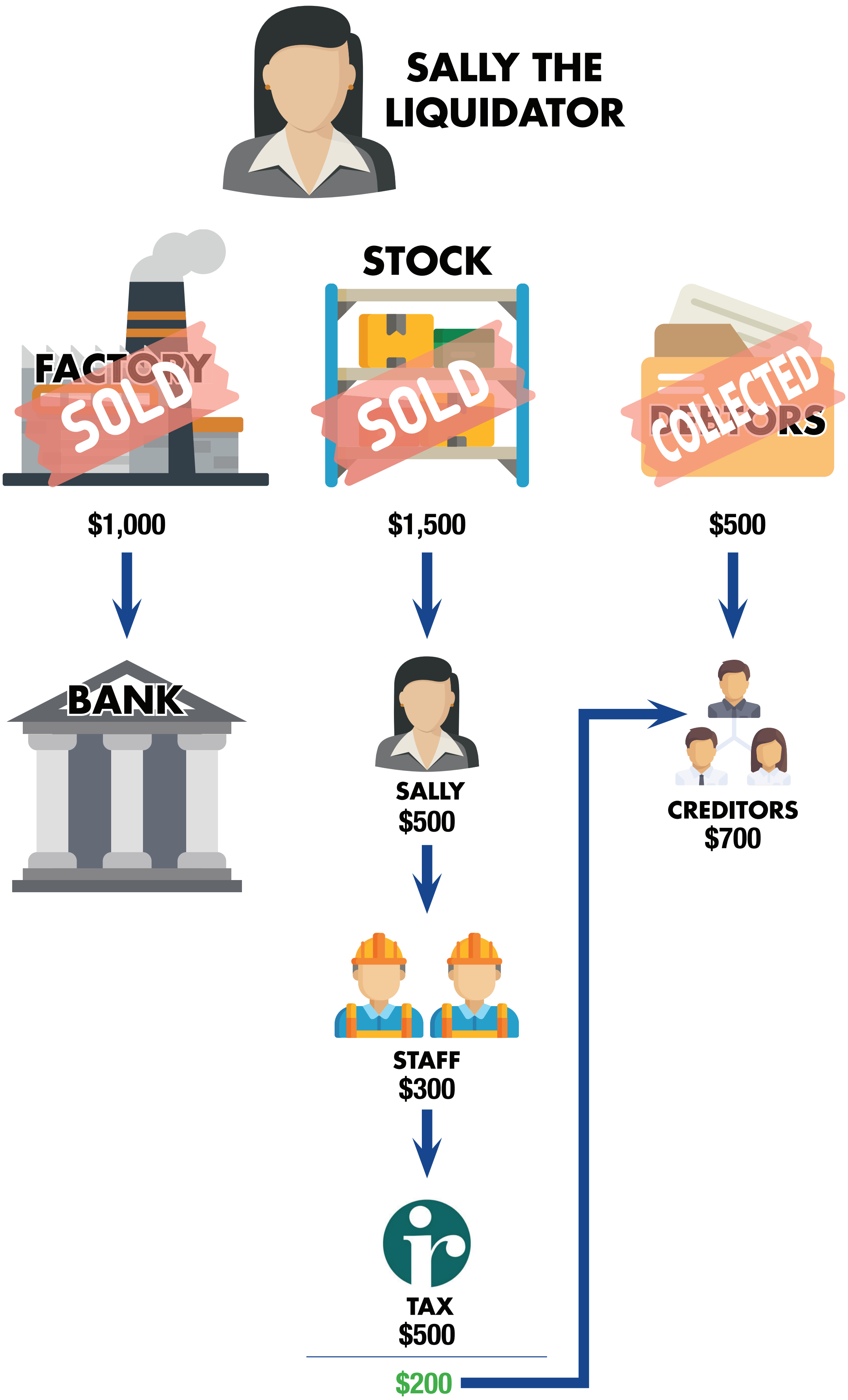
Once the liquidation is completed the Liquidator will write their final report and the Companies Office will strike the company off the register. The Liquidator must keep records for twelve months from the date of strike off.

All washed up.

Liquidation - Step 1



Liquidation - Step 2



Receivership

The Start

A receivership will commence when the General Security Agreement (GSA) holder appoints a receiver. Prior to that the GSA holder usually must demand from the debtor repayment of the debt and the company given enough time to make the payment.

However, many current GSA agreements allow for the GSA holder to appoint without notice if they have valid grounds for concern over the solvency of the debtor.

Once the receiver is appointed they have full control over all of the company's assets and are able to do everything that the director of the company could have done.

Triggering event

The GSA holder will have lent the debtor company money and have taken a GSA over the debtor company to secure the loan.

When this loan falls into default this will trigger the creditor's rights. If the debtor remains compliant with the loan repayments then the GSA holder will have no right to appoint a receiver.

However, many GSA contracts have a catch-all clause that allows the GSA holder to appoint a receiver if they have reasonable ground to believe that their security is in jeopardy despite the terms of the loan being adhered to. This can include an application to liquidate the debtor company, trouble with the directors resigning or some other external event that makes it clear that the debtor is not going to be able to perform on the loan agreement.

Receivership and Liquidation

It's not uncommon for a company to be in both liquidation and receivership. The receiver will have full control over all of the physical and intangible assets but the liquidator retains certain powers to investigate the affairs of the company and the right to take legal action against the directors if necessary.

