INSOLVENCY

In New Zealand

INSOLVENCY in New Zealand

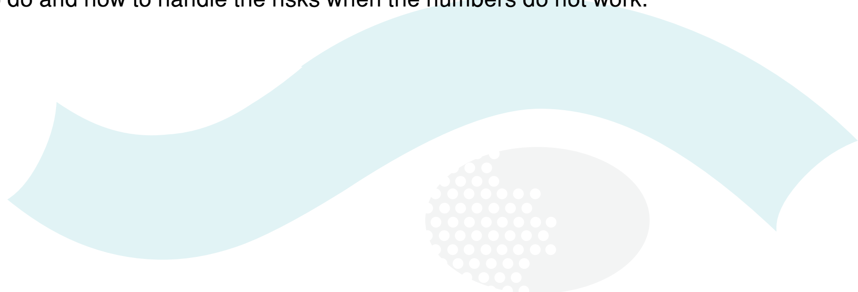
This is a guide to insolvency as practised in New Zealand. Here we look at the options facing companies, their directors and shareholders as they face the challenges of their businesses.

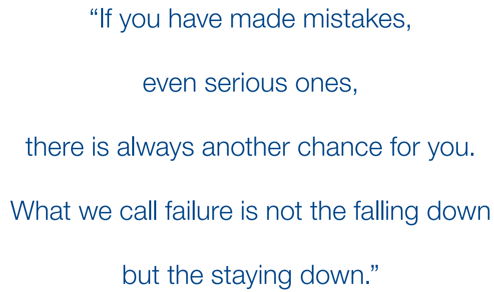
We look at the pitfalls that trap many business people when their business begins to fail and we examine the options that exist for failing businesses.

Despite the hundreds of theories, thousands of books and millions of words written about business, there are four words you need to remember:

Business is about numbers.

Either the numbers work, or they don't. No mission statement, however well worded and glorious, can cover a negative balance sheet for very long and negative cash flow is like blood draining out of the patient. At some point the patient dies. This manual is about what to do and how to handle the risks when the numbers do not work.





Mary Pickford 1893 - 1979

Oscar-winning Canadian movie star and co-founder of United Artists.

Tubthumping lyrics by Chumbawamba, 1997

No publication, even one as humble as this, is the production of a single person. Peter Drennan's comprehensive and well researched section on the PPSA has added a critical enhancement to this version and adds an important component to this manual that was absent from the earlier edition.

Vince Carmine's writing in the section on trading trusts is an important contribution.

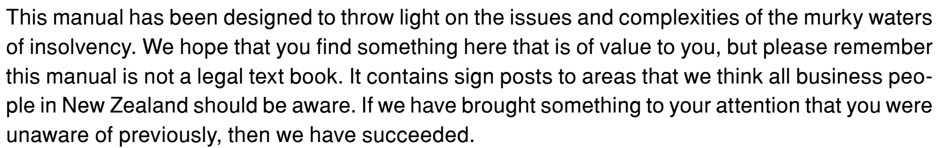
This is the second edition of the Waterstone Insolvency Manual. Ruth Fearnley, Steven Khov and Blerta Xharra worked long and difficult hours to bring the first edition to print against a demanding deadline.

This second edition is the product primarily of Kim Coll, who has equally worked against a relentless deadline and with a difficult client to get this finished product to the presses.

Steven Khov, Josie Hart, Rochelle Bezuidenhout and Rebecca Hindwood are owed a debt of gratitude for keeping the business of Waterstone running smoothly as this project became increasingly time consuming.

Mistakes, errors and omissions are to be laid at my door.

Damien Grant



This manual has been designed to throw light on the issues and complexities of the murky waters of insolvency. We hope that you find something here that is of value to you, but please remember this manual is not a legal text book. It contains sign posts to areas that we think all business people in New Zealand should be aware. If we have brought something to your attention that you were unaware of previously, then we have succeeded.

Our purpose in this manual is to increase the number of things that you now know you do not know enough about. If that makes sense.

For those seeking a deeper understanding of the legal underpinnings of insolvency we recommend the following works:

- Heath and Whale on Insolvency (Lexis Nexis)
- Personal Property Securities in New Zealand (Gedye, Cuming QC, and Wood)
- Private Receivers of Companies in New Zealand (Blanchard and Gedye)
- And of course: Brookers Insolvency Law

We have drawn heavily on these texts for this manual, and in our regular practice. No insolvency practitioner or lawyer working in the field should be without all four close at hand.

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Part One:
Forces Leading to Insolvency

Introduction

The economy is cyclical, going through periods of expansion and contraction. A downturn in consumer or business spending may be temporary, to be followed by a revival the following month, quarter, or maybe next year.

It makes sense not to panic when confronted by a decline in sales or margin. A prudent director will not call in a liquidator after one or two bad months trading. Rather, it makes sense to trade on in expectation of improved numbers, and maybe make some changes to the business to help it trade through.

Businesses, however, also go through a life cycle. Growth, maturity, decline. Managers and directors who mistake a terminal decline in their numbers for a temporary cyclical movement can find themselves in trouble.

Reading the signals can be difficult for a business person, especially when they see their numbers falling in a general economic downturn. Are they facing a temporary decline, to be followed by a revival, or are they seeing the numbers of their business move permanently into the red?

This guideline is not the forum for an extensive review of the reasons for business failure. There is a wide and rich vein of literature on this subject. However, before we review the mechanics of insolvency in the New Zealand context some people might find it useful to know what we see, as insolvency practitioners, operating in New Zealand.

CHAPTER ONE: INLAND REVENUE

Easy Money

Unlike all other creditors, the Inland Revenue Department (IRD) cannot refuse to supply. If a firm does not pay the IRD, nothing happens (in a hurry anyway). Indeed, cash flow improves once the PAYE or GST cheque is not sent out.

Even more accommodating, the IRD does not have a collection department who rings every two days asking for payment. The IRD is a silent creditor. Their demands for payment can be left to accumulate, unopened in many cases, in the top draw.

This involuntary extension of credit by the IRD allows firms to continue trading once they cease to be profitable. Indeed, as it can take months and often years before the IRD gets serious about its debt, insolvent firms can continue to trade well beyond the point where they should have closed.

Directors need to be very aware of the criminal risks they face here (see Chapter Twenty: The Inland Revenue Department).

Easy Terms

It is important to realise that many small New Zealand firms use the IRD as a financier of last resort, especially in the early difficult stages of growth, and once their cash flow has built up they repay the debt to the IRD without consequences other than the penalty interest charged by the department.

Borrowing from the IRD in this manner seems attractive to many business owners. The IRD does not require a business plan to advance funds, they do not ask for an equity stake in the business nor even ask for a personal guarantee. For some individuals, who have the capital to put into their business if required, not paying the IRD can seem like a sensible business decision. If they are gaining a greater economic return on their capital than the interest costs imposed by the IRD then running up an IRD debt makes sense.

The IRD is the easiest source of credit for a struggling New Zealand business.

The IRD may be large and slow but they do eventually respond. The IRD is responsible for about 70% of the court appointed liquidations in New Zealand. If you want an understanding of how the IRD works turn to the Public Notices section of today's Newspaper. You will see applications for the liquidation of New Zealand companies by the IRD.

The problem with borrowing from the IRD is that it is just too easy. The easy extension of credit hides fundamental problems with the business and allows a failing business to trade on longer than it should.

Three Easy Questions

If you are thinking of 'borrowing' from the IRD, you need to ask yourself three questions:

*** Are you comfortable breaking the law?**

Not paying the IRD is a criminal offence that can lead to jail. So is speeding, downloading movies and texting while you drive. Some laws you need to break often and outrageously before you will suffer incarceration as a result but, make no mistake, deciding not to pay the IRD is a crime. And it should be.

Your competitors are probably paying their taxes. What makes you and your business worthy of the unfair economic advantage of involuntary state support? Your chances of ending up on kitchen duty in one of New Zealand's fine penal institutions is pretty remote but that isn't really the point.

*** Is the cash flow drop really temporary?**

As business people we are forced to stretch the truth. We tell our customers we provide a better service than the guy next door, we tell our staff of the great opportunities certain to come their way, we often hide the truth of the numbers from our loved ones and even our professional advisors. But the one person a business person should never lie to is themselves.

Can the business pay this debt back? Really? Are you sure?

*** What would happen if you stopped now?**

If you are thinking of not paying the IRD you should also think about closing your doors. Assuming that you have exhausted all other forms of credit and capital, borrowing from the IRD will allow you to trade a loss making business for another six, even twelve, months. Are you better to close the doors now before the balance sheet deteriorates?

Prudence says:

Not paying the IRD is too easy and leads directors into a false sense of confidence. Once the first payment is missed and nothing happens it becomes easy to miss the second, the third and before long the IRD debt becomes so large there seems little point even trying. If a firm falls behind their IRD payments for more than three months they should cease trading, or gain extra capital.

No one likes paying the IRD but we take for granted the things our taxes pay for: the police, courts and Winston Peter's parliamentary pension.

If you want lower taxes vote for Act. If a firm cannot pay its taxes it increases the burden for those firms that can.

CHAPTER TWO: PROCRASTINATION AND HUBRIS

Facing the Ugly Facts

Some decisions are hard. Plain and simple. Many of us put off decisions that we just do not want to face or delay tasks that are required but unpleasant.

One of the advantages of working for someone else is that they will set the tasks to be done.

Business people working for themselves do not face this external discipline. They must find the determination internally to do what needs to be done.

This does not just include the month end accounts, the GST return or the ugly task of picking up the phone and cold calling for business. It can include firing the non-performing but personable sales rep, fronting up in person to the large debtor who keeps inventing excuses for non-payment, addressing the wads of unpaid invoices silently accumulating in the in-tray or taking the ten minutes to tally up the collectable debtors against the mounting creditors on the out-of-date creditor's ledger.

Failing to face the facts is perhaps one of the single most significant factors in the prolonged failure of small businesses in New Zealand.

Many business people we meet, when facing the liquidation of their business affairs, can list quickly and confidently the half a dozen things they could have done that may have saved their businesses.

If your business is in trouble but not beyond redemption, the simple fact is that you probably know what you need to do to avoid meeting us professionally. You may simply not want to do it.

One of the best books to date on this subject is by Brian Tracy: "Eat That Frog". Buy it. Read it. Act on it.

The Napoleon Complex

The relationship between a business and its founder or key shareholder/director can be complex. Their sense of self can be caught up in their business. Their social network, years of work and source of income is all wrapped up in their relationship with the business. These non-economic returns that many directors gain from their business can cause them to cease seeing the business as simply a source of income. They struggle to maintain the business for too long and for non-economic reasons.

Pride can make a company director fail to face the ugly numbers of his business. It is not unusual for a director to talk to his lawyer, accountant or insolvency expert before talking through the issue with their spouse.

Importantly, their advisors often compound the problem by working on arrangements to try and save the business when the business should not be saved. Professional advisors have a tendency to look for solutions. Sometimes the best solution is a quick liquidation before the problem becomes too large.

CHAPTER THREE: THE WAGON WHEEL EFFECT

Video Killed the Radio Star

The skills required to start a business: perseverance, optimism, risk taking, are exactly the things that can get those same people into trouble when the business model is no longer working.

The manufacturing of wagon wheels was once a large business. Thousands of apprentices learned their craft and hundreds of firms of all sizes supplied a vast array of wagon wheel types, sizes and designs throughout the world. No doubt there are still some wagon wheel firms turning out a few wagon wheels for Wild West enthusiasts and perhaps for commercial use in developing countries.

The most optimistic, hard working, visionary and dynamic business leader would not have been able to save the best, most efficient, best marketed wagon wheel producer after the introduction of the Model T.

Business models come and go. Products needed today are abandoned tomorrow. The tragedy for many business owners of wagon wheel firms was that making wagon wheels was all they knew.

Today many business owners face the same dilemma. Their businesses have been built up, often over many years and sometimes decades. The demand for what they produce has fallen or the business methods they are using made them uncompetitive in a changing market place.

And Lions Must Kill to Eat

The impending demise of a perfectly good zebra.

In the general melee of a market economy firms compete, grow, and some develop economies of scale or intellectual property that give them a competitive advantage over their rivals. There are always more firms competing for work than there is work available. In the process some firms get squeezed out.

Often the failure of a business is nothing more than the fact that other firms are doing it better. There is nothing wrong with the business, the director, the product or the staff. The only problem is that customers prefer other firms.

CHAPTER FOUR: CREDITOR SUPPORT

Access to Other Firms' Capital

Credit has been easy in New Zealand and too few firms do adequate credit checks.

It is common to see a balance sheet with virtually no collectable debtors and a massive list of creditors with the director waiting until every last bit of credit and goodwill has been wrung from the creditors before liquidating the company.

A common start-up business in New Zealand is long on hope, enthusiasm and energy. It is typically short on capital, business planning and accounting skills.

The easy availability of credit from businesses keen to increase their sales results has the effect of products, resources and services being funnelled into uneconomic companies.

The confidence, sometimes well placed, sometimes not, of the directors of these new enterprises causes them to focus on the excitement of the opportunities and not the consequences of failure.

The ability of these directors to gain credit from other firms reduces their capital requirement. Using other firms' staff, goods and services is taking energy from these suppliers. Only if the business succeeds the decision to trade is vindicated. The suppliers are becoming unwitting investors in the new firms success.

Moral Hazard

Taking risks for a business owner makes sense. Typically, most of the capital involved in a firm's balance sheet is provided by creditors. The owners often have only a small fraction of the money invested in an enterprise.

In the event of business failure the business owner will only lose their capital invested and not the large sums advanced by the creditors. However, should the business succeed, the owner will reap all of the profits and the creditors will only get their bills paid.

An extreme example of this was the failure of the finance companies in New Zealand in the credit crunch of 2008.

Here, businesses such as Bridgecorp borrowed money heavily from the public at 10% and advanced these funds to developers at 20%. Of the half a billion lent out by Bridgecorp only a fraction was actually provided by the owners of the business. The numbers for the owners of the business are compelling: they would get to keep all of the profit, if the business failed the depositors bore most of the risk. When you are gambling with other people's money you may as well gamble big.

CHAPTER FIVE: THE BRANSON EPIPHANY

In answering the question, why do New Zealand firms fail, we struggle to come up with much more than anecdotal answers because there is no structured method of measuring company failures in New Zealand, nor for investigating the reasons or even of being able to identify the quantum. All we are left with is anecdotal information from insolvency practitioners.

In search of some answers, we took the most recent 150 insolvencies we have under taken, (138 liquidations, six Voluntary Administrations and six receiverships.) We excluded the solvent liquidations.

We then took a view as to the cause of the failure. If there were multiple causes of the failure, multiple reasons were given by the case manager of the file.

We got the following results:

	A Factor	**Only Factor**
Economy	24.4%	18.9%
Incompetence (director, manager)	41.7%	29.9%
Misappropriation by directors of company assets	15.7%	11.0%
Flawed Business Model	14.2%	11.8%
Insufficient Capital	0.8%	0.8%
Misfortune	9.4%	3.1%
Shareholder Dispute	5.5%	4.1%

This covers the period of 2008 and 2009, during a period of considerable economic stress in the New Zealand economy.

It is a limited sample, there is both selection bias (as it only covers liquidations handled by Waterstone) and it is subject to the observational bias of the insolvency manager working on the file, whose opinions will have been coloured by their interaction with the file and the personalities involved.

Notwithstanding these flaws, it is the only data we have to hand.

What stood out for us was that the competence of the director was a factor in 40% of business failures, and the only reason in nearly 30%. Further, if we add misappropriation of assets by directors, we find that either incompetence or dishonesty was a factor in over fifty percent of failures. On looking back at the dishonesty files it was concluded that in most cases the dishonesty may not have occurred had the director been able to make his (or her, dishonest directors were not exclusively male) business work honestly.

Old chestnuts such as a lack of capital barely rated a mention and dubious business practices and a faltering economy were also primary drivers.

This lead to the development of what we term the “Richard Branson Epiphany”.

The Epiphany has its origins in the difficulty of starting and maintaining a successful business or a successful career of any nature. At the start of any successful venture you will find a bit of luck, and someone who would have seized the opportunity that a bit of luck provides.

Lady luck takes a shine to all of us at some point, but only a select few grasp the opportunity. Of those who do some will fail at the first hurdle, but many will not, and those who succeed find themselves in charge of a small to medium business or riding a successful career.

They survey the world around them, surrounded by lesser mortals who have failed to seize the day as they have. They become accustomed to the small perks that come with success, and the flattery from those with something to gain from delivering such flattery.

Then comes the Epiphany.

If they, alone among men, (and here it is almost always men), had the wisdom, drive, foresight, force of will and winning temperament to succeed at such a level, then maybe they possess what it takes to go all the way! Maybe they are New Zealand's Richard Branson.

Once the Epiphany hits it takes on a life of its own. If the victim is a business owner they will begin to focus on expansion, exploring new markets that they know nothing about (ie: Australia). They will be encouraged by their suppliers who see additional sales. You will find victims looking at bigger premises and believing the sales patter from real-estate agents who see a nice commission, and driven on by staff who imagine a bigger office and salary to go along with the expansion.

Often the victim has no business experience, but due to a success in some other field, (how many former sports stars have we seen try their hand at property development) they have had the Epiphany and now certain of their Midas-like ability set off boldly into some venture with confidence and certainty.

What happens next we see repeated many times. The business owner who suffers the Epiphany will have been running a small business reasonably well but often not brilliantly. He understood his costs, managed his staff, often had his hands dirty in the day to day of the business. He was competent at running his business at the level that it was being run. Indeed, often the business was providing him and his family with a good life, comparable to or better to what he could achieve as an employee.

Prudence Thinks:

Those who leave starting a business too late in life will find it much harder than they expect. Failure can help make someone a better business person, and failures are best endured by the young.

Those with a successful non-business career find out very quickly that success at rugby, writing, or even the law, does not translate to a successful career at the coal-face of small business.