The liquidator also has the power to oversee the receiver and a receiver is subject to a liquidator's investigative powers.

Directors and Receivership

During a receivership a director remains in office but has no real power. Once the receivership ends the directors retake control of the company, although usually this is a hollow task as all of the assets will have been disposed of.

However, a director retains the power to take legal action against the receivers on behalf of the company.

The Receiver

A receiver is not the agent of the secured creditor who appointed them but of the company in receivership. They have a responsibility to the GSA holder who appointed them but also a duty of care to both the debtor company and to the other creditors of the debtor company.

A receiver who fails to act in the best interests of the company in receivership can be sued in much the same was as a director if their actions breach their duties to the company in receivership.

A receiver should not, for example, sell an asset belonging to the company as a discount if that will result in their client being paid if to do so would be negligent.

Importantly, a receiver is personally liable for all of the costs incurred on behalf of the company during the receivership. This is to ensure that creditors who are engaging with the company can have confidence that they will be paid and it is usual that the receiver will take an indemnity from the party that appointed them.

Creditor's Rights

Secured and unsecured creditor's rights remain intact during a receivership. If a creditor remains unpaid they can take the company to court and seek to have it placed into liquidation. If a secured creditor has a right to repossess their asset they can do so.

The appointment of a receiver isn't a statutory process, as in liquidation, it is merely the result of a contract between the debtor company and the creditor that in the event that there is an act of default a receiver can be appointed.

During a receivership, however, secured creditors can choose to leave their assets in the hands of the receiver. While the receiver has possession they can be confident that they will be paid and if the receiver manages to sell the business they might get to retain an ongoing relationship with the new owners.

What a Receiver does

As in a liquidation this depends on the type of business but in a receivership it is far more likely to be an actively trading company. The receiver, mindful that they will have personal liability, will move to get the staff onto new contracts with little or no notice periods and seek to either sell the business as a going concern or manage the wind-down of the business in a way designed to maximise the recovery.

A receiver is not obligated to call a creditor's meeting and they almost never do so. However, a receiver will solicit proof of debt forms from creditors to ascertain who is owed what. Schedule Seven of the Companies Act outlines which creditors get paid what from a liquidation and applies equally to a receivership.

Receiver's Powers

A receiver has no more power than the director of a company and potentially less if the GSA limits the receiver's powers.

In practical terms the receiver can sell assets, borrow money against company assets, hire and fire staff, demand information from banks and other suppliers of the company and interview the firm's staff.

Unlike a liquidator, however, staff and others with knowledge of the affairs of the company are not obligated to be interviewed by a receiver.

Distributing Assets

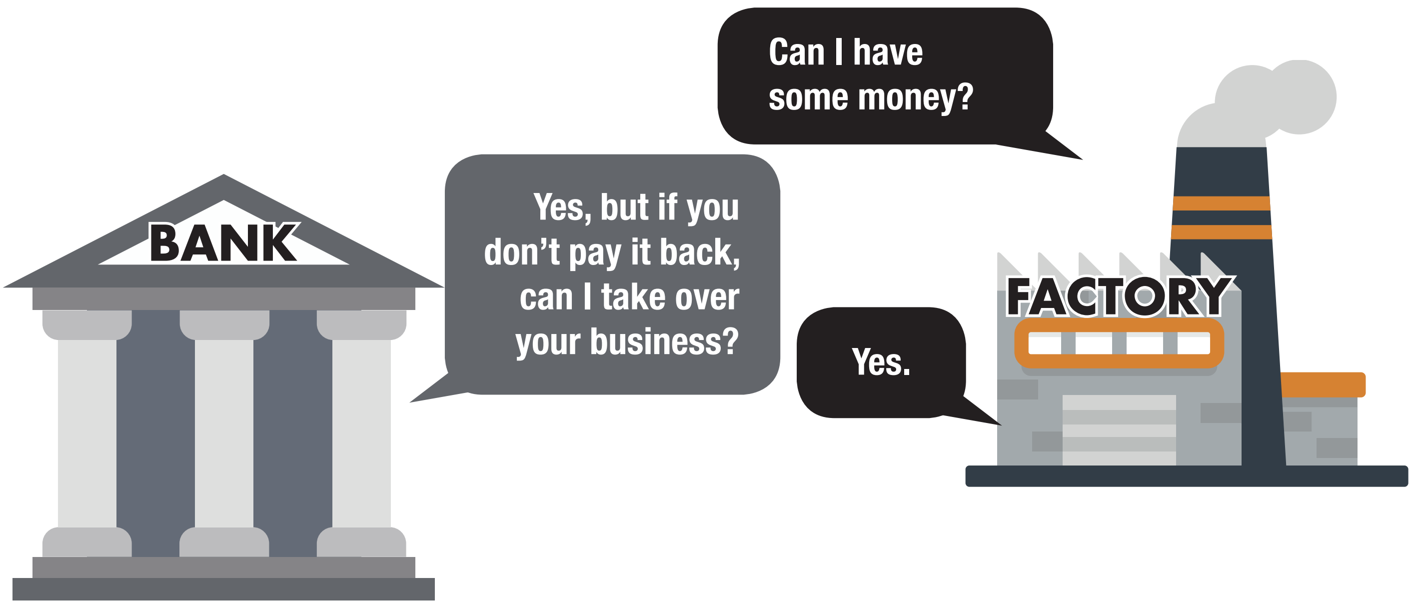
Although the receiver has been appointed by one secured creditor they must follow the law in terms of how to pay out the money recovered from selling the business and there are some key issues.