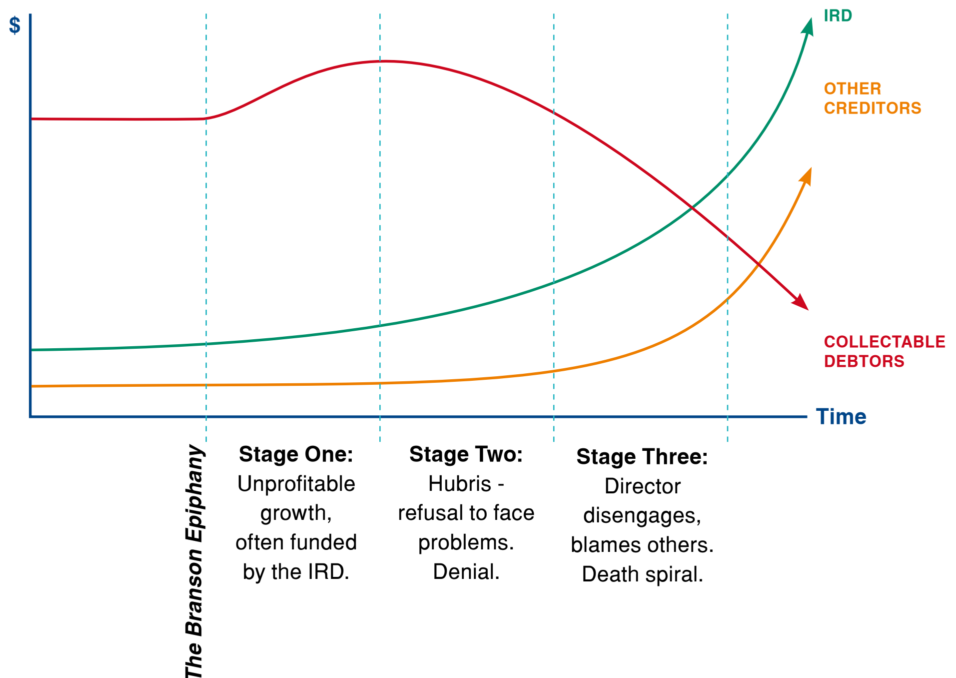
Even more surprised at their commercial mortality are those who have had a successful business career. These victims make the assumption that an ability to clamber up some greasy corporate pole prepares them for anything other than climbing greasy corporate poles.

However, it is important to understand that this is our observation, and we have a uniquely dispiriting seat at the theatre of New Zealand's commercial life. It may be that many people have the Branson Epiphany and this causes them to go on to bigger and brighter commercial success. However, we do not have the pleasure of meeting those people, so our observation of the way things works is not the whole story.

The Typical Stages of a Failing Business

Initial growth, funded by the non-payment of GST & PAYE. As the business grows the director fails to cope with the larger business. Unpaid bills, staff departure, low morale and business failure all follow. This process can occur over many years.

The Failure Graph



CHAPTER SIX: LIQUIDATION

The most common form of insolvency in New Zealand is the liquidation of the company. This can be done by the shareholder(s) of the company voluntarily putting their company into liquidation, or it can be done by the courts appointing a liquidator, usually at the request of a creditor.

Liquidation is a huge topic and this section deals with the mechanics of liquidation and the general outline of the obligations of a liquidator.

Interested readers should also consult sections that are of more specific interest. Directors and managers should read Part Three to examine the impacts of their decisions on them personally. Creditors should read Part Four, detailing their options once a firm enters liquidation and how to protect themselves once liquidation begins.

Liquidation Commences

When a company is placed in liquidation a liquidator takes over the running of the company. The directors effectively cease to have any power.

The liquidator has all the powers that the board of directors had prior to liquidation, plus some special powers to enable them to wind up the company, investigate its affairs and recover any money that has been incorrectly allocated prior to liquidation.

Special powers of a liquidator include:

- Power to cancel contracts, including employment contracts, rental contracts, lease agreements etc [*Section 269*]
- Interviewing directors and others under oath [*Section 261, 266*]
- Ability to get hold of accounting records, bank details and all other company files [*Section 261*]
- Power to ‘void’ payments and securities given by the company [*Section 292-293*]

Voluntary Liquidations vs. Court Appointed Liquidations

Companies can be liquidated by the shareholders voting to appoint a liquidator, or by the courts electing to do it for them, almost always by an unpaid creditor bringing evidence to the court that a company cannot pay its bills.

If a court appoints a liquidator the court will usually appoint a liquidator chosen by the petitioning creditor. If the creditor does not recommend anyone, or the court finds that person unsuitable, the judge can appoint another liquidator, almost always the Official Assignee.

Prudence and the Official Assignee

The Official Assignee is an actual person. Each district has their own appointed Official Assignee. In reality the work is all completed by a division of the Ministry of Economic Development.

The Official Assignee handles all bankrupt estates in New Zealand as well as those liquidations where no private sector liquidator has agreed to take on the role.

People go bankrupt, companies go into liquidation.

If the shareholders choose to liquidate the company, they will get to choose the liquidator.

There is a perception that a liquidator appointed by the shareholders will not be as diligent as one appointed by the courts.

This is important because there are a number of actions a liquidator can take against company directors that can lead to the recovery of money for the creditors. The most obvious actions are:

1) Seeking repayment of money owing by the directors to the company (where they took drawings instead of paying themselves a salary).

2) Prosecution for reckless trading.

3) Recovering assets taken out of the company by the directors prior to its liquidation.

Most liquidators do what is required and make no distinction between court and voluntary appointments. However, most liquidator's work comes from recommendations, usually from the advisors to the company, namely the firm's accountant or lawyer. If the liquidator then proceeds to "rip" the director financially apart, the referring accountant or lawyer is unlikely to refer their next insolvent client to that liquidator.

As a result parliament changed the legislation, and from the end of 2007 companies have just ten working days from the date they receive notice of legal action that could lead to their liquidation to appoint their own liquidator or Voluntary Administrator.

This change in the legislation has had a profound effect of making insolvency much more punitive.

If you are concerned at the independence of a liquidator, a meeting of creditors is the right forum to express your concern in the first instance.

Prudence Explains: The Ten Day Rule

Shareholders looking to put their company into liquidation (or voluntary administration) have ten working days from the date the company receives notice of court action that can lead to the liquidation of the company to appoint their own liquidator or voluntary administrator.

Previously debtor companies could appoint their own "friendly" liquidator on the morning before the High Court could liquidate the company. Creditors (including the Inland Revenue) applying to the courts found this frustrating as a liquidator appointed by the company may not be as thorough or aggressive in investigating the affairs of the company as would a liquidator appointed by the courts. The new rule goes a long way to ending this practice. It means creditors who take the time and effort to pursue debtor companies through the courts will get to choose and possibly fund the activities of the liquidator. This makes it more likely that the liquidator will use their full powers to investigate, review documents and interview under oath company directors, their lawyers and accountants.

Liquidators' Duties

A liquidator, whether appointed by the courts, or by the shareholders, works in the interest of all the creditors and not the company, its shareholders or directors. The liquidator works for the creditors of the company and if the creditors are not happy with the liquidator, they can elect to change the liquidator at a meeting of creditors.

The key task of the liquidator is to collect as much cash as possible and pay this money out to the creditors. In many cases the only source of money is the directors and shareholders in terms of their current accounts or possible action against them for trading recklessly. (This is why the independence of the liquidator is important.)

In addition there are a number of obligations imposed on a liquidator by the Companies Act 1993.

The liquidator has some specific tasks that must be performed:

First liquidators report:

This must be done within five workings days if the liquidator was appointed by the shareholders, and twenty working days if appointed by the courts. In this first report the liquidator must:

- Provide a statement of the company's affairs
- Explain the process to call a meeting of creditors
- Provide a list of all creditors known to the liquidator at the time of writing the report

Call a meeting of creditors:

A liquidator must call a meeting of creditors, within ten working days if they are shareholder appointed, thirty working days if court appointed, unless the liquidator feels that:

> "...the likely result of the liquidation of the company, and any other relevant matters, that no such meeting should be held" [Section 245 (1) (a)]

If the liquidator dispenses with a meeting of creditors the liquidator must notify all known creditors of this decision.

However, if a single creditor requests a meeting of creditors, the liquidator has fifteen working days to call one and any such meeting must be advertised by way of a public notice in the regional newspaper and the New Zealand Gazette.

Report crime:

A liquidator has a statutory obligation to report all criminal activity to the relevant authorities. If a liquidator appointed by the shareholders fails to do so he faces consequences that may result in him being banned by the courts from accepting new appointments.

Meeting of Creditors

Role of a meeting of creditors

The key role of a meeting of creditors is to:

a) Confirm or replace the liquidator:
- If the liquidator was court appointed, the courts will need to ratify any change of liquidator.
- If the liquidator was appointed by the shareholders, the creditors can change the liquidator immediately, so long as they have a new liquidator ready to take on the assignment.

b) Elect, if they desire, a creditors' committee.

c) Provide guidance to the liquidator as to their opinions on the probable course of the liquidation.

The meeting of creditors is one of the important checks in the liquidation process. If the shareholders appoint a liquidator that is seen to be too friendly to the shareholders and directors, the creditors can call a meeting of creditors and replace the liquidator with one more to their liking.

Prudence Says: The Squeaky Rule

The creditors' meeting is important. If you are a creditor of a company in liquidation do not be afraid to ask the liquidator for a creditors' meeting.

Liquidators, like most professionals, get very busy with completing files. If the creditors in one liquidation are more active then that file is going to get more attention. At a meeting of creditors you can meet other creditors, learn directly from the liquidator what progress is being made on the file and help the liquidator gain some understanding of the wishes of the creditors.

If you and the other creditors decide the liquidator appointed by the shareholders is not taking an aggressive enough approach to the directors and shareholders then the creditors can vote to replace the liquidator.

Voting and running a creditors meeting

Schedule Five of the Companies Act specifies how meetings of creditors are to be run. A detailed look at creditors' committee meetings is outlined in Chapter Eight.

If a resolution passed at a meeting of creditors was determined by the voting of interests related to the shareholders, then the court can set aside such a resolution. For example, if the shareholders, who appointed their own liquidator are also creditors in the liquidation and they vote to retain the liquidator against the wishes of the other creditors then one of the creditors can petition the court to overturn that resolution and replace the liquidator.

Role of a creditor's committee

A creditors' committee has limited real power but they can ask the liquidator to provide reports on the progress of the liquidation, call a general meeting of creditors and can apply to the court to review a liquidator's decision [Section 284 and 286].

The real role of a creditor's committee is to provide pressure on the liquidator to complete the liquidation in a manner favourable to the creditors and to provide the liquidator with guidance where there are issues relating to the disbursements of funds.

In some cases the liquidator may have accumulated funds to distribute to the creditors but there may be some other options such as issuing proceedings against the directors that may bring in extra money. In such a case the liquidator will put the matter to a creditors' committee and let the creditors decide as to whether issuing proceedings is prudent.

Powers of a Liquidator

Once appointed, a liquidator controls all the assets of a company including bank accounts, the debtors' ledger and any physical assets including vehicles. The liquidator must decide how to dispose of the assets.

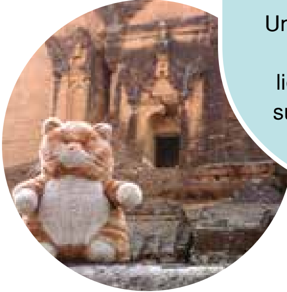
In some cases a liquidator will be faced with a still running company. There will be staff, ongoing contracts, premises and often work-in-progress. In such a case the liquidator can continue to trade the business. In order to do this the liquidator must get in touch with all suppliers (including staff) and open 'liquidation accounts', treating these as new accounts separate from the amounts owing to the company at the time of liquidation.

Where the company has assets at the time of liquidation, the liquidator can use these assets (or money from the sale of those assets) to cover the running costs of the business, rather than using that money to pay the creditors. This is normal if the liquidator is confident that this will result in a better result than simply stripping the assets, especially if the business can be sold as a going concern.

Prudence On Essential Supplies:

A special section of the Companies Act 1993 [Section 275] specifies that some suppliers, namely utilities, for power, water, gas electricity and telecommunications, cannot refuse to supply a liquidator who elects to run a business in liquidation. All other suppliers have a choice.

Unlike Voluntary Administration and Receivership a liquidator is not personally liable for costs incurred during the period of liquidation. However, no professional liquidator would not pay suppliers in such a situation, even if the business made a loss during the time it was run in liquidation.



In most cases the liquidator will simply dispose of the assets, collect the debtors book and cancel any contracts that may be in place. Specific powers that a liquidator has to help with this process are outlined below.

Cancelling contracts

A liquidator can cancel any contract the company is a party to if this is deemed to be onerous. This includes employment agreements, lease agreements, hire purchase agreements and so on.

The legal term is to “disclaim” the contract or property.

Common examples:

Staff Employment Agreements

Staff laid off in these circumstances are not entitled to redundancy pay as their contract has been cancelled before redundancy can be effected. Other pay outstanding, such as holiday pay and unpaid wages counts as a preferential claim in the liquidation.

Lease Contracts

Where the company is leasing property the liquidator will typically cancel this lease. The company, however, is still liable for the full lease and the landlord can claim in the liquidation for the total rent due.

As an example, if there was two years remaining in the lease when the liquidator disclaims the lease then the landlord can claim for the full two years as an unsecured creditor in the liquidation.

Real Property

Where there is Real Estate owned by the company, but the debt is greater that the value of the property, then a liquidator may choose to disclaim the companies interest in the property. If a liquidator disclaims Real Property (ie: land) the land reverts (or escheats to use the correct but obscure legal term) to crown ownership.

A liquidator can only cancel onerous contracts. Where a supplier has an ongoing relationship with the company and the contract is not onerous on the company then the court may rule that the contract is not onerous. An example may be where a Real Estate Agent has an agency to sell land. If the liquidator still intends to sell the land but wishes to use a different Real Estate Agent, this may not be an onerous contract.

Interviewing Relevant Parties

A liquidator can compel parties instrumental to the running of the business (including the businesses lawyers, bankers, accountants and personnel), to attend an interview, and this interview can be under oath.

When a liquidator asks someone to an interview under oath, that person does not have a right-to-silence. A company director, for example, must answer the liquidators questions even if those answers are incriminating. The only protection a person has in this situation is the right to a lawyer. Anything said to a liquidator cannot be used in any criminal trial, except in the event of perjury.

If a person refuses to talk to a liquidator, the High Court can issue an order compelling that person to do so or face arrest.

This power is very important, especially in court appointed hostile liquidations where the company director is anxious to avoid having to explain what happened to the business. It also gives the liquidator authority to obtain information from the firms' accountants and lawyers, who often hold the key material relating to the affairs of the business.

Interview Under Oath

Pleading the Fifth

No good American police drama is complete without some hapless villain declaring that he or she is going to 'take the fifth'.

The Fifth Amendment of the United States protects the accused from answering questions that may be self-incriminating. This right to silence is also enshrined in New Zealand law with a few exceptions.

A company director, lawyer, banker, accountant, etc cannot claim 'self-incrimination' as a reason not to answer questions asked by a liquidator.

This is a very important point. A liquidator, tasked with understanding what has happened to the company and its money, can ask a director or other staff member what happened to the company

and any missing money. Even if that person was directly responsible for stealing that money, they cannot refuse to answer the question on the basis that telling the truth would incriminate them.

If they do, the liquidator can apply to the National Enforcement Unit of the Ministry of Economic Development who may than prosecute. Maximum penalties (as per Section 373(3)) are a fine of up to $50,000 and up to two years in prison.

A critical protection for the witness is that anything said to a liquidator under oath cannot be used in a criminal case against them. However, this evidence can be used in a civil case to recover money or to sue the witness for the recovery of the money.

These rules are covered under Sections 261, 265 and 267 of the Companies Act 1993.

Interview Options

A liquidator has two options when interviewing a company office holder;

They can interview the director themselves or arrange a barrister or solicitor acting for them to conduct the interview [Section 261]

The liquidator can also seek to have the person interviewed at court in front of a High Court judge [Section 266]. This is not common and usually occurs only after the person has refused to comply with a 261 request.

There is no obligation for the liquidator to first seek an interview under section 261. They can proceed directly to court to obtain an order to compel the witness to turn up to court.

Prudence Explains:
Who must assist the liquidator

The legislation refers to the following people:

- Director or former director
- Shareholder
- Person involved in the ‘promotion or formation of the company’
- Person who has been an employee
- Receiver, accountant, auditor, bank officer or other person having knowledge of the affairs of the company
- A person who has acted as a solicitor for the company

All of these people must, if asked in writing by the liquidator, attend an interview (under oath if requested) and must supply all information, documents etc to the liquidator if asked to do so.

In most cases the liquidator will seek to interview the witness directly and if that fails seek an order from the court to compel the witness to attend an interview.

Failure to attend an interview, or provide information, when asked in writing by a liquidator is a criminal offence, and people have seen the inside of a prison cell for this refusal. Failing to comply with an order of a High Court Judge is contempt of court, and again, criminal sanctions can and have been applied.

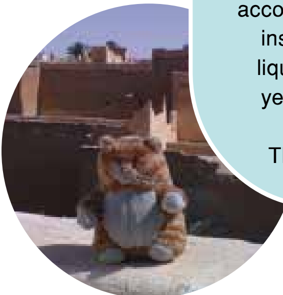
There are grounds to refuse to answer a liquidator's questions, however. The only one with any merit is where the liquidator has begun or is going to undertake legal action against the witness. The Court will consider that forcing a witness to testify before a liquidator gives the liquidator more access to information than they would normally be allowed under the normal rules of discovery. In these cases a judge will consider denying a liquidator's request.

Insolvent Transactions

Voidable transactions is a chapter in itself (see Chapter Twenty Seven: Risks of Voidable Transactions) and are one of the most powerful tool at the disposal of a liquidator.

A liquidator can go back two years where the transaction advantaged one creditor over another. The key facts to keep in mind when it comes to voidable transactions:

- Applies to transactions, including the granting of a security
- Only applies where the other contracting party is a creditor of the company in liquidation
- Can go back up to two years
- Money paid to a creditor in the previous two years can be called back



Prudence Says:
An example of a voidable transaction:

Stonewater Airlines Limited owes money to all its creditors. In the weeks before liquidation the firm's key fuel supplier, Aero Fuel Limited, manages to get their account up to date by threatening to withhold supply and insists on cash terms. When the company goes into liquidation Aero Fuel Limited is not owed any money, yet they were owed $45,000 two months previously. No other creditor had such success. The liquidator can recall back the recent payment.

How is the Money Distributed?

The proceeds from liquidation are distributed in a specific format depending on where the money was receipted from.

There are four places a liquidator can receipt funds:

Revenue from ongoing business operations:

If the liquidator is continuing to run the business, any money receipted from work done by the business in liquidation must be used first to pay those who supply the business in liquidation. So, if Stonewater Airlines Limited (In Liquidation) buys fuel and employs staff to keep its planes in the air, any money that comes from those flights must first be used to pay for fuel used and staff employed to complete the flights and not those creditors who lost money in the liquidation.

If there is a profit from the trading, then this money can be used to pay the creditors who lost money to Stonewater Airlines Limited (In Liquidation).

Sale of secured assets:

Any money received from a secured asset (ie; a vehicle with a finance loan registered on it) must be paid to that secured party. If there is any money left over, then this money comes back into the pot for the rest of the creditors. If there is a shortfall then the finance company is an unsecured creditor for the balance.

Sale of unsecured assets:

Any money received from unsecured assets, such as the firm’s debtors’ book, sale of plant and machinery if there is no finance owing on it, vehicles and the like, is distributed in a very specific schedule, [Schedule Seven] as follows in order of priority:

- Liquidators fees are paid before any distribution
- Staff holiday pay and any unpaid wages (up to four months), up to a maximum of $18,700 per staff member
- Unpaid GST and PAYE owed to Inland Revenue
- Unsecured creditors on a pro-rata basis
- The shareholders

Funding creditor’s action:

Where an unsecured creditor has funded recovery action (usually legal action against the director for reckless trading or for removing company assets below fair value) then any money from this action goes first to reimburse the creditor for the cost of the legal action, and then paying out this creditor up to the value of their unsecured debt.

If there is any money left over then this money is available for preferential and unsecured creditors.

Role of a Funding Creditor

The legislation surrounding funding creditors is relatively new, being given royal ascent only in November 2007.

This legislation was brought in to deal with an anomaly in the existing legislation. In many liquidations there is an opportunity to pursue action against either the director(s) or some related party for funds or assets removed from the company prior to liquidation.

Such action is rarely cheap, requiring lawyers and all their endless disbursements. If the action was successful the money from this action would then be paid out to the creditors as per Schedule Seven, i.e: staff, then IRD, then unsecured creditors on a pro-rata basis (assuming there was no General Security Agreement (GSA) in place, in which case it would go to the GSA holder first).

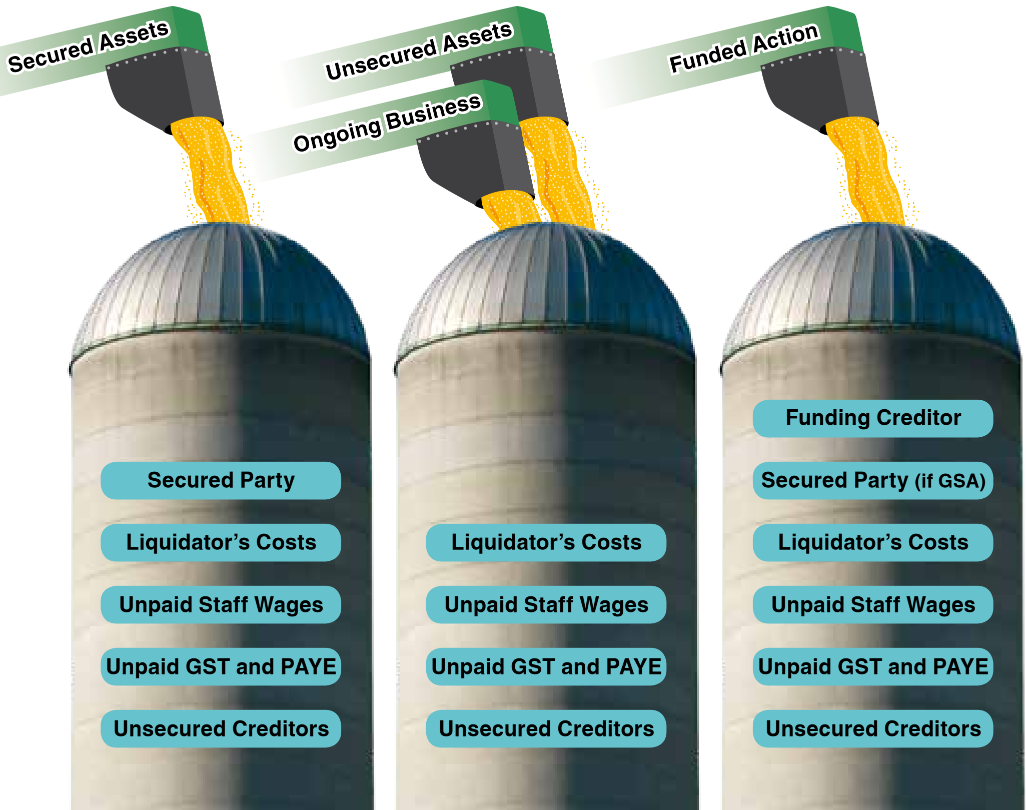
The problem with this process was that the party who stood to gain from the successful action may not be the party who was prepared to fund the legal action.

The changes now specify that if an unsecured creditor fronts up with the cost of the legal action they stand ahead of all creditors, including the GSA holder, staff and the IRD. Any money that comes from a successful action funded by a funding creditor will be paid to the funding creditor, up to the value of their unsecured debt.

Prudence Announces:

The funding creditors' provision is very bad for directors with overdrawn current accounts or those who have traded recklessly.

Now unsecured creditors can choose to fund legal action against the director. If they win the unsecured creditors get paid from the proceeds of this legal action before any other creditors benefit. This creates a large incentive for unsecured creditors that did not exist before.



Think of money recovered by a liquidator being placed by a liquidator into different silos.

Money from secured creditors go into a silo for that creditor. If there is any money left over it is then treated as money recovered from an unsecured asset.

CHAPTER SEVEN: LIQUIDATION: A CASE STUDY

Liquidation is always the death of a company, but it is not always the death of the business. This case study demonstrates.

Boston Enterprises was the company. The business was the Grosvenor Hotel in Timaru. The director of Boston Enterprises had many successful years running small rural pubs. With the backing of a finance firm he purchased the Grosvenor Hotel but not the land.

Sadly for Boston Enterprises things started to go down hill. Timaru went through a construction boom and many new motels were built, eating away at the nightly head count. To compound problems, the director did not have the temperament to run a large urban pub. Regular patrons drifted off to other watering holes.

In June 2007 Waterstone was called in.

We found the pub down on its luck but with a bit of life left in her. We faced two problems to keeping the doors open:

- The finance company was owed $300k and had a GSA, which allowed them to appoint a receiver.

- The landlord had the right to re-enter the premises.

There was not enough revenue to pay the rent and the finance company. The finance company knew a receiver could only really strip out the assets and in a fire sale they would receive maybe $50k. The landlord, if he re-entered, would inherit a stripped out shell.

To keep the doors open we agreed to pay the finance company interest only on their loan, and the landlord agreed to receive a third of his rent. We then went to find a buyer for what the locals grandly called "The Grand Old Lady of the South".

In truth, The Grand Old Lady was a bit long in the tooth (and she had not been flossing.) Despite an extensive campaign we could find no takers and part of the reason was the landlord's uncompromising attitude to the rent. It became clear that the only buyer was going to be the landlord.

The landlord saw the place was a bit tired and he didn't want to run a hotel in Timaru. To convince him the Old Girl still had a few moves in her we ran three high profile, for Timaru, events (the details of which do us, or Timaru, no credit). We faxed daily revenue figures to the landlord and finally, after nearly four months, he parted with $250k to buy the chattels off the finance company.

The profits from the business were used to pay the staff their holiday pay.

Importantly we convinced the finance company that the director, who had stayed on during the liquidation and worked like a trooper to keep the place running, had done all that could be expected. Although they never waived their rights, they have not enforced the balance of the unpaid loan. It was a good result for the finance company, the director, the staff and the landlord.

Here, the company failed but the business did not. This was a classic example of what an insolvency firm can do when brought in quickly.

CHAPTER EIGHT: LIQUIDATING A COMPANY

Voluntary Liquidation

The voluntary liquidation of a company is defined by the Companies Act 1993 as a major transaction. It is the shareholder's responsibility to appoint a liquidator, not that of the directors.

Because the resolution is a major transaction the rules governing this resolution are separate from normal board or shareholder decisions and these differ from company to company depending on their constitutions.

However, in almost all cases, the following should suffice:

Step One:

Find a liquidator. There are a number of firms who specialise in this work. Talk to your accountant or lawyer for a recommendation. Ensure that the liquidator has signed a consent before his appointment. A company cannot be liquidated without a liquidator. (The Official Assignee cannot be used as a liquidator when the liquidation is voluntary.)

A person cannot be a liquidator of a company if they:

a) Are a creditor of that company
b) Own shares in the company
c) Have been a director, auditor, or receiver of the company in the last two years (or a related company).
d) Have done paid work for the company in the previous two years

Step Two:

Call a shareholders' meeting. In the notice enclose a copy of the resolution to place the company into liquidation. Be careful to make sure that the shareholders' meeting is properly called, especially in relation to the requisite notice period (two weeks if the company has no constitution).

If all of the shareholders agree then the shareholders need not call a meeting. They can simply all sign a shareholders' resolution putting the company into liquidation.

Step Three:

Put the resolution to the vote. Remember, this is a special resolution, usually requiring 75% of all eligible shares voting for the resolution. This only applies to eligible shareholders' who actually vote, an abstention does not count in the total. Some constitutions may specify different rules for special resolutions.

The rule on shareholders' meetings (unless there is something different in the company's constitution) is that 75% of those eligible to vote, and who do vote, need to support the resolution.

This means that if only half of the shareholders turn up to a properly called meeting and 80% of attendants (by number of shares) vote for the resolution putting the company into liquidation, then the company can be liquidated.

Step Four:

Well, there is no step four. From the moment the liquidator is appointed, the directors' rights and involvement in the business cease. They can take the rest of the day off.

The Board

The directors can resolve to put the company into liquidation but only if the constitution of the company allows for this. If the company has no constitution then the board has no power to appoint a liquidator. If the company has a constitution then the directors have a statutory obligation to upload this onto the Companies Office website. That is usually the first place to check.

Court Appointments

The Shareholders are Deadlocked

In some situations a shareholder or a director can petition the court to appoint a liquidator. This may happen where the shareholders are unable to agree.

The court can appoint a liquidator if it is 'just and equitable' [241(4)(d)] for the court to do so. Case law on the issue relates to a breakdown in trust between the parties. The court will also probably grant a liquidation if one shareholder brings proof to the court that the company is insolvent but it unable to pass a special resolution.

Creditor Applications

Creditors can also petition the court for liquidation of a company. There are very specific processes around the appointment of liquidators by the court.

A liquidator appointed by the court has the same powers as one appointed by the shareholders, although some of the processes and time frames they need to follow are slightly different.

A statutory demand is a demand on the company to pay an undisputed debt. It is detailed in more detail in Chapter 32. If the demand is not challenged in court in ten working days, and left unpaid for fifteen working days, then the creditor issuing it can apply to court to seek an order to liquidate the company. If the debt is disputed, the creditor must seek a court judgement first, if this is unpaid, a statutory demand can then be issued.

A ruling from the disputes tribunal is considered a court judgement and can be used to issue a statutory demand if it is not paid. There is a legal fiction at this point, where the court will pretend that the demand was not issued as a means to collect a debt, but will treat the unsatisfied demand as a test of the solvency of the business, one which the company has failed.

Once the debtor company has been served with the documents leading to its liquidation, the shareholders have ten working days to appoint their own liquidator or Voluntary Administrator. If they do not do so in that time they must wait until the court appoint one for them. The petitioning creditor usually has the choice of selecting their own liquidator.

Choice of Liquidator

The court is not obligated to select the liquidator presented by the petitioning creditor, but usually will do so. If no liquidator is nominated by the petitioning creditor the court will appoint the Official Assignee.

Prudence Explains:

Cartune Limited was an automotive workshop operating in Glenfield and Ponsonby. As things got difficult the director established a second company, Cartune New Zealand, and continued to trade the new business as the first one was allowed to fall into voluntary liquidation. One business, but two companies.

Bryan Williams, from BWA Insolvency, was appointed to be the liquidator. As often happens, the liquidator and the appointing shareholder ceased to be on good terms, and when the creditors came after the second Cartune, the shareholder was inclined to let it go to the courts, which it duly did.

The creditors who were chasing down Cartune NZ limited wished to have a different liquidator than Mr Williams. Mr Williams, however, had significant support from some of the secured creditors and went to court to argue for the appointment over the objections of the petitioning creditor. The High Court overruled the wishes of the petitioning creditor and awarded the liquidation of the second Cartune to Mr Williams.

Liquidation Dates

Where a liquidation proceeding is underway creditors with unsatisfied statutory demands can step in and support the initial creditors application. This is important because if the company settles with the first creditor the second creditor can take over an existing process and not be forced to start again. This has another important effect. Many of the remedies available to a liquidator are limited by time. A voidable transaction, for example, can usually only be unwound in the last two years of a company's life. For a voluntary appointment this two years starts from the date the company as liquidated. However for a court appointed liquidation, it starts from the time that the application for liquidation was lodged with the courts.

The 290 Trap

A debtor company faced with a statutory demand must apply to the court within ten working days if it wishes to challenge that demand. The areas to challenge are either that the debt is disputed, is not owed, or the demand was procedurally defective.

The court will hear this application in a timely (for the High Court) manner, and it will usually get heard faster than the processing of a liquidation application.

If the court, on hearing the evidence, concludes that the debt is not disputed, the court has the option (but not the obligation) to make a ruling that the company be placed into liquidation immediately. They can also let the matter sit for a short period, often a week, to see if the debtor company can pay the debt. If not the court may, if the petitioning creditor asks, place the debtor into liquidation.

Thus, the 290 trap catches a few unwary debtor companies unawares.

The "Friendly" Liquidator

Company directors facing pressure from their creditors and having things in their accounts they may wish to hide, can elect to appoint a friendly liquidator. The purpose of a friendly liquidator is to protect the interests of the directors and shareholder at the expense of the company's creditors.

By law, a liquidator is there to protect the interest of creditors but some liquidators do not do this, and not all people who take on liquidation appointments are in fact insolvency practitioners. Thus, it is easy for a shareholder or director seeking to protect themselves from an honest examination of their affairs, to appoint a friendly liquidator.

Faced with a friendly liquidator a creditor has the option of calling a creditors meeting to replace the current liquidator. A liquidator does not have to call a creditors meeting. He can decline to call one if he feels that there is no just cause for one to be held, given the lack of resources in the liquidation and the cost of calling a creditors meeting.

But, before he does this, he must send a notice out to all creditors advising of this decision not to call a creditors meeting. The affected creditor may, once receiving this letter, write to the liquidator and demand that a meeting be called, but must do so within ten working days of receiving the notice.

However, a “friendly” liquidator has a number of defences to defeat an honest creditor.

a) They can simply deny that a debt is owing.
b) They can ignore the request, despite being legally obligated to do so.
c) The liquidator can call a meeting, but rely on related party debts to defeat the attempt to replace him.

At a creditors meeting, a vote to replace the liquidator must be passed with 50% of numbers of creditors representing 50% by dollar value. If creditors friendly to the shareholders (staff, shareholder trusts who have advanced money to the company) vote against the attempt, it will often fail.

Faced with these obstructions, the frustrated creditor has a wide range of legal options. These must be employed thorough the courts, which can be expensive and greater than the value of the debt.

This is often the strategy employed by friendly liquidators and their clients to evade the spotlight of an honest liquidator investigating their affairs. However, if the petitioning creditor had began court action, and the liquidator was employed within the ten days allowed to the company, the petitioning creditor can seek a judicial review of the liquidator (via 241AA(3)). This can be incorporated into the proceeding underway, and the creditor can ask the court to replace the liquidator appointed by the company with one selected by themselves.

The court does not need to grant this request. At the time of writing, it is possible the court had never received such a request, so we have no framework to determine how the court would react.

What does a friendly liquidator look like?

Because the liquidator is appointed by the company this does not always mean that he is friendly to the shareholders. Most people who practice insolvency in New Zealand take their responsibilities seriously and will not defend a shareholder or director if they have acted dishonestly. However, there are some indications that the liquidator selected by the company is not acting in the interests of the creditors.

The first thing to look for is the website of the insolvency practitioner. If they have none, and are not an insolvency practitioner by profession, you can safely assume that they are a patsy. Remember that it is possible to appoint anyone to be the liquidator of your company, including your brother, (see below), so if the person appointed has no track record of acting as a liquidator then you can assume that they have no intention of investigating the affairs of the company.

The second thing to look for is how the react to enquiries from you. A liquidator committed to looking after your interests will ensure that you receive the information that you need and will forward you a proof of debt form.

The third thing is to talk to your accountant or lawyer. Chances are they will know who the liquidator is and will be able to give you some guidance.

Waterloo: A Worst Case Study

It is rare to find a case as blatant as this. Brent Clode was the director of the firm Waterloo Building Limited.

He also was the director of the shareholder, Ultimo. The shareholder (ie: Clode) put the business into liquidation. Fair call. There has been fatal (literally, fatal) problems with his construction business.

The liquidator, however, was a Mr Michael Joseph Cooper. It turned out that Mr Cooper was Mr Clode's brother in law. When some claimed that this was perhaps not a good look, Mr Clode told the New Zealand Herald that Mr Cooper was perfectly competent to be a liquidator, he had been involved in 21 previous liquidations.

What he failed to mention was that all of these other 21 companies were also firms associated with Mr Clode.

No matter. There is nothing in the legislation to say that you cannot be the liquidator for your brother's in law's companies. But there is a restriction on being a bankrupt and being a liquidator. Clearly he was not making a good living from his insolvency practice because Mr Cooper was facing a bankruptcy call. Time to step down as liquidator.

To keep it all in the family, Mr Cooper stood down in favour of a Peter Clode. After all there is nothing in the legislation that says you cannot be the liquidator for your brother's company, even if you are a masseuse living in San Diego.

Can you imagine what that creditors meeting would have been like had it ever been called! Rubdown anyone? There was most certainty no happy ending happening to this story.

Perhaps deciding that having an overseas based masseuse who also happened to be the director's brother as liquidator was a bad look, someone convinced a Melissa Wilson to step into the breach and accept the task of liquidating Waterloo Buildings Limited.

It was never clear how Ms Wilson and the Clode's were acquainted, but there seems little doubt that they were, if facebook can be relied upon. The High Court finally put an end to the saga in December 2009 and removed Melissa Wilson in favour of the Official Assignee.