The main one is that the proceeds of stock and debtors must be used to pay preferential creditors; specifically staff for unpaid holiday pay and the IRD for unpaid GST and PAYE. The other key task for a receiver, as for a liquidator, is ensuring that proceeds are distributed according to the complex rules around the PPSR and priority rules over secured assets.

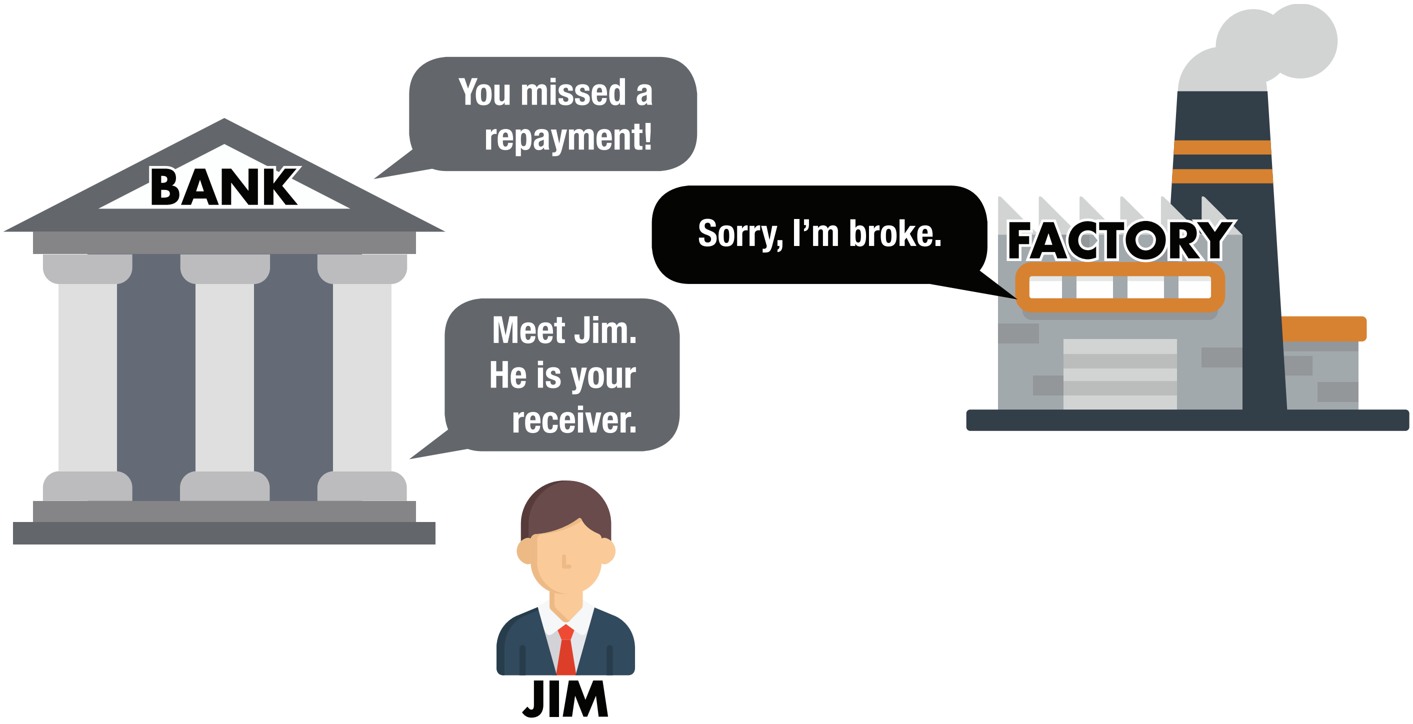
End of Receivership

Once the receivers have completed their tasks they resign and hand the company over to the board, or if the company is in liquidation, the liquidator.