CHAPTER NINE: MEETING OF CREDITORS

Creditor meetings have their own specific set of rules as laid out in Schedule Five of the Companies Act 1993 and the Liquidation Regulations.

Meeting, or no Meeting?

The first issue with a meeting of creditors is should it be called?

As outlined above, a liquidator does not need to call a meeting of creditors if he feels that there is no value in one being called, and in most cases they are not called. Most of the information that needs to be conveyed to creditors can be done so through a liquidators' report.

If a liquidator does not call a meeting of creditors he needs to write to all creditors outlining that he does not intend to call one and why he does not intend to call one.

However, if a single creditor writes asking for a meeting of creditors, however, the liquidator must call a meeting within fifteen working days and this meeting must be advertised:

- In the New Zealand Gazette
- In the local newspaper of the region where the business registered office, or where the business operated from

To constitute a valid meeting there must be at least three creditors (or their proxies or postal votes) present. If there are less than three creditors then there are no quorum requirements.

Prudence on Proxies:

If a creditor wants to give someone a proxy for a meeting of creditors, this proxy must be given to the liquidator two working days before the vote.

To Confirm, or not to Confirm?

A first meeting of creditors has one key task, and that is to confirm, or not, the appointment of the liquidator.

If the liquidator has been appointed by the shareholders then the creditors can vote to change the liquidator with another one of their choosing.

This is done by way of a vote. In order to replace the liquidator, a creditor must propose a resolution to that effect.

To pass, the resolution requires both:

- A simple majority of creditors attending (or by proxy) by total debt owing
- A simple majority of creditors attending (or by proxy) by number

Thus, if a majority of creditors by total debt owing want to change the liquidator, but not the total majority of creditors, then the liquidator remains in office.

The rule is different for court appointed liquidators than for shareholder appointed liquidators.

If the liquidator was appointed by the shareholders, then a replacement vote by the creditors automatically results in a change of liquidator.

If the liquidator was appointed by the courts then the court appointed liquidator must go back to the court with the recommendation of the creditors. Until the courts validate the creditors' decision, the liquidator remains in office.

CHAPTER TEN: SOLVENT LIQUIDATION

In some cases a company that can pay its bills will be wound up. In this case the directors must sign a Solvency Certificate declaring that the company can pay its bills prior to the appointment of the liquidator.

The liquidator must still advertise the liquidation in the New Zealand Gazette and a newspaper circulating in the area but does not need to call a meeting of creditors.

However, if it transpires that the company was in fact insolvent then the directors who signed the false certificate may be fined up to $5,000.

If the liquidation is solvent the firms Accountant can be the liquidator.

CHAPTER ELEVEN: COMPROMISE WITH CREDITORS

This arrangement is rarely used in New Zealand. This is a shame because it is a well thought out piece of legislation and was the forerunner of the Voluntary Administration regime.

There was some consideration to its abolition during the introduction of the Voluntary Administration legislation but it was retained.

An Arrangement with Creditors

Part 14 of the Companies Act 1993 allows for a company to seek a compromise with its creditors. Legally, the process is straight forward and can be broken into three steps:

Step One:

All creditors must be notified. The notice must include:

- Who is making proposal (the company, the director, third party, etc)
- Contact details
- The proposal
- Any personal stake the person proposing the compromise may have (any debts owing by the Company to the director proposing the compromise, etc)
- Advise to the creditors that, if the proposal is accepted, the proposal will be binding on all creditors including those who did not show up to the creditors meeting or who did so and voted against the compromise
- A full list of all creditors

Step Two:

The meeting. There are rules regarding the holding of meeting of creditors, but the key issue is the majority required to pass the compromise.

To pass, a majority of the creditors need to vote for the proposal, and the total of the debt they are owed needs to be 75% of the debt held by those taking part.

ie: if there are ten creditors, and one of them is owed $40k, and the other nine have $5k between them, then the $40k creditor has to approve. And assuming they do, five of the rest also have to approve.

Step Three:

Continue trading, pay the creditors, forward a copy of the compromise to all affected creditors.

Classes of Creditors

In a compromise under part 14, creditors are broken into three classes:

Secured Creditors:

Those creditors whose debt is secured over part or all of a companies assets. A bank with a GSA, or a finance company with a debt secured against a company owned vehicle is a secured creditor.

Preferential Creditors:

These creditors are those who would, in a liquidation, receive money ahead of unsecured creditors. They include:

- The IRD for unpaid GST and PAYE (but not penalties)
- Staff for unpaid wages and holiday pay up to $18,700
- New Zealand customs for unpaid duty
- Lay-by customers

Unsecured Creditors:

Unsecured creditors have a claim against the company but lack any form of security against the companies assets. A personal guarantee by the director is not a security in this situation.

For the purposes of Part 14, preferential creditors can have a creditors meeting, and make a decision about their debt. This, to our knowledge, has never happened but it is allowed for in the Act. Therefore Part 14 does not impact on IRD debt. This will remain unaffected. If the company has a large IRD debt, a Part 14 compromise with unsecured creditors has little value.

With respect to secured creditors, it is possible for secured creditors to waive some of their security, allowing them to vote. This is fairly common if a large secured creditor is anxious that the company continues to trade. It is also common for secured creditors to have a personal guarantee from the directors and shareholders of the business.

Related Party Debt

Related party debt is defined as money owed by the company to directors, shareholders, their families and trusts. This debt is entitled to be voted at a creditors meeting. If this debt is critical in getting a proposal passed a creditor can seek a judicial review of the vote.

However, the court will not overturn a creditors vote simply because the proposal relied on related party debt to pass. There must be some procedural error or injustice before such a scheme will be overturned.

When to do it

The time to undertake an arrangement with creditors is when the following four conditions are met:

A) The company is trading at a profit month to month

B) Historical debts from past trading are threatening the viability of the business

C) If the meeting of creditors votes the proposal down, the shareholders must be willing to liquidate the company and walk away

D) There is not an unsustainable debt to the IRD

Key Issues

Existing Terms of Trade with suppliers

Many of the terms of trade with suppliers (almost certainly including the landlord) will give them rights in the event that a firm ever seeks a compromise with creditors. This can include terminating critical wholesale contracts and ending the lease.

The Inland Revenue Department

The IRD maybe a preferential creditor, and if so they are not affected by this agreement. If the company has a large debt with the IRD then the company is better to look to Voluntary Administration.

Personal Guarantees

Affected creditors may agree to a compromise and then seek to recover any loss against the directors and shareholders if they have signed a personal guarantee.

No Moratorium

In Voluntary Administration all court action against the company is suspended. This is not the case with Part 14, although the company can go to court and seek a delay of legal action. This means that if the company is under pressure and court action is underway, it may be too late to undertake action under this section.

Importantly, the ten day rule does not apply to a Compromise. Once court action has formally commenced a company only has ten days to appoint a liquidator or Voluntary Administrator. This does not effect a Compromise, and indeed Section 232 specifically gives the court power to suspend legal action already underway where a Compromise is being proposed.

Post Compromise Liquidation

If a compromise is approved and the company is subsequently put into liquidation there is the provision for a creditor to apply to court to have the compromise set aside.

This is important because if the compromise is left in place and there are new post-compromise debts incurred these debts will be valued in full in the liquidation and the compromise debts will only be valued at the post-compromise value.

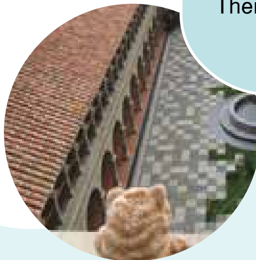
As an example: a creditor was owed $100,000 and as a result of a compromise their debt was reduced to $50,000, of which $20,000 was still outstanding at the time of liquidation.

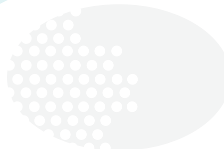
If there was to be a distribution to creditors from a post compromise liquidation, the question would be should the liquidator value the creditors debts at $20,000 or $80,000?

Without a court intervention setting aside the compromise, the answer is $20,000.

Prudence on Privacy:

One of the advantages of a Part 14 compromise is that it is private. There is no need to advertise, as there is with a Voluntary Administration.





CHAPTER TWELVE: VOLUNTARY ADMINISTRATION

Voluntary Administration (VA) became law in New Zealand on 1 November 2007, although it has been used in Australia for over fifteen years.

VA is about trying to save a company that is trading profitably, or has a profitable core business, but has debts that make it insolvent. It is similar to the Chapter Eleven process in the United States.

Very simply, VA is about getting the unsecured and preferential creditors to write off a large part of their debt so the company can trade on. Importantly, this includes the Inland Revenue Department.

Voluntary Administration places a troubled company in the hands of an Administrator. A moratorium is placed on the company's debts, but the Administrator is able to continue to trade the company while an agreement is reached with the creditors.

Strict time limits apply to this moratorium and if agreement cannot be reached the company may go into liquidation. The Administrator is personally liable for most of the company's costs during administration and must focus on negotiating a Deed of Company Arrangement (DOCA) that outlines how the company will be run and how the creditors will be compensated.

The DOCA must be agreed by both the creditors and the company's board.

If the DOCA is agreed the period of Voluntary Administration ends and the company moves to a new status, that of a company under a DOCA. The Voluntary Administrator will become (in most cases) the Deed Administrator. The Deed Administrator is only responsible for enforcing the DOCA and is no longer in total control of the company.

The Five Phases Of Voluntary Administration

1) **Appointment of an Administrator**
The appointment of an administrator is commenced by a company resolution of the Board (although it can be done by the courts or a secured creditor in some cases).

2) **Initial Meeting of Creditors**
A meeting of creditors is convened within 8 working days after appointment of the administrator. The purpose of this initial meeting is to confirm or change the Administrator and whether or not to appoint a creditors committee.

3) **Ongoing Administration**
As the Administrator comes to grips with the issues facing the company, he can continue to run the business as a going concern.

4) **Watershed Meeting**
Within twenty five days after the appointment of the Administrator, the Administrator must present to a second creditors meeting a proposal for the restructure of the company (The Deed of Company Agreement or DOCA), or a recommendation for the liquidation of the company. The creditors can accept the DOCA or not. The creditors can vote to end the voluntary administration and hand the company back to the board. If the creditors vote the proposed DOCA down, the company immediately goes into liquidation.

5) **DOCA or Liquidation**
The board has fifteen days to consent to the DOCA, at which time the company moves from being in Voluntary Administration to being governed by the Deed. The Deed is administered by the Deed Administrator (typically the Voluntary Administrator), and the Deed expires at a set time or once events specified in the Deed are reached (repayment of companies debt, after ninety days, etc).

Obligations and Powers of the Administrator

The administrator must investigate the company's affairs and form an opinion on what is in the best interests for creditors; a deed of arrangement, administration to end, or the company to be wound up.

The Administrator has powers very similar to that of a liquidator, ie: almost total power to run, sell all or part of a company's assets, cancel leases, nullify contracts, fire staff, etc. However, an administrator cannot cancel onerous contracts in the same manner as a liquidator. If an administrator cancels a contract this has the same effect as if it was done by the company's board.

The Administrator has obligations to secure two creditors meetings within six weeks to decide on the future of the company, in addition to running the company and protecting company assets.

Voluntary Administration: Case Study A

The Company

Northern Energy was a medium 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 $160K.

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

When they came to our door, Northern Energy had $168K in debt, with less than $25K in liquid 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 2008.

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 2008. 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 split equally between all creditors.

In total, the creditors would receive 30c in the dollar. In liquidation the creditors would have received almost nothing. The creditors, after voicing their displeasure at losing 70c in the dollar and having to wait over two years for their money voted to accept the proposal. It was New Zealand's first Deed of Company Arrangement, or DOCA.

Damien Grant (Waterstone), Stu Fraser and Tim Donaldson (Northern Energy), Steven Khov (Waterstone) and Ross Dillon (Gaze Burt) just after the passing of New Zealand's first DOCA.

The Numbers

The numbers tell the story:

Northern Energy

	Before VA	After VA
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**

The above balance sheet demonstrates why Voluntary Administration will become a major part of New Zealand's commercial landscape over the next decade and poses substantial risks and opportunities for suppliers of credit to limited liability companies.

The Watershed Meeting

At the Watershed meeting the Administrator may present to the creditors a DOCA. The administrator is not obligated to and can recommend liquidation as an alternative.

The directors also have an obligation to attend.

The creditors have three options:

1. Accept the proposed Deed of Arrangement
2. End the Administration
3. Put the company into liquidation

The administrator is the chairman of the meeting, and in order to pass, a resolution requires both:

A majority in number (i.e. at least 50%+1)
and 75% in value of creditors votes.

However, in the event that both criteria are not met, the Administrator has the casting vote.

The use of the Administrator's casting vote is an area that is not clearly defined in the New Zealand legislation.

In Australian statute, there are clear guidelines for use by the Administrator to use their casting vote.

If Australia a DOCA is passed if 50% of creditors by both number and value of debt support the proposal. If the DOCA obtains a majority of one but not both, then the Administrator can exercise a casting vote in favour of the DOCA if they, in good faith, believe that the DOCA is in the interests of the creditors.

In New Zealand there are no such legislative guidelines. Most commentators are of the opinion that if the creditors are deadlocked, the Administrator's vote can put the DOCA over the line. Thus, if a majority of creditors in number, but representing less than 75% of the debt, are in favour of the DOCA then the casting vote of the Administrator can pass the DOCA. Alternatively, if creditors representing over 75% of the debt but less than 50% of the total number of creditors are in favour of the DOCA, again the consensus in the commentary indicate that the casting vote of the Administrator will be decisive.

This is an area that is certain to be settled by case law.

After the Watershed Meeting

If a DOCA is approved by the creditors, the board must approve within fifteen days or face liquidation.

If termination of administration is preferred, the company reverts to the position before administration. The administration can also be terminated if the meeting is not held within the prescribed time or there is no resolution passed at the meeting.

If liquidation is chosen the company will go into liquidation immediately. If the company fails to execute the deed within the prescribed time then the company goes into liquidation and the administration is terminated.

The Deed Of Company Arrangement: DOCA

Once the creditors and the company's board agree to the DOCA, the company comes out of VA and is returned to the board and its directors for daily running.

There will be a Deed Administrator who will oversee the Deed, but not the running of the Company.

The creditors are prevented from taking any action against the company except as allowed for by the DOCA. Typically a DOCA will provide for the creditors to receive a percentage of their total amount owing over a period of time.

Once the Voluntary Administration ends the directors resume control of the company although the DOCA may impose limitations on the company by empowering the Deed Administrator in some way; such as appointments to the board must be approved by the Deed Administrator, capital purchases to be subject to Deed Administrator approval, and so on.

The legislation is silent on the operation of the DOCA. Australian examples are many and varied where creative provisions have been used to ensure that the directors, who ran the business into trouble in the first place, are constrained for a set period of time. This has the benefit of installing confidence in the creditors as to the wisdom of dealing with the company moving forward.

What about the IRD?

The IRD is a creditor for the purposes of the Watershed meeting. They are bound by the DOCA.

If the company subsequently goes into liquidation the IRD is often a preferential creditor. In the event of a liquidation, the IRD preferential debt ranks ahead of all but the liquidators' costs, some staff costs and secured creditors.

The question as to whether the IRD retains its preference in a Voluntary Administration is not explicitly dealt with in the legislation. No doubt it will be dealt with by the courts in short order.

Overseas jurisdictions have determined that if the Voluntary Administration is merely an alternative to liquidation then the DOCA should not change the outcome that would occur in a liquidation. ie: where the business is not going to continue but the Voluntary Administration is being used rather than a liquidation, unsecured creditors should not be able to gain an advantage over preferential creditors by the use of the VA regime as opposed to the liquidation regime.

However, where Voluntary Administration is being used as it was intended, where the business (if not necessarily the company) is being salvaged, and the financial restructuring is designed to save the business, then removing the status of preferential creditors is permissible.

This has yet to be determined by the New Zealand courts and is already the subject of litigation.

It is assumed by some commentators that the IRD would prefer liquidation in most cases and therefore not support the DOCA. In the small number of cases to date the IRD has generally not supported the proposed DOCA, but they have not opposed them all. In most cases of Voluntary Administration there would be a secured creditor who would be taking the lions' share of any assets in liquidation. Therefore the IRD may typically do better in keeping the company alive than in seeing it move to liquidation.

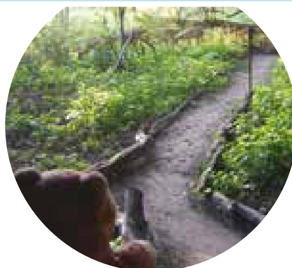
The IRD has some specific criteria concerning DOCAs. They require confidence that there is a viable business and a solid business case for the company moving forward. The IRD is open to a discussion prior to entering voluntary administration and this is highly recommended.

Prudence Explains: A GSA

A GSA stands for a General Security Agreement. This is where a company grants a security over all of the companies assets. A typical example is where a bank lends money to a company. The bank will often insist on taking a GSA. This is no different from a finance company taking a security over a car, the security company has a claim over everything in the car.

Where a GSA has been issued, the person owning the GSA can claim everything in the company.

The key difference is that a GSA will often include the right to appoint a receiver. A receiver (see section on receivership) will take over all of the company's assets and acts much like a liquidator.



Issues for Secured Creditors in Voluntary Administration

A secured creditor whose security covers all, or virtually all, of the company's assets, (ie: hold a GSA or debenture, or a PPSR security against 'all current and future assets' or similar) has special rights in the case of a Voluntary Administration.

- They have ten working days from receiving notice of the appointment of an Administrator to enforce their rights to repossess assets or appoint a receiver
- If they wait longer than ten days they lose their rights and must wait for the outcome of the Administration to run its course
- After the ten days they have no more rights than an unsecured creditor during the period of Administration
- They cannot vote their secured debt at creditors meetings

A secured creditor whose security covers only specific assets, has limited protection:

- They will be unable to collect their assets and the Administrator will be able to continue to use their assets
- The Administrator will be obligated to pay any lease costs, but not capital loan repayments
- If their security covers or includes perishable stock they can enforce their rights and recover the perishable items assets unless the courts prevent it

This brings into play a key element in Voluntary Administration; the consent of major secured creditors.

Before a company enters VA it would be prudent for it to discuss the options with any such secured creditors. The secured creditors could then decide to support or not support the appointment of an Administrator. If the company went ahead and appointed an Administrator without the consent of a secured creditor the secured creditor could appoint a receiver within the ten day period and effectively prevent the Administrator from running the company.

In addition to the ten day rule, there is Section 239ACT(2)(a). This provides that a secured creditor only loses his rights if:

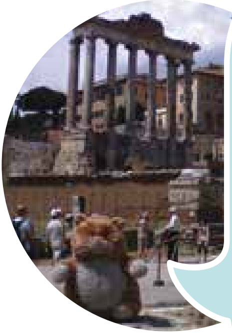
A) The DOCA states that the secured creditor loses their rights

and

B) The secured creditor votes for the DOCA

A secured creditor cannot lose their security unless they consent to losing their security, although they may be temporarily unable to enforce their rights during the five to six weeks that the company is in Administration.

They are prevented from enforcing their rights during the course of the Administration, (except for the first ten days) but they gain their rights after the end of the Administration when the company either goes into liquidation or into the DOCA period. This gives a secured creditor considerable power. It means that they have a veto on the DOCA.



Prudence Announces:

Companies thinking about Voluntary Administration must first talk to any parties with a GSA over the business. ICP Biotechnology was a listed start-up that fell into trouble. They borrowed money from EasyFactors who had a GSA over the company.

The board called in Staples Rodway as Voluntary Administrators on the morning of the 14th of May. Alas, EasyFactors were not in agreement with this, and that same day they appointed KordaMentha as receivers over the business.

This resulted in the liquidation of the business at the watershed meeting six weeks later. Voluntary Administration is not going to work unless the GSA holders are on board.

Personal Guarantees

Enforcing a personal guarantee during the period of Voluntary Administration is prevented by the new legislation. This is an important part of the moratorium. Directors have a respite from creditors as they try and resolve the issues facing their company.

In Australia there have been a number of DOCAs that state that personal guarantees are voided. The Australian courts have taken a dim view of this and rejected such attempts. If someone has given a personal guarantee it cannot be expunged by the passing of a DOCA.

Supplying Goods and Services to a Company in Administration

The Administrator is personally liable for all debts incurred during the Administration and is able to use any company assets not covered by a security to cover the running costs of the business going forward. The Administrator is not able to use items covered in a PPSR or other enforceable security to recover his costs.

An element of Voluntary Administration is the treatment of lease agreements that the company may be contracted into. The Administrator has seven days to either agree to continue to lease, or to serve notice on the landlord that the property is not needed. The Administrator is not personally liable for the first seven days if they cancel the lease in that time.

The landlord will not lose their rights as a creditor in the company, but they will not be able to enforce a claim against the Administrator personally for non payment of any rent.

The same is true for employees. The Administrator has ten working days to cancel employment agreements. If the Administrator does so in that time the Administrator is not personally liable for wages incurred during this time.

Voluntary Administration: Case Study B

An example of the flexibility of the VA regime was demonstrated in the case of the Jones group of companies, a publishing business who printed magazines such as Dish and Top Gear.

The principals of the business were creative and effective at getting high quality magazines out to market. Where they struggled was the nuts and bolts of running a business and paying the bills.

Their major creditor was their printer, who was owed over a million dollars. They were aware of the Jones' financial predicament and they saw an opportunity to acquire the business rather than let it fail and be forced to write off their debt.

The companies went into Voluntary Administration.

The DOCA proposed letting the major creditor buy the magazines and run them for the benefit of all the creditors. If the magazines made a profit the creditors would get some money back, if not they were no worse off than if the magazines were closed.

There were three critically important parts of the DOCA:

Fortunately for the principals of Waterstone, attractiveness, posture and dress sense are not skills required to pass DOCA's.

1) The debtors were collected by the Administrators and paid to the creditors (except for the new owners who waived their claim in the debtors to sweeten the deal for the other creditors.)

2) The existing directors, who had brought the business to grief, were replaced by new directors and new shareholders, although they continued to work for the business.

3) The IRD, who would have been paid out first in a liquidation before the other creditors, were treated as an normal creditor, giving the other creditors a far greater return than they would have otherwise.

CHAPTER THIRTEEN: RECEIVERSHIP

Receivership is a little understood but very powerful process. It allows for a secured creditor to step in and take control over a company and its assets almost immediately, without having to go through a court process. The governing legislation is the Receiverships Act 1993.

The directors cease to control the company and the receiver will run the business for the benefit of the creditor that appointed him.

The Debtor

The debtor is the party that granted the security. Formally referred to as the grantor, the debtor, typically (but not necessarily) a limited liability company that borrowed money from a third party and gave that third party a security over the assets of the company.

The General Security Agreement (GSA)

A General Security Agreement (formerly called a debenture) is a security given over a company in support of a loan. Commonly referred to today as a GSA, the GSA document will give the creditor rights in the event of a breach of the loan agreement. In some cases, the GSA holder can take over the asset, or it can appoint a receiver to run the company.

In the GSA document there will be trigger events that will allow the GSA holder to appoint a receiver. These are typically:

- Default in payments
- Appointment of a liquidator
- Debtor ceasing to trade
- A compromise with creditors (See Chapter Eleven: Compromise with Creditors)
- Breach by the debtor of some obligation in the debenture agreement (such as debt to equity ratios)
- The debtor's actions are threatening the GSA holders security

Unlike a statutory demand, there is no formal process set down in legislation for the appointment of a receiver, but the following are minimum requirements:

- Appointment must be done according to the terms of the GSA
- Appointment of the receiver must be done in writing
- Receiver must be a person not barred by legislation from being a receiver
- Receivership begins once the receiver accepts the appointment

In most cases the GSA will specify that the debtor must receive a demand for payment before the appointment of a receiver. However, this is not a legislative requirement.

The Demand

A loan is usually for a set period, with repayment terms spelt out. This protects the debtor from the lender capriciously calling up the loan. It is not uncommon for lenders (ie: finance companies) to get into trouble. Borrowers want to be protected from the lenders sudden need for cash.

So long as the repayment terms are met the loan cannot be called up.

If a breach of the loan occurs then the loan document will allow the lender to recall the entire debt. The amount owing then becomes “on demand”, meaning that the debtor must repay the amount demanded.

This is important, because a GSA holder can put a business into receivership in as little as one hour.

If a company is in default of the GSA, and the agreement allows for payment ‘on demand’, the GSA holder can wait as little as one hour before appointing a receiver.

To quote one judge:

> “A debtor who is required to pay money on demand must have it ready, and is not entitled to further time in order to look for it.”

The key is, the GSA holder has to give the company as much time as required to effect payment. Effectively, as long as it takes to collect a cheque book.

If the debtor company admits that they cannot pay the amount demanded, the GSA holder can appoint a receiver on confirmation that the demand will not be met.

A prudent GSA holder may give the debtor several days to collect the money, but if the GSA and loan document allows for an ‘on demand’ repayment, they are not obliged to.

Commencement of a Receivership

A receivership occurs when the creditor formally appoints a receiver. The obligation is on the creditor to prove that default and if the receiver is subsequently found to have been improperly appointed the creditor and the receiver can be liable for substantial damages.

A receiver is usually appointed by the GSA holder according to the terms of their GSA. However, if the GSA and loan document is unclear, the security holder can seek an order from the courts to proceed with a liquidation.

A receiver who was invalidity appointed is considered to be trespassing. Although the GSA holder has an exposure the receiver is explicitly held liable in statute for all losses suffered by the company by his actions.

The Receivership

Once appointed, the receiver must:

- Give written notice to the debtor
- Give public notice in the NZ Gazette and relevant newspaper(s) detailing
    - * Date of appointment
    - * Receiver's office address
    - * Receiver's full name
    - * Brief description of the property in receivership

All documents from the company must make it clear that the company is in receivership.

The receiver has the power to run the business in receivership, including hiring staff, managing property, selling assets and entering into contracts. The receiver can also call up unpaid capital.

The Directors

In a receivership the directors powers are suspended sufficiently to allow the receiver to do their job. They do not cease to be directors and can undertake some action in the name of the company. In reality, this is limited to legal action against the receiver.

The company in receivership must make available to the receiver all documents, bank details etc.

The Receiver

The receiver has a primary duty of care to the GSA holder that appointed him. However, the receiver also has a duty of care to the company and other creditors not to act in a negligent manner. If a receiver is negligent he risks being held liable by other creditors and by the company.

The receiver has a statutory obligation to obtain the best price for the assets. He cannot sell the assets cheaply to recover just enough for the GSA holder at the expense of other creditors.

The receiver must, within two months and again after every six months after his appointment, report on the progress of the receivership. These reports are to go to the debtor and the appointing GSA holder. If appointed by the court, the court must also receive a copy of his reports.

A receiver can be held personally liable for other costs of the company in receivership. In most circumstances the receiver will seek an indemnity from the appointing creditor before accepting a receivership.

Reporting Crime

A receiver must also report any defalcations he becomes aware of during the receivership. The Receiverships Act 1993 does not refer to the 1994 Tax Administration Act so the receiver does not have to report breaches of this act. Most do, however. If the company has been submitting fraudulent documents to the IRD, this is proffering a document for pecuniary advantage and will land the directors in some trouble, being covered by the Crimes Act, which is mentioned in the Receiverships Act 1993.

Priority of Security Interests

Once a receiver has sold a property or asset, any security interests in that property that are subordinate to the security interests of the appointing creditor are vacated. If there is anything left over, this money will be paid out by the receiver according to the following:

- Any person with a security interest registered in the PPSR
- Any person with a security interest not registered in the PPSR
- The debtor

The ranking of priorities when it comes to paying out the surplus comes under the PPSR legislation and is detailed in Part Six: The PPSR.

Once the receiver has recovered funds from the sale of the secured asset all other security interest in the asset ceases. Thus, if there is a second GSA holder, their rights are extinguished.

If the receiver is unable to sort out competing claims on any surplus, he can deposit the funds with the court and let a judge sort it out.

Prudence Reports

A company can be in liquidation and receivership at the same time. It is possible for a GSA holder to put a company that is in liquidation into receivership to protect their position. If there is a liquidator and a receiver, the receiver controls the assets and is usually in a stronger position.

CHAPTER FOURTEEN:
MAKING THE BEST DECISION FOR A BUSINESS

There are risks in business. The ability to take risks, and bare losses, is a key skill in any business person and sometimes failure is the result of legitimate business risk.

Where Hope Remains

If the business has a viable core, and there is staff motivation to continue, then Voluntary Administration is an option.

There are two key issues to consider when facing Voluntary Administration.

1) Voluntary Administration relies on creditor support not just to pass a DOCA but also in supporting the business if a DOCA is passed. Here the credibility of the directors is critical. Directors who have lied, made unrealistic payment promises or generally behaved in an unpleasant manner prior to the administration are likely to face a hostile reaction from creditors. No matter how solid the business case, creditors are likely to vote emotionally, especially if the return to them is low.

2) Ideally the Inland Revenue should be consulted prior to entering Voluntary Administration. If the company has a GSA then it is important that the GSA holder be consulted. A competent insolvency firm will help manage this process.

If there is widespread creditor support and the level of IRD debt is low a company may look at a compromise with creditors. The advantage here is that it is less disruptive to the business as there is no external management. The process can be faster, as little as two weeks, to issue a proposal and hold a creditors meeting.

A compromise need not be public. There is no need to advertise in the gazette or the local paper.

However, the IRD is not bound by such a proposal and the requirement to gain 75% of creditor approval is a tough hurdle.

In a Voluntary Administration the administrator can use his casting vote to force a DOCA through. This power is often enough to help bring reluctant creditors to the table. This ‘bully pulpit’ is not available in a compromise.

Early Liquidation

Insolvency is like an infection. It spreads. Once the rot is established in a company it infects everyone in the business. Honest directors come under pressure to lie, staff become compromised, suppliers get caught up in the mess.

As the business slowly fails directors typically do three foolish things that they come to regret.

1) Sign personal guarantees or run up further debt to suppliers that they already have personal guarantees with.

2) Drive a marginally insolvent firm into a grossly insolvent firm, taking inappropriate business risks and breaching their directors duties: becoming liable for prosecution under section 135 and/or 136 of the Companies Act.

3) Cease to pay the Inland revenue and breach the 1994 Tax Administration Act. Criminal sanctions apply.

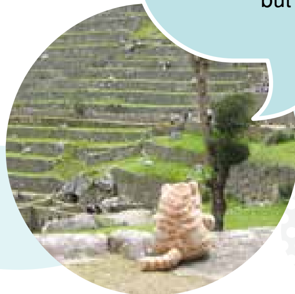
A competent insolvency practitioner can act quickly to protect the value of a business if given the opportunity. Too often directors hold on too long. By the time the company falls into liquidation the debts are too high, the creditors too angry and the staff too jaded for any salvage operation. Critically, an early liquidation has the advantage of limiting the debt exposure of the director to personal guarantees.

Going early can often save the family home.

Prudence States

If a company that is in trouble is referred to an insolvency firm early, then there are more options available.

Many business owners wait to long, leaving the insolvency firm little option but to close the doors.



Is Voluntary Administration right for your business?

Can the business pay its bills as they fall due?
- YES → Continue
- NO ↓

Is your business covering its ongoing running costs? (ignoring historical debt)
- NO → LIQUIDATION
- YES ↓

Does the business have a GSA?
- NO → Are the rest of the creditors likely to support a proposal?
- YES ↓

Does GSA Holder support VA?
- NO → LIQUIDATION
- YES ↓

Are the rest of the creditors likely to support a proposal?
- NO → LIQUIDATION
- YES ↓

VOLUNTARY ADMINISTRATION

Part Three:

Directors Risks

CHAPTER FIFTEEN: RECKLESS TRADING

"Why have you not taken a reckless trading prosecution?" is perhaps one of the most commonly asked questions asked of a liquidator.

It is a good question, and we have two simple answers:

a) A business failure is not proof of reckless trading

b) It costs a ton of money

To qualify for reckless trading a director must break a narrow section of the Companies Act 1993: Section 135, and by extension Section 136. These sections outline two duties of a director.

Section 135 Reckless Trading

A director of a company must not:

Agree to the business of the company being carried out in a manner likely to create a substantial risk of serious loss to the company's creditors; or

Cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

Section 136 Director's Duty of Care

A director of a company must not agree to the company incurring an obligation unless the director believes at the time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

The principle is, if a liquidator can prove a director has breached either of these duties, then the director can be held personally liable for the losses of the business. The courts, however, are reluctant to lift the corporate veil that stands between a director and the creditors of his insolvent company, so the breach needs to be substantial and not merely technical.

Some examples overleaf are instructive.

South Pacific Shipping: Theory

This company failed in February 1998. The liquidators, PricewaterhouseCoopers (although just Pricewaterhouse back in 1998), with the backing of a motivated creditors' committee took the director to task. The Background:

- The company, a Christchurch based shipping firm, lost six million in 1994
- The director owned eight of the ships being used by the company
- Despite such huge losses and appalling management reporting the director continued to trade

The liquidator, Gary Traveller, wrote back in 2004:

> "It should have been apparent to the directors from late 1993 and early 1994 that the company was incurring further losses, that the projections of profit were hopelessly adrift and that the trading environment was becoming increasing difficult."

The Judge took into account the commercial advantages accruing to the director, Klaus Lower, as a result of his ownership of eight of the firm's eleven ships which gave him the ability to generate substantial collateral advantages. The judge found that this conflict of interest caused Mr Lower to gamble with the firms creditors money whilst enjoying significant commercial advantages. He further found that the firms accounting practices were "lamentable".

To quote from the High Court Judge in 2004:

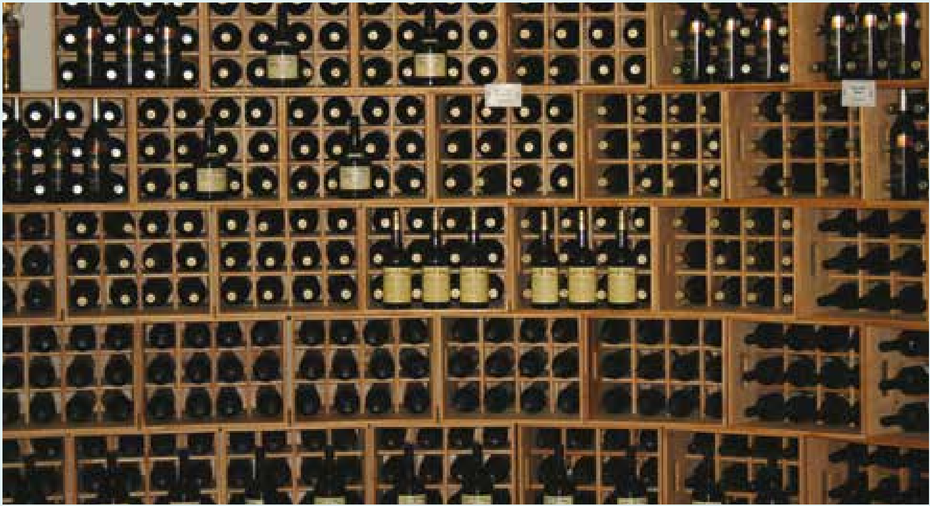
> "In those circumstances, I think Mr. Lower can fairly be regarded as having forfeited the protection of limited liability for what followed. Given his wish to permit South Pacific Shipping to continue to trade despite insolvency... he ought to have been prepared to put his own money up by capitalising the company... His behaviour departed so markedly from orthodox business practice and involved such extensive and unusual risks to the creditors that it can be fairly stigmatised as reckless."

The Court of Appeal concluded that the company should have closed and that a responsible director should have known that. To continue to trade was taking extensive risks. It was reckless of the director to continue and his decision to do so increased the losses to the creditors. He was found liable for all seven million of the company's debts.

South Pacific Shipping: Application

According to the final liquidators' report from PricewaterhouseCoopers, the costs of taking the court case was 2.3M. The amount recovered from settlements was 1.8M.

In essence, despite a clear and unambiguous case, it took the liquidators nine years to settle this reckless trading action. By taking the case, even though the liquidators collected 1.8M dollars, unsecured creditors were left $500,000 out of pocket.



Cellar House

In this case the company had a one million debt due to Customs, dating from 1992. The director disputed the debt and did not properly account for it in the company accounts.

The court found that because the debt was due the company was insolvent despite the directors refusal to account for it in the firms accounts. Because the director choose to trade on beyond that point he was found liable for the company's debts.

Global Print Strategies

The company had been surviving because the main shareholder and director, Graeme Grant, had been defrauding his factoring company. Mr and Mrs Lewis were minority shareholders and inactive directors of the business.