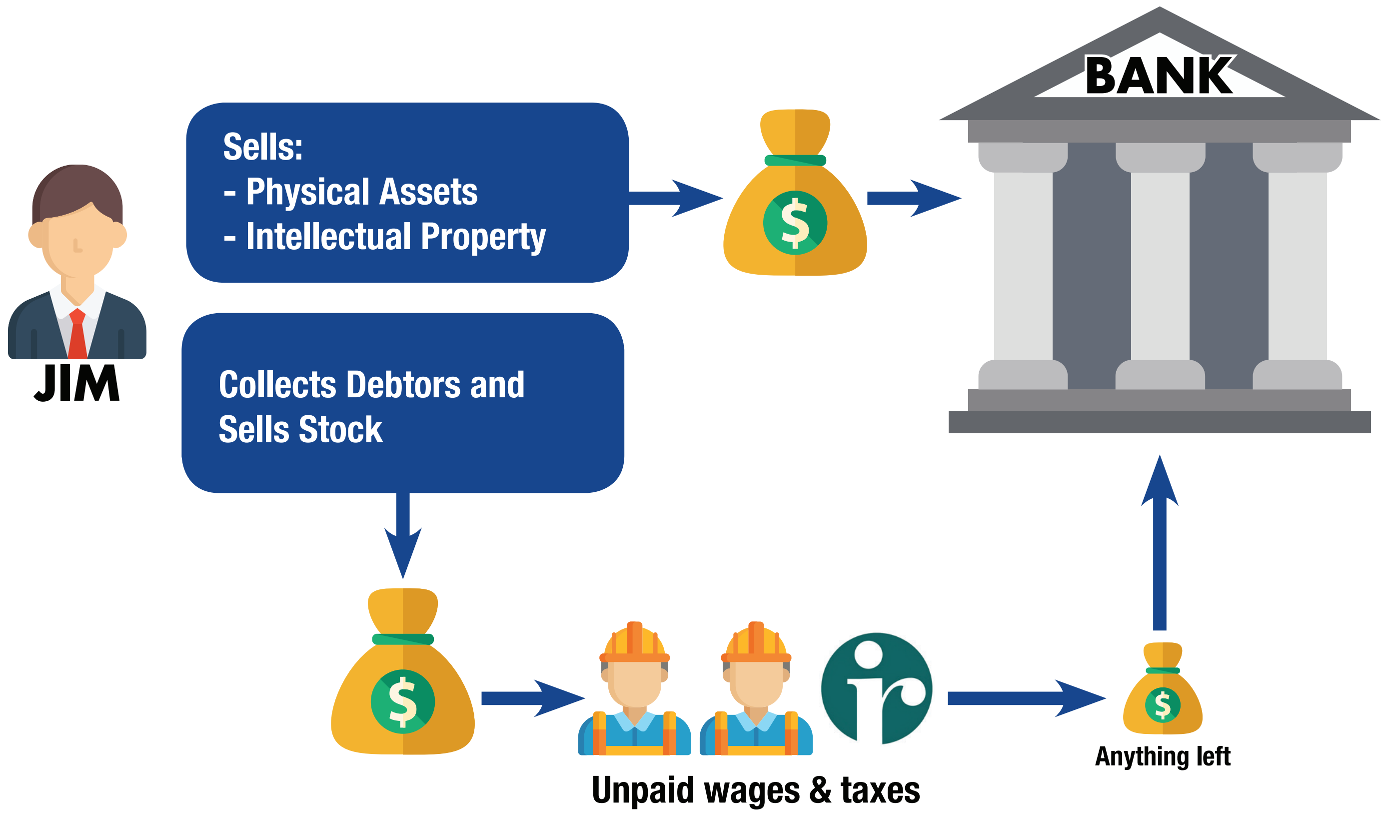
Receivership - Step 1



Receivership - Step 2



Receivership - Step 3



Receivership and Liquidation; Practical distinctions

Despite their very different historical origins today the regimes are virtually indistinguishable to an external observer but important distinctions remain. A liquidator is a role created by Parliament and a liquidator has a range of investigative and legal powers that neither a director nor a receiver has.

Parliament has mandated how the assets of a failed company should be handled and imposed the liquidation regime onto receiverships; so as far as creditors are concerned the process should result in an identical outcome. However, there are some residual distinctions.

The End

A receivership isn't the legal end of a company. Once the receiver has done their work they resign and hand the company, usually stripped bare of any assets, back to the directors.

Once a liquidator has completed their work the company will be struck off the companies register.

Voidable Transactions

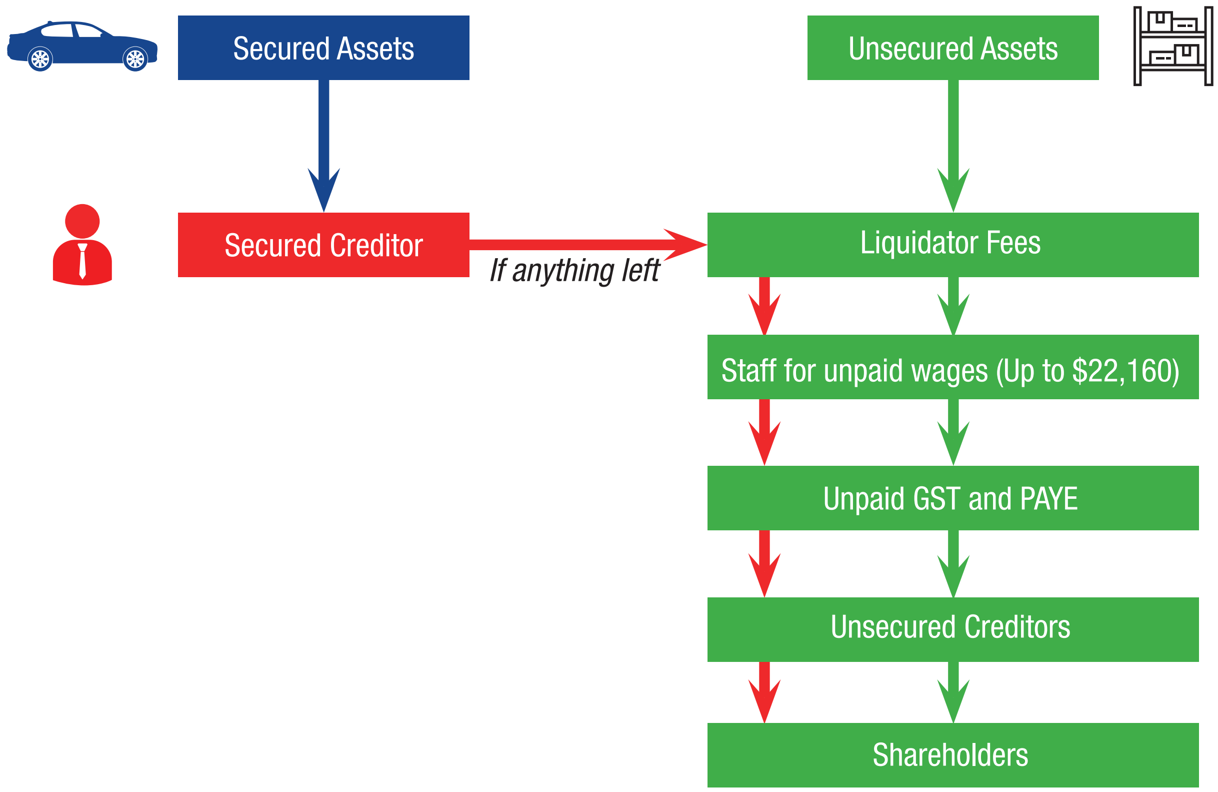
Recent court decisions have meant that the voidable transaction regime is mostly defunct but only a company in liquidation can make a claim for a voidable transaction. There are no voidable transactions when unless a company is in liquidation.

Investigation

Liquidators have substantial powers to interview a range of people associated with the company under oath. This includes directors, bank officers, lawyers and in some cases creditors. A person confronted by a liquidator exercising this power must answer the questions put to them and lying under oath is considered perjury.

A receiver has no such authority. The powers of a receiver is limited to the powers that the company had prior to receivership. This reflects that receivership is a contract between a debtor company and their creditor. Liquidation was designed by Parliament and Parliament has given liquidators special powers.

To understand how the distribution works, given the existence of not just a GSA but secured creditor's generally the distribution waterfall can be updated as follows;



Sadly; for most creditors, once a company sinks, they will receive nothing.

Classes of Creditors

Before we go any further it is helpful to consider that there are, in insolvency, different classes of creditors.

At the top are the secured creditors. These come in two forms; those with a specific security over an asset and those with a General Security agreement (“GSA”).

Specific Security Creditors

This includes the example of the finance company who advances money to the company to buy a car, or who may have lent the company money taking a specific asset as a security. It is common for factoring companies to lend money using debtors as collateral.

Other common examples are photocopier suppliers who sell their equipment on finance. The photocopier firm usually has their own finance arm who lend the money and lend the company the cash to buy the equipment.

It is also very common for suppliers to give credit and to take as collateral the goods they have provided. An example would be a building supplies firm providing timber to a builder on credit. The builder agrees that the supplier can repossess the timber if they remain unpaid for, although if the timber is attached to a building the supplier may find they have lost their security to a person with a mortgage over the land.

Less common would be an example of a lender agreeing to advance funds based on taking an existing specific asset as security. A factory may agree to borrow money and agree that if they default the lender can take possession one of their pieces of equipment.

Factoring companies are also in this class. They lend money to a firm based on a specific security, being the invoice raised. If the company fails the factoring company can demand that the invoice be paid directly to the factoring company as they owned this specific asset.

General Security Agreement Creditors

Formally called debentures, this is a charge over the entire company. The debtor company agrees that in the event that they default the GSA holder can take all of the assets of the company as repayment of the debt.

It is typical for a GSA to include the right to appoint a receiver in the event of a default but this isn’t always the case.

In the event that a receiver is appointed the receiver becomes the agent of the company and has the same rights as the director of the company to enter into contracts, sell assets, employ staff etc.

The one complicating feature of a receivership is what happens to account receivable and inventory of the debtor company.

The idea of a GSA is that the debtor company can buy and sell stock, raise invoices and collect payments. As it does so the asset position of the debtor keeps changing and so does the level of security of the GSA holder. Only when the GSA appoints a receiver does the GSA holder get to claim the outstanding invoices and stock on hand in repayment of their outstanding debts.

However; under the Companies Act and the Receivership Act Parliament has clipped the wings of a GSA holder and mandated that any outstanding debtors and inventory be used to pay for outstanding wages and preferential taxes ahead of the GSA holder.

Preferential Creditors; Staff

In the ranking of creditors, unpaid wages and holiday pay rank the highest; up to a maximum of $22,160 per employee. This preferential claim extends only to debts owing for unpaid wages and holiday pay. This will include commission for sales, untaken holiday pay and unpaid worked days.

Claims by staff who have receipts for expenses such as mileage allowance are not preferential, but are unsecured.

Preferential Creditors; PAYE and GST

The IRD is a preferential creditor but only for its core unpaid GST, PAYE, RWT and NRWT. Unpaid income taxes or accumulated interest and penalties are not preferential.

Preferential Creditors; Accounts Receivable and Stock

Importantly, if the company is in receivership the receiver must use the proceeds from the accounts receivables and inventory to pay preferential creditors before paying the GSA holder any proceeds from these assets.