As Mr Grant was in prison at this time, the liquidator took Mr and Mrs Lewis to task. They had received notices from the IRD about unpaid taxes and were aware that the accounting was lax, at best.

This case bounced between the various levels of New Zealand's judiciary before finally the unfortunate Lewises were found liable for a portion of the company's debts.

This is a very important case because the Lewises were inactive directors. Although they took no part in the running or management of the business, they were still found liable for a portion of the company's debts.

Advanced Plastics

Petros Developments was a manufacturer of plastic products and its key supplier was Advanced Plastics.

The two firms had a close relationship but over time there grew a large debt owed to Advanced Plastics by Petros.

The relationship turned sour, Advanced Plastics called up their debt and Petros went into liquidation owing Advanced Plastics over 800k.

The reckless trading case against the director of Petros failed because the director of Advanced Plastics knew of the financial position of Petros. A creditor who knows of the commercial risks and continues to trade with a firm in trouble cannot rely on a reckless trading prosecution case to recover their losses.

Reckless trading is a subjective judgement. What is a valid commercial risk in one person's eyes may be considered reckless by another.

Because the outcome of a prosecution is so uncertain liquidators are reluctant to take the cases unless the breaches of the Act are egregious. Making the issue more complex, the type of directors to engage in such flagrant business abuses are not the sort of people who will have acquired significant assets over the course of their careers, making any court victory ultimately worthless.

Three principles:

A) Ignorance (or negligence) is not a defence. If the company is insolvent then a director should know it is insolvent. The courts will act as if the director knew the company was insolvent because a director should know if the company is insolvent.

B) Trading a business on when there is no reasonable prospect of survival is reckless.

C) Legitimate business risks are not reckless, the courts are not going to hold a director personally liable for taking legitimate business risks that do not work out.

CHAPTER SIXTEEN:
FAILING TO KEEP ACCOUNTING RECORDS

In many cases a liquidator finds inadequate accounting records. Sometimes no accounting records.

Sometimes, as evidenced by the picture on the right, all we find are boxes of assorted paperwork as was the case of a South Auckland scrap metal yard we liquidated in 2008.

When this happens the director is deemed to be in breach of the obligation of Section 194 of the Companies Act.

Section 194: Accounting records to be kept

> The board of a company must cause accounting records to be kept that ...correctly record and explain the transactions of the company; and will ... enable the financial position of the company to be determined with reasonable accuracy;

Where a director fails to keep proper accounting records the liquidator can turn his attention towards the director.

Section 300: Liability if proper accounting records not kept

> ...if a company that is in liquidation and is unable to pay all its debts has failed to comply with Section 194 of this Act ... and the Court considers that... the failure to comply has contributed to the company's inability to pay all its debts ... the Court, on the application of the liquidator, may... declare that any one or more of the directors and former directors of the company ... personally responsible ... for all or any part of the debts and other liabilities of the company as the Court may direct.

Both sections have been abridged here. The issue facing directors is that failing to keep accounting records is not a defence.

It is similar in concept to refusing to give a breath test. By doing so the conclusion of guilt can be made. Likewise, a director who does not know how badly his company is performing because the accounting is a shambolic mess faces the risk of having to cover the losses of the company.

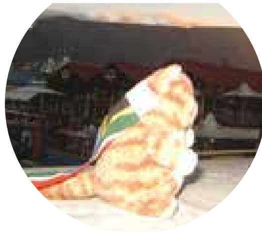
Prudence Pounces On Dodgy Bookkeeping

Directors can get caught out on two grounds here.

If they did not maintain good records, and this was part of the reason for the failure of the company, then they can be forced to pay for the company's debts.

But also, if they kept good books but some of the information was wrong, and they knew it was wrong (like the director in the Cellar House case not counting in the extra one million he owed Customs) then he can also get caught out and be held liable for the debts of the company.

But; it is not enough to just keep bad records; the liquidator must show that the bad record keeping contributed to the failure of the company.



CHAPTER SEVENTEEN: RETURNING COMPANY PROPERTY

Section 301 is a remedy that gives the court power to force a director or other people involved in the management of the business to hand back assets that they have taken from the business or to cover business losses caused by their negligence.

This procedure can only be used while the company is in liquidation. It cannot be used prior to liquidation and it cannot be used once liquidation is over and the company has been struck off the registrar.

The court can make orders under this section of the Act against:

- Directors
- Managers
- Promoters
- Receivers
- Liquidators
- Voluntary Administrators

The court can make an order if any of the above have:

> "....misapplied, or retained, or become liable for accountable for, money or property of the company, or been guilty of negligence, default of breach of duty or trust in relation to the company..."

If the court thinks that a person is guilty of any of the above breaches then the court can order that person to:

> " ...repay or restore the money or property or pay part of it with interest at a rate the Court thinks just or to contribute such sum to the assets of the company by way of compensation as the Court thinks just."

The sort of specific examples that are given in case law include, but are not limited to:

- Paying dividends out of capital (especially if the company did not pass the solvency test, this is akin to paying a dividend out of creditors money)
- Paying one creditor in preference to another (very common when there are personal guarantees at stake)
- Failure to use proper skill and care in performing duties leading to a loss by the company
- Removing company assets
- Selling company assets to related parties at below or no value

Section 301 is a kind of catch-all designed to hold company office holders to account for breaches of their duties. It replaces civil tort remedies that existed prior to the enactment of the legislation.

This section of the Act does not cover those who make bad decisions or whose business get into trouble through no fault of their own. It is designed to catch those who act dishonestly or negligently.

Prudence Explains:

Decisions not covered by Section 301

- Making a legitimate investment decision that turns out to be disastrous
- Continuing to trade after a disastrous result in the honest belief that business can recover
- Continuing to trade confident additional capital can be found
- Continuing to trade after canvassing issue with creditors

Decisions covered by Section 301

- Selling business to wife for $1 when it was worth much more
- Taking assets and putting them into own name
- Not taking steps to manage the company once problems had become apparent
- Not being aware of problems when the director should have been aware of them

Amount of Exposure

The courts have been reluctant to impose damages on people covered by this section. So if an asset of $100,000 was removed, it can be expected that this will be the value of the court order. Likewise, if the losses suffered by the company due to the negligence of the director was $100,000 then this will be the value of the order, not necessarily the total losses of the company.

CHAPTER EIGHTEEN:
THE PHOENIX PROVISIONS:
THE COMPANIES ACT 1993: SECTION 386A-386F

The Phoenix provisions came into force in November of 2007. They fill what law makers believed to be a gap in the legislation whereby companies were able to go into liquidation and, shortly before or after, a new company with effectively the same name was able to be formed which carried out the same business, and to many dealing with it would appear to be the same company.

Some Terms Defined

Failed company:

A company that was placed into liquidation when it was unable to pay its debts.

Failed company director:

Anyone who was a director of the failed company within the 12 months prior to liquidation.

Phoenix Company:

A company that at any time before, or within 5 years after, the commencement of the liquidation of the failed company is known by a name that is the same or similar to a pre-liquidation name of the failed company.

Similar Name:

Means a name that is so similar to a pre-liquidation name of a failed company as to suggest an association with that company.

Section 386A of the Companies Act provides that a failed company director may not, except for the leave of the court, be a director of or directly or indirectly concerned in the promotion formation or management of a Phoenix Company, or any business with a same or similar name for five years after the commencement of the liquidation of the failed company. The use of the term 'or any business' means that former directors will be liable under this section where they set up sole traders or partnerships, not just where a company has been created.

Exceptions

Under Section 386D a director will be excused if the Phoenix Company acquired the property of the failed company as part of an arrangement with a liquidator, receiver or under a DOCA. In this case a notice will need to be sent by the successor company to all known creditors within 20 days of the arrangement.

An exception is provided where the Phoenix Company had been known by the name in question and had been trading for at least 12 months prior to the commencement of the liquidation.

Consequences

Contravention of this provision exposes the director to a criminal conviction. However the real power of this section lies in Section 386C. A director who breaches this section is personally liable for all the 'relevant debts' of the Phoenix Company. Relevant debts are defined as those incurred by the Phoenix Company while the person was involved in the management of the company, and the company was known by the phoenix name.

The section also provides liability for those who act on the directions of someone they know to be in contravention of Section 386A.

Prudence Elaborates:

If a company is liquidated someone who was a director of the failed company cannot just set up another business with the same name.

This is to stop people having one company, say "Masterton Plumbing", putting that company into liquidation and starting a new company called "Masterton Plumbing and Drainage".

If they do they are personally liable for the debts of "Masterton Plumbing and Drainage". Plus prison!

CHAPTER NINETEEN: THE INLAND REVENUE DEPARTMENT

The Inland Revenue has been funding New Zealand firms for many decades.

The major significant issue facing the Inland Revenue is the inability to supply credit to questionable firms. This issue creates significant collection problems and is responsible for some very significant powers held by the IRD.

This chapter reviews some of these powers.

HK11

No. Not an Asian rugby competition. This elegant piece of tax legislation, contained in the Tax Administration Act, specifies what happens to directors who engage in asset stripping.

If a company director, or someone acting as a director, enters into an asset stripping arrangement, where the assets of one company are removed into those of another, then this director becomes liable for income tax owing by the first company.

This section also captures shareholders but their liability is limited to the market value of their shares.

Diverting the Crown's Revenue

Section 143(A) of the Tax Administration Act specifies that if a director uses money collected on behalf of the IRD and uses it to pay another bill, this is a crime.

143(A) Knowledge offences

(1) A person commits an offense against this Act if the person:

D) Knowingly applies or permits the application of the amount of a deduction or with holding of tax made or deemed made under a tax law for any purpose other than in payment to the commissioner.

The sanctions are 5 years in prison and/or a $50,000 fine.

Put simply, if a company director has money in the company bank account at the time GST or PAYE is due and decides not to pay the IRD but uses the money to pay another creditor, this is a crime. Not a civil offence or a minor breach of tax regulations but a criminal offence which parliament has set a term of five years as a maximum penalty.

It is not often that people go to prison for this crime, but some do.

IRD Press Release:

Businessman who "undercut the opposition" jailed for tax fraud
25 May 2007

Business people who cheat the tax system are undercutting honest businesses, Inland Revenue said today after an Auckland man was jailed for two and a half years for fraud.

Wilfrid Edward Gain, was sentenced today in the Manukau District Court for 12 charges of tax evasion, relating to $165,268 of GST and Income Tax.

Mr Gain had pleaded not guilty at a hearing in November 2006 but Judge J. E. Maze found him guilty, rejecting Mr Gain's statement as "lacking credibility and reliability" and saying she was satisfied Mr Gain had intended to evade the tax.

Mr Gain had worked as a self-employed door manufacturer and wholesaler and had operated a company called Inwall Sliding Doors Ltd. Between April 2001 and March 2005 the business turnover was about $1.1 million. Judge Maze said Mr Gain had a business policy of deliberately undercutting the opposition and competitors to get work.

In sentencing today, Judge Epati said this was serious offending, and there was a high level of premeditation. Tax fraud was a fraud against all taxpayers, the judge said.

Inland Revenue had sought a custodial sentence and said it was important for the business community that there was a level playing field.

Tracey Lloyd, Area Manager Investigations, said Inland Revenue owed it to all the honest businesses who do comply with their tax obligations to make sure that rogue operators are brought to account.

"The custodial sentence was a fair outcome, given the amount of tax evaded, that it was over a four-year period, Mr Gain's lack of cooperation during our investigation, and his lack of remorse," said Ms Lloyd.

"Taxes are used to fund schools, hospitals, and other government and community services," she said. "People who try to rip off the system are stealing from the community."

Section 17

There is no hiding from the Inland Revenue.

Section 17 of the Tax Administration Act specifies that any person holding information must hand it over to the Inland Revenue, if required to by the IRD.

This includes: Banks, Lawyers, Accountants, even Liquidators.

This allows the IRD to work out where a company has been receiving money and where it has been applying it.

To assist the IRD section 16 gives the IRD the power to enter buildings to seize documents. The IRD does require a warrant to enter a private residence but not to enter commercial property.

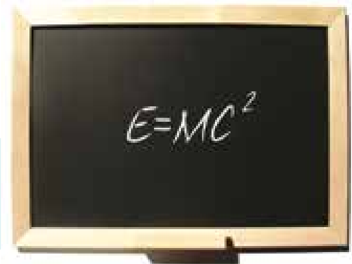
The Practical Risk?

Directors who simply get into trouble and fail to pay the Company Tax will probably not be targeted by the Inland Revenue. Probably.

The courts are unlikely to send a director to prison for not paying taxes because the company had no money.

Most IRD staff have too much work to do, so, like the rest of us, they prioritise which files to work on and which to let slide. If a tax payer's behaviour has been outrageous and they have driven the business into the ground, paid themselves massively, not filed returns and left the IRD with a huge debt, then that file is going to get attention.

CHAPTER TWENTY: THE LAQC



" The hardest thing in the world to understand is the income tax."

Albert Einstein, physicist

One of the traps many directors fall into is the LAQC trap.

An LAQC is a Loss Attributing Qualifying Company. This means that any losses that the company makes can be netted off against the shareholders personal tax. This is useful for people who have an income from employment and run a business (usually a rental property) and can claim losses from the business. In effect, if the tax payer earns $100,000 from their day job, and their rental property business loses $20,000, they only have to pay tax on $80,000.

But, and with the IRD there is always a but, if the company is an LAQC, the legislation stipulates that the shareholders are personally liable for the tax on any profit the business makes.

Normal advice is, once a company stops making losses, have the accountant change the status from LAQC to non-LAQC. This IRD is okay with this arrangement, but it cannot be retrospective.

A shareholder's obligation is only on the tax on the profits on the company. They are not liable for the PAYE, GST or any other form of tax that the company may owe the IRD. Only the tax due on profit of the company.

CHAPTER TWENTY ONE: PERSONAL GUARANTEES

Most creditors, and landlords, supplying small to medium businesses will want a personal guarantee. Many business people facing the collapse of their businesses will state with confidence and certainty that do not have any personal guarantees.

They are usually wrong.

Personal guarantees are the means by which creditors get around the restrictions of dealing with a limited liability company. Many people who have never run a business will mock those who have and got caught by a personal guarantee.

It is very difficult to trade in New Zealand without giving personal guarantees.

Prudence ponders:

There is a battle going on in commerce between debtors and creditors. First, debtors came up with limited liability companies to limit their exposure to their businesses losses.

In response creditors began to demand personal guarantees. Flummoxed for a while, debtors then began to move their assets into trusts. Not to be outwitted, creditors started to demand that the trusts guarantee their debts and took security over specific assets.

It is like evolution, with the hunter and the hunted each trying to stay one step ahead of the other in the battle to control the director's assets.

CHAPTER TWENTY TWO: SHAREHOLDERS ACCOUNTS

Shareholders and directors can extract cash from their business in three ways:

- As wages and salary, where PAYE is deducted
- As drawings, treated as a loan from the company, to be repaid at some future time
- As a dividend

Where money is taken as wages, in the event of the liquidation of the company this income is treated as belonging to the shareholders and the liquidator has no claim over it, even if the PAYE was not paid. However, it does mean that the company assumes a PAYE obligation to the IRD each month as the money is withdrawn but the company can claim this money paid as an expense in the end of year tax accounts, reducing their total obligations.

If the money is taken as drawings then there is no PAYE obligation but the company is not able to expense the money paid, increasing the end of year tax obligations of the business. Where a business is not trading profitability the shareholder may decide that not having to pay PAYE on their own income provides the business with a short-term cash advantage.

The end result of this process is that, if the company does fail, money taken as drawings is money owed to the company and the liquidator has every right to call this money up. The fact that the shareholder has done unpaid work for the company is not relevant.

When faced with a liquidators demand for a current account the shareholders, or more accurately their lawyers, typically put up a quantum meruit defence. The argument is that despite the accounting treatment of the drawings the shareholder is entitled to payment. To date the argument has yet to be settled definitely by the courts.

From an insolvency practitioners perspective a shareholder or director has a choice when taking cash from their business. If they elect to treat the payment as a loan and not salary they should not be able to retrospectively change the treatment of these payments.

CHAPTER TWENTY THREE: TRANSACTIONS UNDER VALUE

Third Parties (Section 297)

If a company disposes of assets during the last 12 months prior to liquidation (for court appointed liquidations, this time starts at the time court proceedings commence and not the date that the company was liquidated by the court) then a liquidator can look to recover from the person who acquired the asset the difference between the market value of the goods and the price paid.

For this section to be able to be applied, there are four requirements that must be met:

A) The transaction was within the specified period (usually 12 months)

B) The company was insolvent at the time of the transaction

C) The insolvent company did not receive sufficient benefit for the services or goods provided

D) The other party did know, or should have known, about the insolvency of the company

Thus, if a party acts in good faith and can prove that they did not know of the company's insolvency, they have a defence to the liquidator's claim. This is not a defence available to related parties (see next section).

Related Parties (Section 298)

Where a related party (ie; director or related party to a director, including trusts etc) obtains a benefit from the company in the last three years before a company goes into liquidation (again, in the event of a court appointed liquidator three years before the legal case commenced) the liquidator has recovery options.

The key difference between Section 297 and 298 is under the later section the liquidator does not need to prove the company was insolvent, and there is no defence open to the director or related party because they were unaware of the insolvency of the company.

CHAPTER TWENTY FOUR: WASTED YEARS: WAGON WHEEL EFFECT REVISITED

Perhaps the greatest risk facing company directors is the wasted years trying to keep a sinking ship afloat. It is important to remember that a company is not a real thing. It is an intellectual construct, a set of accounting records. It has no real life or purpose of its own other than the value we individually and collectively ascribe to it.

A failing business draws in time, the single most valuable commodity any of us have. It draws in cash, resources and careers.

If you are involved in a business that is failing you should get out. There is nothing noble about spending years of your life and other people's money in trying to keep a failing business afloat.

Part Four:
Issues for Creditors

CHAPTER TWENTY FIVE:
RISKS OF INSOLVENT TRANSACTIONS

We have put this section, Insolvent Transactions, in the risks for creditors section rather than in the general section on liquidations because it is creditors who are usually affected by voidable transactions, although directors and shareholders can find their current accounts impacted as well.

Insolvent Transactions

Insolvent transactions are one of the most controversial areas of Insolvency. An insolvent transaction is one where the liquidator can compel a creditor who has received a payment to pay it back to the company.