However, if a supplier who sold the company the inventory has a specific security over the stock, then the secured creditors have a priority claim over the assets ahead of the preferential creditors.

Unsecured Creditors

Finally we come to the unsecured creditors. These creditors can only be paid once all the secured creditors have been paid out, the preferential creditors have collected everything owing to them and the liquidator and/or receiver have also taken their share.

It is very unusual for unsecured creditors to receive anything from an insolvency.

Creditors and the Pari Passu Philosophy

Pari-Passu, literally Equal Step in Latin, is the basis upon which creditors of a set class are paid from an insolvency.

Creditors of an equal class are paid equally as funds become available. If a liquidator or receiver has funds to pay the staff some of their outstanding wages but not all of it, then all of the staff will receive an equal percentage of what is owed.

If the preferential and secured staff are paid in full then the unsecured creditors will also be paid out equally. If there is one million dollars of unsecured creditors and only two hundred thousand to pay them, then all unsecured creditors will receive twenty cents in the dollar, regardless of the size of their debt.

Creditors and the Proof of Debt Form

Although distributions are not common, liquidators and receivers can only legally pay those creditors who actually submit a claim form. When a liquidation is advertised you will typically see the liquidator sets a date by which creditors must claim, usually about a month after the date of the advertisement. By law a liquidator must wait twenty working days before making any distributions to allow all creditors to submit a claim.

Beyond that date a liquidator can make a distribution and any creditor who has not claimed is not entitled to anything. They can still submit a claim into the liquidation and get a distribution of any subsequent distributions but no provision will be made for the fact that they missed out on the first distribution.

Some creditors go down with the ship: others find a way to get to shore.

Part XIV Compromise

Buried in the Companies Act is Part 14. This is a small section, merely a handful of pages, and it's surprising that more isn't known of this regime.

It provides for a company to come to a deal with their creditors and if enough creditors agree with the proposal the deal becomes binding on all creditors, even those who oppose the deal. Under a compromise all of the creditors in a class can vote to approve an arrangement put to them by the company. This agreement, if it wins the support of half of those creditors voting with over 75% of the total debt voting, becomes binding on all creditors in that class; but only in that class.

There is a lot of flexibility in how the compromise can work and although each compromise is limited to a single class it is possible to make conditional agreements; such as that a deal offered to one class of creditors is only binding if a similar deal is agreed to by a different class.

It is easiest to outline the options by way of an example.

Let's take a printing company, they are always getting into financial strife. They owe their trade creditors $1.8m dollars, as well as owing the IRD $400k for unpaid GST and PAYE and a further $200k in interest and penalties. To add to the directors' stress they owe the bank $200k, and this is secured by $50k each.

The staff will also be preferential creditors but we will leave them out of this example for simplicity.

There are, therefore, four classes of creditors.

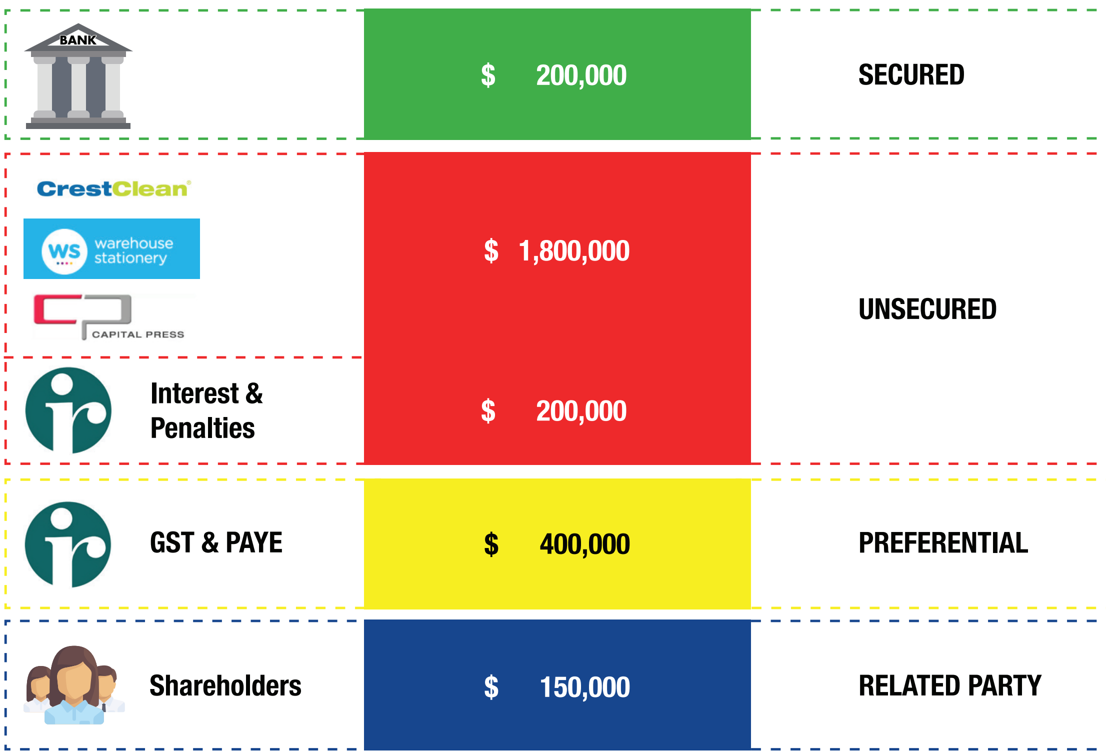
- Unsecured: $2m. This includes $1.8m of trade creditors and $200k of IRD debt.
- Preferential: The IRD $400k for unpaid GST and PAYE.
- Secured: The Bank, with a GSA for $200k
- Related Party Creditors: The Shareholders, a total of $150k

Let's have a look at what the balance sheet of this struggling printing company looks like;

Assets:		
Cash	$	10,000
Work in Progress	$	550,000
Physical Assets	$	600,000
Total Assets	**$**	**1,160,000**
Liabilities:		
Bank	$	200,000
Trade Creditors	$	1,800,000
IRD GST and PAYE	$	400,000
IRD Interest and Penalties	$	200,000
Shareholder Loans	$	150,000
Total Liabilities	**$**	**2,750,000**
Net Position	**$**	**(1,590,000)**

Clearly, this company is in trouble. The director, however, has recently secured a large contract and is confident that he will keep his head above water if he can just fix the firms broken balance sheet; so he proposes a compromise.

Stonewater Printers Limited



Compromise One;

The director offers to pay the unsecured creditors twenty cents in the dollar. Half now, half in three months. He writes to his unsecured creditors, there are a total of twenty of them.

Only sixteen creditors vote in response and those sixteen are owed only $1.6m.

In order for this compromise to pass the director will need nine creditors voting yes and those nine must represent $1.2m of the debt. In order for the proposal to pass the proposal must only get half of the votes and 75% of the debt of the creditors who actually vote; not the total creditor's pool.

However, he is unsuccessful. Eleven creditors vote for the proposal, but together those eleven only have $1.1m of debt. The proposal fails.

Compromise Two;

Undeterred the director puts up a second offer. This time he offers to pay thirty cents in the dollar but this time personally guarantees the thirty percent and the three shareholders agree to forgive their debt to the company.

This sweetener does the trick and this time eighteen creditors vote and together they are owed $1.8m of the $2m of unsecured debt outstanding.

Of the eighteen who vote, 16 vote yes and those 16 are owed $1,6m.

This means that not only did this compromise pass, but that this agreement is binding on all of the creditors in that class; the unsecured creditors. The deal isn't binding on the IRD for its unpaid taxes, staff for their claims for unpaid wages, nor the bank for its secured debt.

As a result, the company's balance sheet now looks like this;

Assets:		
Cash	$	10,000
Work in Progress	$	550,000
Physical Assets	$	600,000
Total Assets	**$**	**1,160,000**
Liabilities:		
Bank	$	200,000
Trade Creditors	$	540,000
IRD GST and PAYE	$	400,000
IRD Interest and Penalties	$	60,000
Shareholder Loans	$	0
Total Liabilities	**$**	**1,200,000**
Net Position	**$**	**(40,000)**

This still isn't great. Let's look at a third offer the director could have put before his creditors.

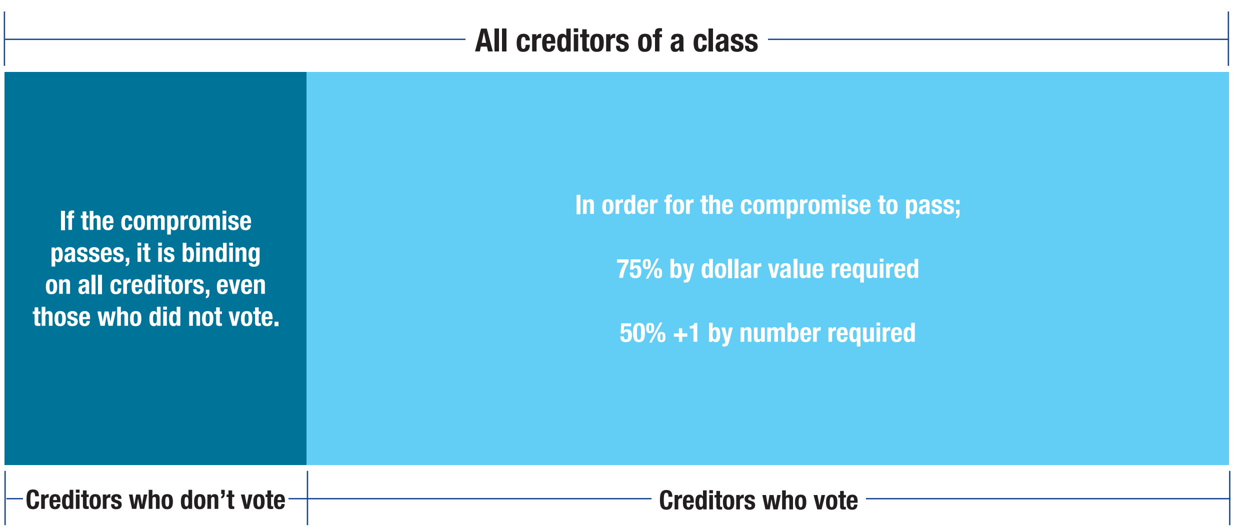
Compromise Three;

The director knows there isn't any point trying to do a deal with the bank. They have a personal guarantee as well a mortgage over his house to secure their debt. He approaches the IRD and asks the IRD if they will agree to waive half of the preferential debt owing to them if the unsecured creditors agree to the proposal and the shareholders agree to waive their debt.