The rules have changed, and so have some of the terms. Insolvent transaction has replaced voidable transaction, and a new concept of running account has been introduced.

An insolvent transaction is defined as one where:

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 is 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

Insolvent transactions are transactions that the liquidator may void, include the granting of securities as well as the payment of money. This would also typically include any questionable entries that paid off the current account of the directors.

The Ordinary Course of Business Defence

The old rules allowed for a creditor to claim the payment was in the ordinary course of business. The new rules do not allow for this. The new legislation is based largely on the Australian Corporations Act (2001). It replaces the 'ordinary course of business' with the 'running account' or 'continuing business relationship' test.

A Transaction

Rather than looking at a specific transaction, the new test looks at the commercial relationship between the creditor and the insolvent company, essentially the 'running account' between the two. The reduction in a creditors debt over a period caused by a series of transactions (payments and new debts raised) is essentially a single transaction for the purposes of the new rules.

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. ie; the outstanding debt fluctuates over time as payments are made and further goods and services are supplied.

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

Why is a running account important?

If an insolvent company makes a payment to a creditor in the last 24 months of its life, the liquidator may be able to 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 of a successful defence

Compass Airlines was a regional airline operating in Australia. AirServices Limited provided a range of aviation services. Compass Airlines was required to pay AirServices 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.

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. However, as the legislation closely follows the Australian law, Australian case law will be relevant in interoperating the provisions of the Act.

Three schools of thought:

Peak indebtedness

The running account should start at the highest 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 at 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 or 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 proving insolvency falls on 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 being 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 if you suspect that you are trading with an insolvent company look for some form of security.

Specifically:

A) Personal Guarantees

B) PPSR Security over specific assets, although beware of voidable charges (Section 293)

C) Get the director to pay you the debt from his personal account. This means that the director will incur a debt to his current account and you will be safe from a claw-back from a liquidator

The Act, Section 296(3) gives one very specific defence to an order of recovery from a liquidator;

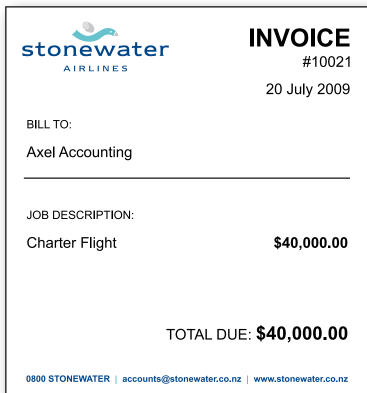
> The person from whom recovery is sought received the property in good faith and has altered their position in the reasonably held belief that the transfer to that person was validly made and would not be set aside; and
>
> They were without knowledge or had reason to believe that the company as solvent.

CHAPTER TWENTY SIX: NO NETTING OFF, RISKS OF TRADING WITH INSOLVENT

One of the trickiest pieces of insolvency legislation is Section 310. This outlines the rights of firms who are both debtors and creditors of a company in liquidation.

The rule being that if you owe money to a company that is in liquidation you can deduct from this debt any money that the company owes you, where that debt was incurred more than six months before the company went into liquidation.

Working through this issue; you supply goods to a firm that has just gone into liquidation. You are owed $20,000. $5,000 of this debt is over a year old, and $15,000 of it is current. At the same time you buy services from this same firm, and you have a debt to this firm of $40,000. You can only claim the $5,000 debt off the money you owe, but you must pay the liquidator of the firm $35,000.



stonewater AIRLINES

INVOICE
#10021
20 July 2009

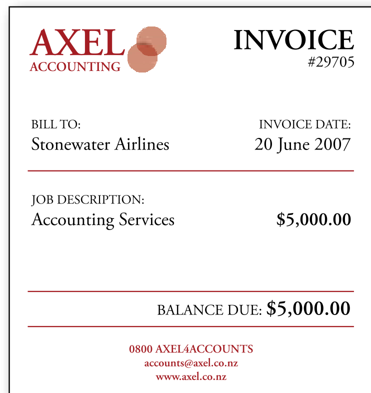
BILL TO:
Axel Accounting

JOB DESCRIPTION:
Charter Flight $40,000.00

TOTAL DUE: $40,000.00

0800 STONEWATER | accounts@stonewater.co.nz | www.stonewater.co.nz

Axel must pay this bill but...



AXEL ACCOUNTING

INVOICE
#29705

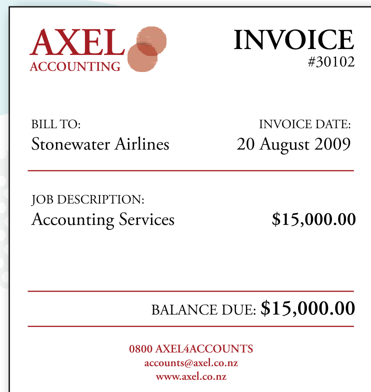
BILL TO: Stonewater Airlines
INVOICE DATE: 20 June 2007

JOB DESCRIPTION:
Accounting Services $5,000.00

BALANCE DUE: $5,000.00

0800 AXEL4ACCOUNTS
accounts@axel.co.nz
www.axel.co.nz

... Axel can deduct this bill (over 6 months old)



AXEL ACCOUNTING

INVOICE
#30102

BILL TO: Stonewater Airlines
INVOICE DATE: 20 August 2009

JOB DESCRIPTION:
Accounting Services $15,000.00

BALANCE DUE: $15,000.00

0800 AXEL4ACCOUNTS
accounts@axel.co.nz
www.axel.co.nz

... Axel can not deduct this bill (less than 6 months old)

CHAPTER TWENTY SEVEN: SECURED CREDITORS AND INSOLVENCY

Secured Creditors come in two categories; those with a security over a specific asset, and those with a security over the entire company. The later is called a debenture or a General Security Agreement (GSA). They are both covered by Section 305 of the Act.

Secured Creditors: Liquidation

Creditors who have a security over a specific asset (including those with a GSA) have three options once the company that has possession of their asset goes into liquidation:

a. They can recover the asset (assuming their security ranks ahead of all other securities), and in the case of a GSA appoint a receiver

b. They can place a value on their asset, advise the liquidator of the value of their asset and make an unsecured claim for the balance of the debt. This means that if the liquidator subsequently sells the asset the secured creditor will be able to recover the funds recovered, up to the value of that the creditor valued their asset

c. They can surrender their charge and become an unsecured creditor

This applies to all secured creditors, whether they have a GSA or a security over a specific asset.

The liquidator has the option of issuing a notice to force the secured creditor to, within 20 working days, elect a, b, or c. If the secured creditor does not respond then it is assumed they have elected option c, and waived their security. They cannot get this security back without the permission of the liquidator.

Where the secured creditor has been claiming interest, they can claim the interest as a secured debt up until the date of liquidation. After that time the interest becomes an unsecured debt.

Prudence Discusses Security Lapses

Section 305 (8)
This is a tricky section. Just because you have a security does not mean you have to do nothing to protect it. Once a company goes into liquidation a liquidator can write to the secured creditor, including a creditor with a General Security Agreement, asking them to exercise their rights; ie; collect their asset or provide a value to the asset and claim the balance as an unsecured creditor.

If the secured creditor does not respond in 20 working days, the charge is lost, and the liquidator can sell the asset and use the money to pay the other creditors. Not many people know this.

Prudence Declares: Court and related fines

Fines handed down by the court on a company (eg: traffic, violations of labour laws etc) stand outside the liquidation process. It is as if the liquidation process does not exist when it comes to court fines.

The court bailiff can enforce a court notice, seizing assets etc, in order to satisfy a court debt, provided that the asset is not covered by a registered security interest. They rely on Section 308 for this enforcement right.

CHAPTER TWENTY EIGHT: PERSONAL GUARANTEES: VALUES AND PITFALLS

Personal Guarantees

Personal guarantees can be powerful tools but they need to be done correctly if a creditor wishes to rely on them subsequent to the company failure.

There are three elements that a Personal Guarantee needs.

A) **Must be explicit.** It is not enough to bury a clause in the terms of trade signed by the director that says something like, “The person who signs this agrees to be personally liable for the debt”.

Ideally the person signing should sign twice. Once on behalf of the company and once in their personal capacity as guarantor. It should be clear and explicitly state that they are personally guaranteeing the debt.

Now that we have a Voluntary Administration regime it makes sense for the guarantee to cover the possibility that, if the company’s debts are changed as a result of a successful company restructure via a DOCA, that the guarantor is liable for all of the debts incurred by the company up to the date of Administration. There have been cases in Australia where personal guarantees have failed because the guarantee only covered the debts owed by the company, which can be reduced by a DOCA, as opposed to debts incurred by a company, which remain incurred, even if not owed with the passing of a DOCA.

B) **Must be for consideration.** The person signing must gain some advantage for the signing of the guarantee. Usually this is no more than a creditor agreeing to supply credit to the company. However, where a debt has been incurred a personal guarantee can be worthless if no consideration is given for the guarantee.

Two solutions to this are to get the director to sign a deed to guarantee to the existing debt, or offer some consideration with respect to the existing debt. Two common options are to agree not to enforce the current debt in return for a time payment by the company, or to agree to extend further credit.

C) **The person signing must be a person who benefits from the guarantee.** Personal guarantees have been attempted to be enforced against accounts clerks who rather recklessly sign them for the companies they work for (these tend not to stand up).

Our strong advice is spend the money with a lawyer to get the terms of trade and personal guarantees locked tight. And most importantly, get them signed. It is depressingly frequent that we see the most beautifully worded and comprehensive guarantees. Unsigned. Worthless.

Part Five:
Personal Compromise

CHAPTER TWENTY NINE: PERSONAL COMPROMISE

The Insolvency Act 2006 is the relevant legislation governing the insolvency of individuals, as opposed to commercial insolvency. The Insolvency Act is virtually a mirror in many important respects of the relevant sections of the Companies Act.

Insolvent transactions, transactions under-value, creditors meeting and powers to interview the bankrupt under oath all mirror the similar sections in the Companies Act.

The treatment of a person's financial affairs once they are bankrupt is almost identical to the treatment of a companies affairs once it is in liquidation.

There are four important distinctions.

- The first is that all bankruptcies are managed by the Official Assignee. There is no role for private insolvency practitioners in personal bankruptcies.
- The second is the role of the director in liquidation, for which there is no equivalent in bankruptcy.
- The third is the management of the affairs of the bankrupt and the end of their bankruptcy, that clearly does not occur with a liquidated company.
- The forth is the alternatives to bankruptcy differ from the alternatives to liquidation quite substantially.

Alternatives to Bankruptcy	**Alternatives to Liquidation**
No Asset Procedure	Part 14 Compromise with Creditors
Summary Instalment Order	Voluntary Administration
Part 4 Compromise with Creditors	
Compositions (Post bankruptcy)	

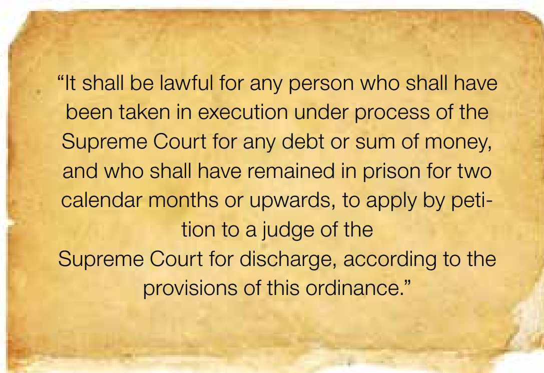
This section looks at the first three alternatives to bankruptcy. It is not an exhaustive examination of the path to bankruptcy or bankruptcy itself.

Bankruptcy: A Review

The historical roots of bankruptcy in England can be traced back to 1542, and there has been a steady evolution away from the incarnation of debtors and towards the modern and fairly benign personal insolvency regime we live with today.

Falling into bankruptcy is no longer the social stigma it once was and over two thousand New Zealanders make this journey every year.

The beginning of New Zealand's bankruptcy laws can be traced back to an 1844 Ordinance that contains the following gentle words:


"It shall be lawful for any person who shall have been taken in execution under process of the Supreme Court for any debt or sum of money, and who shall have remained in prison for two calendar months or upwards, to apply by petition to a judge of the Supreme Court for discharge, according to the provisions of this ordinance."

Curiously, this ordinance specifically excluded those wallowing in debtor prison who owed a debt to the Crown!

Today becoming bankrupt is no longer a barrier to a successful business career. High profile bankrupts, or recently discharged bankrupts, can even be seen dancing gracefully across our television screens before reappearing late at night and flogging miracle creams to make us younger and more beautiful.

How we went from debtors prisons to bankrupts dancing like Cossacks is a book in itself and may reflect a uniquely benign New Zealand approach to business. One that even allows high profile business men to emerge from prison to relaunch successful new listed entities.

The Americans may have Oprah, the couch for the disgraced to tearfully confess before beginning their second act in public life. In New Zealand we expect the fallen to either vanish from view or graft their way back into our grudging affections. No public apology needed. Just get on with it!

Bankruptcy Itself

Like liquidation, a bankruptcy is the end of a person's commercial life up until that point. Unlike liquidation, it is not the end of the person.

It should be remembered that one of the goals of the bankruptcy provisions is to protect the bankrupt. Once a person is bankrupt they are absolved of their past commercial sins, as well as most (but not all) of their assets.

Honest debtors, even those who have been reckless, foolish even unethical (but not unlawfully so) are given a clean slate by the Insolvency Act. They have statutory obligations but they are allowed to continue on with their lives unmolested by their creditors who must look to the Official Assignee for any distribution of assets.

Upon adjudication the Official Assignee (OA) becomes responsible for the managing all of the assets of the bankrupt, as well as retaining some control over the life of the bankrupt during the period of the bankruptcy.

A bankrupt must complete a statement of affairs and disclose fully and honestly to the OA all of their assets and debts, and provide all accounting and other relevant records.

Other obligations on bankrupts:

- May not be a director
- May not manage a business without the consent of the OA
- May not leave New Zealand without the consent of the OA
- Must keep the OA informed of their employment and residential status
- Prohibited from obtaining more that $1,000 of credit without disclosing their bankruptcy status
- Make payments from their earnings, as directed by the OA, for the benefit of their creditors

A bankrupt is allowed to keep a vehicle, up to a maximum value of $5,000. They are allowed to keep any tools of trade and household effects up to a value as determined by the OA. The reasoning is that the bankrupt must be allowed to earn a living.

Typically, and practically, the adjudication of bankruptcy is a relief for the honest debtor. Their financial problems vanish and invariably they find themselves with more cash in their pocket at the end of the week and a weight and burden gone from their mind.

A bankruptcy is often the end of a long and hard road. To end up at that destination is to have been on a journey and close to 50 New Zealanders find themselves at that final destination every week. No two routes will have been the same. Each will have their own story, but there are three distinct paths:

A) Over a third of all bankrupts cite losing their employment as the primary cause of their predicament. These are people not engaged in business who have overcommitted themselves, often in real-estate, based on a high income and in the belief that their current high status and income will prevail.

B) Failed business owners brought down by their personal guarantees once their business has failed. Parents and relatives of business owners can also find themselves caught in this trap.

C) Ten percent of bankrupts blame excessive use of credit cards. This is without a doubt an underestimate. Simple fiscal imprudence, getting into too much debt on consumption is a common mistake and bankruptcy is often the only way to get out from under the burden of compounding interest charges.

Bankrupts fall into two categories, those who fall on their own sword by applying to the OA themselves, around 60% take this route. The other 40% are placed in bankruptcy by their creditors through the courts.

Of those who elect to enter bankruptcy voluntarily, 70% have debts under $100,000. For those who are placed in by the courts, only 40% are for debts under $100,000.

Summary Instalment Orders

The Summary Instalment Orders (SIO) is designed for debtors whose debts are under $40,000, but have the ability to repay their debts, or a portion of them.

The debtor makes an application to the OA and there is a $100 fee. The OA approves, or declines, the application.

The OA may also approve a 'supervisor' who will oversee the distribution of the repayments to the debtor's creditors, or the OA can choose to oversee the process directly.

Once accepted the debtor makes regular payments to the supervisors, the OA, or the creditors directly over a period of three years. This can be extended to five years if special circumstances apply.

Creditors are bound by this process, and they cannot pursue the debtor once the SIO is in place. They can re-commence or start legal proceedings if the debtor defaults or with the permission of the OA.

There are around 250 Summary Instalment Orders made each year.

No Asset Procedure

This is a new regime that came into force at the end of 2007. There are now as many No Asset Procedures (NAP) as there are bankruptcies each year, around 2,800 at the time of writing.

The underlying principal is that if the debts of the debtor are under $40,000 and they debtor has no way to repay those debts, then their debts shall be waived.

The debtor enters a 12 month period of minimal supervision, and at the end of this time their debts are waived and they are released from the process.

The restrictions that apply to bankrupts during their three year period do not apply. Someone under the NAP faces no restrictions on running a business, travelling overseas or being a director of a company.

The restrictions provided before entering NAP are:

- Debtor has no realisable assets
- Debtor not been bankrupt or through a NAP before
- The debts are less than $40,000, and greater than $1,000
- No means of repaying the debts
- The debtor has not concealed assets
- The debtor has not committed an act that would be a breach of the Insolvency Act if the debtor was bankrupt
- A creditor has not began bankruptcy proceedings against the debtor
- A creditor would be better off if the debtor was bankrupt

The debts under consideration does not include student loans. The government does not want dental students entering the NAP at the end of their third year! Also excluded are debts owing under the Child Support Act or a maintenance order under the Family Proceeding Act.

During the 12 month period that the debtor is under the NAP they cannot obtain more than $1,000 credit without disclosing the status, and must keep the OA informed as to their financial status. Any thing that may impact on the debtors ability to repay their debt is relevant. Obtaining a new job or inheriting assets would be events that would need to be disclosed to the OA.

Compromise with Creditors

A person who is unable to pay their debts, but is not currently bankrupt, is defined as an insolvent.

An insolvent seeking to avoid bankruptcy and does not qualify for the NAP or SIO has two options before them.

The first is an informal arrangement with their creditors. This is simply the process of coming to an arrangement the creditors, either individually or collectively, usually by getting the creditors to support a deed of arrangement whereby those creditors accept some time payment for some or all of their debt.

This process is used often, and with good effect. Often, the arrangement is only made with a creditor who is determined to bankrupt the debtor. Creditors who write off their debt are unlikely to be included in the process.

A more formal process is Part 4 of the Insolvency Act that specifies a process for creditors to come to an arrangement for the settlement of their debts with the insolvent.