The IRD agrees that they will accept a payment of $200,000 in full settlement of their debt on the condition that the unsecured creditors agree to the proposal as per Compromise Two. In order to meet this commitment the director has to borrow $200,000 from his cousin, Vinnie, who runs a garbage contracting business. This new money is introduced as is treated as a loan to the director.

This compromise passes and the new balance sheet looks like this;

Assets:		
Cash	$	10,000
Work in Progress	$	550,000
Physical Assets	$	600,000
Total Assets	**$**	**1,160,000**
Liabilities:		
Bank	$	200,000
Trade Creditors	$	540,000
IRD GST and PAYE	$	0
IRD Interest and Penalties	$	60,000
Shareholder Loans	$	200,000
Total Liabilities	**$**	**1,000,000**
Net Position	**$**	**160,000**



Voluntary Administration

Voluntary Administration, or VA, is largely redundant in New Zealand today. It is included here only for completeness.

It was introduced in 2008 with the intention of rehabilitating companies but a few structural flaws in its drafting has made the legislation not fit for purpose and it is mostly used now to take advantage of some technical rules.

VA can best be understood as a five step process.

Step One;	The Board of the company appoints an Administrator. This Administrator has complete control of the company until the period of Administration ends, usually six weeks later. The Administrator has all of the powers of a director plus all of the investigable authority of a liquidator. The moratorium begins.
Step Two;	The Administrator must call an initial creditors meeting within a week of their appointment. This meeting is for the purpose of confirming or replacing the Administrator and deciding if they want to appoint a creditor's committee.
Step Three;	The Administrator continues to run the company and draft a Deed of Company Arrangement (DOCA)
Step Four;	The Watershed meeting; held within six weeks, where the creditors vote to either; Approve a DOCA Appoint a liquidator Hand the company back to the board
Step Five;	Post Administration; either liquidation, under a DOCA or back with the board.

VA, despite being completely redundant, has its own terminology.

Administrator	The person or persons appointed to run the company during the Administration. Like a receivership, the Administrator is personally liable for all of the expenses incurred during the Administration. This includes staff costs and rental expenses.
Deed Administrator	In the unlikely event that a DOCA is approved, the person who is appointed to oversee the DOCA
DOCA	A Deed Of Company Arrangement; exactly identical in principal and effect as a Compromise under the part XIV Compromise.
GSA	A General Security Agreement (GSA) Holder has ten days from the

	appointment of an Administrator to appoint a receiver. If they don't they must sit by during the length of the Administration and wait for the outcome.
Moratorium	During a VA minor secured creditors are unable to recover their assets. Thus, a finance company who has a security over a photocopier cannot recover the photocopier during the Administration. They can, however, insist on being paid a rental during the period.
Watershed Meeting	The meeting where the creditors approve or decline a DOCA. To approve a DOCA a majority of creditors with 75% of the debt must approve it. The same rules regarding classes apply as in the Part XIV Compromise. This meeting must be held within six weeks of the Administration commencing but it can be extended with the High Court's approval.

Voluntary Administration as a means of rehabilitation

The reason why VA isn't used as a legitimate means of rehabilitation is that everything that can be achieved under a VA can be done through a Part XIV Compromise and at a fraction of the cost. The need to have an external administrator placed in charge of the company is onerous and there isn't any obvious reason why an Administrator is likely to get a better outcome negotiating a DOCA than a lawyer or insolvency practitioner acting as the company's advisor could obtain.

However, there can be times when the management or board of the business is dysfunctional and external management provided through a VA can be a circuit breaker needed to steer the company and its stakeholders towards an agreement.

Voluntary Administration and Liquidation

To appoint a liquidator 75% of shareholders must agree. A board, however, appoints an Administrator. The most common use of VA is when a shareholder who has less than 75% of the company's shares but has control of the board wants to put the company into liquidation but knows that the minority shareholder will not agree.

The Administrator will then run the VA process over a six week period before the inevitable liquidation at a watershed creditors meeting.

Voluntary Administration and Receivership

It is common to see in a large receivership that the board appoints an Administrator at the same time that the company is placed into receivership by the GSA holder.

The reason for this is that the GSA holder and the receiver do not want to have to deal with the minority secured creditors seeking to recover their assets.

The moratorium is a means by which this can be prevented. The secured creditors must sit and wait until the VA ends before they can collect their assets.

They can and should demand payment for the rental on their assets and if their assets are stock to be sold they are entitled to be paid the wholesale price for their goods if the receiver sells them during the period of the Administration.

Typically the Administrator will seek the court's permission to extend the Administration for up to six months, to allow the receiver time to compete their work without the inconvenience of dealing with the other secured creditors.

The Voluntary Administration regime has sunken with barely a ripple.

waterstone
INSOLVENCY

Auckland	16 Piermark Drive Albany Auckland New Zealand
Christchurch	Unit 3 245 St Asaph St Christchurch New Zealand
Postal	PO Box 352 Shortland Street Auckland 1140
Phone	0800 CLOSED (256 733)
Website	waterstone.co.nz