This process does not mix preferential creditors (money owed to employees of the insolvent, or GST and PAYE owed by the insolvent) and non-preferential creditors. In effect, this means this is a scheme available for the insolvent to deal with their non-preferential creditors, effectively excluding debts that they owe to the IRD for GST and PAYE from their personal trading. Income Tax is not a preferential debt.

The process can be broken down into five parts.

1. The Proposal

First the insolvent engages an insolvency expert, either a lawyer, accountant or an insolvency practitioner. Together they, the insolvent and their advisors, put together a proposal. The proposal must contain the following:

- Statement of Financial Position of the insolvent
- A Trustee or Trustees who will oversee the proposal
- Details of all creditors, including amount owed and address
- Details of any securities held by any creditors

The proposal must be in a set form as detailed in the legislation and High Court Rules. It is common, but not a requirement under the legislation, for the insolvent or their advisors to engage with the insolvents creditors to ascertain the level of creditor support for a proposal and what sort of deal the majority of creditors are likely to commit to.

2. Lodging the Proposal: Critical Date

Once the proposal is ready it is lodged with the relevant high court.

Two key events occur. The first is that the provisional trustees must call a meeting of creditors for the purpose of approving or declining the proposal.

The second is that date that the proposal is lodged determines the creditors who are able to participate in the meeting, and they can vote the level of debt that existed at the date the proposal was lodged, not their level of debt at the time of the meeting. This is a critical point if the vote is going to be close.

3. Creditors Meeting, and Voting Levels.

At the creditors meeting the proposal needs to pass with over 50% of creditors by number representing 75% or more of the total level of debt.

The proposed trustee is the chairman, although the creditors can elect a replacement chairman if they desire.

There are two important issues with the creditors who are allowed to vote:

> Secured Creditors are allowed to vote their full debt, even if the value of their security is greater than the level of debt. Thus, a finance company with a $500,000 debt over a property worth $800,000 can vote their full $500,000 debt even though they face no loss.
>
> Related party debt can vote. If a trust, controlled by trustees friendly to the insolvent, is owed money by the insolvent, this trust can vote their debt in favour of the proposal.

At the creditors meeting, the creditors can make amendments to the proposal, and if passed do not require the consent of the insolvent.

4. Court Approval

If the proposal is passed the court is required to give its ascent to the proposal. The court is not bound by the decision of the creditors and may reject the proposal on a number of grounds. These include but are not limited to:

- There have been material breaches of the act in terms of the proposal, or the process
- The compromise is not reasonable
- The compromise benefits one creditor or group of creditors over another
- Preferential creditors (ie: GST and PAYE) would do better in a bankruptcy
- The proposal is vague, overly optimistic or unrealistic in nature

Historically the Courts have had an oversight role in these matters because of the high level of fraud perpetrated by debtors. It was felt that knowing judicial discretion would ultimately determine the success or otherwise of the scheme, debtors would resist the temptation to manufacturer creditors or engage in other shenanigans.

As a result the courts formally took the view that it was their role to assess the proposal on its merits independent of the opinions of the creditors.

Recent judicial opinion and statutory guidelines has swung the other way. Unless there is a valid reason to reject the proposal, the views of the creditors should take precedence.

5. Compromise In Effect

Once given judicial ascent the proposal is binding on all creditors, including those who objected to the proposal.

A creditor cannot seek to bankrupt the debtor once the proposal is in force or take any other enforcement action against him for debt covered by the proposal.

This includes a creditor who was not aware of the proposal, and included contingent liabilities that existed at the time of the proposal but had not been crystallized.

Such creditors, unless they can show some malfeasance or fraud on behalf of the debtor, do not have a claim against him, but may, if they proposal allows for this, participate in any distribution that flows from the trustees managing the affairs of the proposal.

Prudence Points Out:

Secured creditors can vote all of their debt. This is different from commercial insolvency where a secured creditor must waive their security before voting on a compromise or a voluntary administration creditors meeting.

This means that a bank, with a mortgage debt lower than the property, can vote. Critically, if the mortgage was owing at the date the compromise was lodged with by the court, but repaid by the time of the creditors meeting, the bank could still vote. However, a judge must always approve a personal compromise.

Part Six:
The PPSR

CHAPTER THIRTY: RETENTION OF TITLE

The Role of Credit

A central tenant of all capitalist economies is the concept of credit. Whether it be the provision of stock on consignment to a retailer, the granting of an overdraft secured over vehicles and machinery or traditional unsecured credit terms common in all modern commerce, it is this availability of credit which allows businesses and the economies they populate to expand.

The goal of anyone providing credit is to obtain the greatest return possible, whilst ensuring that their risk exposure is minimal. While there are certain measures that can be taken to minimise the risk of default on the part of the debtor, the focus of this section is to look at the taking of security over the assets of debtors.

Fixed vs Floating Charges

Prior to the enactment of the Personal Property Securities Act ("PPSA") in 2002 this area of law was a patchwork of common law rules, equitable doctrines and statute. To enable those providing credit to take security over debtors assets' the concepts of 'fixed charges' and 'floating charges' were developed.

Basically a fixed charge gave a creditor a security over a specific good, if the debtor wished to deal with the asset they had to seek the creditors' consent. This created a problem for items with high turnover such as inventory and accounts receivable, to constantly be getting consent for these assets would be impractical. To get around this the concept of a floating charge was developed whereby a creditor could have a charge over these high turnover assets and future assets which the debtor could then deal with without needing creditor consent.

Retention of Title

Another method creditors used to protect themselves when supplying goods were retention of title clauses (also known as 'Romalpha clauses', see overleaf). In agreements for the purchase of goods these clauses provide that the title of the goods will not pass to the purchaser until they have actually been paid for. In the event that the goods are not paid for the seller can take back possession of goods despite other securities having been lodged over the purchaser. In much the same vein as retention of title clauses numerous other mechanisms were created to enable sellers to retain title of goods despite having handed over possession, for example consignment stock and security leases.

Sale of Goods Act 1908

The New Zealand Sale of Goods Act 1908 stated that once the purchaser takes possession of a good they own it. The purchaser did not need to pay for the good to own it. If they subsequently did not pay the supplier could sue for the debt but title had passed to the buyer.

Romalpa Aluminium: the start of all the trouble

In 1976, a Dutch company by the name of Aluminium Industrie Vassen, (AIV) delivered aluminium to Romalpa Aluminium, an English company. Before they delivered the aluminium, the ever canny Dutch got the ever perfidious English to sign an agreement stating that the aluminium in question would remain the property of the Dutch until the English had paid in full. The English did not pay, and instead went into receivership owing AIV £122,000. The receivers were in possession of £50,000 in aluminium and £35,000 from aluminium sold by Romalpa.

After much legal wrangling it was agreed that the Dutch still owned the aluminium and the identifiable £35,000, proceeds of recent sales. Without this agreement, the ‘Romalpa Clause’, the aluminium would have been sold and the money used to pay secured creditors.

Importantly, the English courts rules that the Romalpa clause trumped the GSA holders rights.

The effect of this case was that suppliers of goods began demanding that the purchasers sign agreements stating that if they did not pay for their goods, ownership remained with the seller. This common law ruling by the British courts in turn influenced commercial thinking in other commonwealth jurisdictions.

Prudence Declares:

Curiously, the so-called ‘Romalpa Clause’, was actually drafted by the Dutch, so it possibly should be the Aluminium Industrie Vassen Clause. Thankfully it is not. Romalpa clauses are also often called Retention of Title clauses, and their use in New Zealand was effectively the parties contracting out the Sale of Goods Act.

A New Approach

By the late 1980’s it was decided that a new approach was needed. It was believed that a more all encompassing system would provide greater transparency to those looking to provide credit and would create a clearer set of rules for identifying the priority of competing security interests. In 2002 the much anticipated PPSA came into force. With it came a new security regime which brought to some an end to the headache and confusion of the previous system, and to others a harsh and seemingly inequitable lesson.

CHAPTER THIRTY ONE: SCOPE OF THE PPSA

What does the PPSA cover?

Central to the function of the PPSA is the concept of a 'security interest'. Certain transactions will give rise to a creditor having a security interest in the personal property of the debtor. Assets owned by or in the possession of the debtor to which a security interest can attach are commonly defined as collateral.

Section 17 of the PPSA defines what transactions create security interests, whilst Section 23 provides a list of transactions which are specifically not covered by the Act. It is only transactions which satisfy Section 17 and that are not specifically removed by the Section 23 exceptions which will be covered by the PPSA.

The Section 17 definition is intentionally worded very broadly to catch all manner of transactions. It is specifically stated that the form of the transaction is of no consequence, nor is the identity of the person who has title to the collateral. It is this point that has caused much frustration amongst lay people who have unwittingly given up possession of the goods which they own, whether it be through a lease or retention of title clause, only to find that another party has registered a security over their goods which are then taken in satisfaction of their debt.

The Section 17 definition looks to the substance of the transaction. This renders the retention of title clause and other mechanisms designed to retain title to goods relatively useless. If a transaction in substance secures payment or performance of an obligation then it will give rise to a security interest. Also, Section 17(1)(b) lists four other transactions which are deemed to be security interests despite falling outside the definition, these are:

- Transfers of accounts receivable
- Transfers of chattel paper
- Leases for a term of more than one year
- Commercial consignments

There are numerous transactions which Section 23 removes from the ambit of the Act. The main exceptions to the Act are interests in land, and interests in ships over 24 metres in length. The registration of land and large ships and their related interests are governed by their own Act and register. With land and ships being the main exception, the PPSA dictates what constitutes a security interest in most forms of collateral, from vehicles and machinery to intangibles such as goodwill and intellectual property.

The effect of establishing a security interest is that this brings the transaction within the scope of the PPSA and as such will be subject to the rules provided within PPSA. However to have any practical effect the next step is to have the security interest 'attach' to the collateral.

Conditions for the Attachment of Security Interests

A security interest will only come into existence when it attaches to collateral. The discussion above regarding what constitutes a security interest will dictate whether the transaction is

covered by the PPSA, whilst the rules for attachment given in Section 40 provide when the security interest comes into existence, and is enforceable against a particular piece of collateral.

There are two basic stages of attachment. The first requires that value be given by the secured party, and that the debtor has rights in the collateral. The requirement that value be given is a fairly low hurdle, this can include past value given, or value provided to another debtor. Also money need not be advanced, value can include any granting of credit.

Likewise the requirement that the debtor have rights in the collateral is also a fairly low bar as it can basically include any proprietary right. In most cases this will be ownership, however it also includes the rights of a lessee and possessionary rights. Once these requirements have been satisfied the creditor will have a security interest that is enforceable against the debtor. In order for attachment to occur the security agreement must also be enforceable against third parties (for example other creditors with a security interest in the collateral).

The real power of the PPSA lies in Section 36. This section details how a creditor with a security interest can enforce their security against a third party: ie: someone other than the debtor.

Prudence Exclaims:

Section 36 is the cause of most controversy when it comes to the PPSA. It details how one creditor can take goods in the possession of the debtor but owned by (or claimed by) a third party. A third party refers to any competing creditor, and also any other party with rights in the collateral, this may in fact be the person who owns the collateral.

A Romalpa clause can be used to enforce a creditors rights against assets supplied by the creditor to the debtor, and still in the possession of the debtor. However now we are talking about the enforcement of these rights against all other parties.

To att t third pa required by Section 40(c), Section 36 must be

complied with. Section 36 specifies the two circumstances in which a security interest will be enforceable against the claims of a third party:

- If the collateral is in the possession of the secured party (for example a pawn broker type situation where money is lent to the debtor and the security remains with the broker until the money is repaid).

- The debtor has signed or assented in writing (which can include email, etc) to a security agreement which provides an adequate description of the collateral, or states that a security interest is taken in all of the debtors present and after acquired property (often referred to as a General Security Agreement or GSA)

Several things spring from this. Section 36 only applies to third parties, and not the contracting parties. Thus, if a wholesaler provides goods to their customer, a retailer, and the parties agree verbally to a Romalpa clause, the wholesaler still has a valid right to recover their goods from their customer, but not against a third party, ie: a GSA holder, or someone who has purchased the goods from the retailer.

The term adequate description is important. Describing the asset as “a tractor” or even “the green tractor” is unlikely to meet the standard required, especially if the asset has a serial number. Although if the debtor only owns one tractor and there is no dispute as to the tractor in question (and hopefully it is in fact green) then the courts may decide that the description is adequate, but may not if the debtor is a large farm with multiple tractors, or worse, a tractor retailer.

The third key point is that the debtor must consent in writing to the security being given. Canadian case law on point has declared that it is not a requirement that the document specifically states that a security interest is granted, only that a debt exists and that the secured party has an interest in the asset being described. Regardless, prudent security holders should ensure that the paperwork makes explicit that such a security exists and that the debtor explicitly grants a security interest.

Attachment of Security Interests

A secured creditor wants to be able to use a debtor’s assets (or assets in the debtor’s possession) as security, and he wants this security to be enforceable against other secured creditors. To do this the secured creditor must tick three boxes.

☑ They must provide some value to the debtor

☑ The debtor must have some rights over the asset

☑ The debtor must have agreed in writing, with adequate description of the asset, to the security being given (ie: complied with Section 36, as above)

If these three boxes are ticked then the secured creditors security interest is said to have attached to the specified assets. An exception to the above is where the asset in question has been given to the creditor, as in the pawn broker example referred to above.

Perfection of Security Interests

The final step to be taken with most security interests will be to have them 'perfected' under Section 41 of the Act. The importance of having a perfected security interest will become more apparent when the PPSA priority rules are discussed later, but basically a security interest is of limited use unless it is perfected in accordance with Section 41.

Two steps are required to achieve perfection under the act:

1. The security interest must attach to the collateral (as discussed above); and

2. Either a financing statement must be registered on the Personal Property Securities Register (PPSR) detailing the security interest, or the secured party must have possession (see again the pawn broker example above)

It does not matter in which order steps 1 and 2 above occur, for example a financing statement can be registered well in advance of attachment, however perfection will only be attained once both steps have been taken.

It is important to remember that registered security interests must comply with Section 149-152 which dictate which errors or omissions in financing statements will be considered seriously misleading and will in turn void the registration and perfection. Although a detailed description of these sections is outside the scope of this manual. The main areas to be particularly careful of are the correct spelling of the debtors' name, serial numbers for certain collateral (eg cars and aircraft), and incorporation numbers for companies.

CHAPTER THIRTY TWO: COMPETING SECURITIES

The Priority Rules

Throughout the act are various special priority rules which are too numerous to detail here, however it is the general priority rules under Section 66 which determine most competing security interests. There are three main rules to remember:

1. A perfected security interest defeats an unperfected security interest.
2. Where there are two perfected security interests, the party which first registers their financing statement on the PPSR, or takes possession of the collateral (but not through seizure or repossession), will have priority.
3. Where there are two unperfected security interests the party which attaches first will have priority.

These rules illustrate the importance of perfecting all security interests, and to register the security interest or take possession of the collateral as quickly as possible. Despite the fact that perfection is essential, it is not the time of perfection that is determinant for rule two, but the time which the financing statement is registered, or possession of collateral taken. It is for this reason that it is good business practice to register financing statements early, even if a security agreement has not yet been signed (eg attachment hasn't occurred).

Purchase Money Security Interests – The Super Priority

The priority system above creates a problem for anyone wishing to extend credit to a company which is already subject to several perfected security interests. Under the rules above unless the new creditor can convince other creditors to subordinate their perfected security interests they will be left exposed to loss. A typical scenario is where a company wishes to receive stock on credit, but they are already subject to a general security agreement over all assets of the company granted to the company's bank.

The PPSA deals with this through the Purchase Money Security Interest or 'PMSI' (pronounced pimsey). The PMSI gives that creditor an interest superior to other security interests, whether they be perfected or not, but only in the specific asset financed.

There is a lengthy definition of what constitutes a PMSI; however the basic definition of a PMSI is a security taken in collateral to secure repayment of that collateral's purchase price. This covers two basic scenarios:

1. Where a seller hands over goods to the debtor with a credit component, the seller can take a PMSI in that collateral. For example a supplier of stock that allows that stock to be taken on consignment.

   Or

2. Where a lender advances value to the debtor who then uses that value to obtain rights (usually ownership) in the goods. For example a lender gives a small loan to a business for the purpose of purchasing a vehicle, the lender can then take a PMSI in the vehicle.

For a PMSI to be effective against another registered security interest it must be perfected. The timing for registration is very important. For inventory the security interest must be perfected at the time the debtor takes possession of the inventory. For all other goods (excluding intangibles such as patents or goodwill) perfection must be achieved within 10 days of the debtor taking possession of the collateral.

Effect of Liquidation

In the event of liquidation the liquidator will then begin the process of establishing which assets are subject to securities, and which creditors have priority. In these circumstances attention will be paid not just to the financing statements registered on the PPSR but also to the supporting security agreements provided by the creditor, and in the case of PMSI's the date which possession of the collateral was taken.

Once the validity of all security interests are determined the liquidator will distribute those assets subject to securities to the rightful holder of the security interests. In any given liquidation this may involve the returning of stock subject to PMSI's to suppliers, leased or financed vehicles subject to PMSI's being returned to finance companies, and the proceeds of other assets being remitted to a bank with a perfected GSA. Inevitably other entities who've failed to register their security interests or who hold defective paper work will be left to claim as an unsecured creditor.

One effect of liquidation which is often overlooked by creditors, (and indeed some liquidators) is

the effect of the preferential creditors' definition in Section 312 of the Companies Act 1993. It is this definition which provides that assets subject to a charge will not be distributed to preferential creditors; however it notes one important exception to this rule under clause 2(1)(b) of the Schedule 7 of the Companies Act. This clause provides preferential creditors will rank ahead of secured creditors in regards to inventory and accounts receivable, unless the security interest is a perfected PMSI (for Inventory), or a specific security interest for a transfer of an accounts receivable for which new value was provided (ie: debt factoring).

This has important implications for creditors, as General Security Interests will not extend to stock or accounts receivable. For some companies using a GSA to secure repayment will be completely inappropriate as these excluded assets will make up a significant portion of the company's assets.

Take by way of example a furniture retailer. This retailer gets stock from suppliers and on sells to consumers, many of whom are sold furniture on credit. The company leases its premises and has no plant or machinery and little in the way of fixtures and fittings. In this situation the GSA holder would be left to realise whatever they could out of the fixtures and fittings, whilst any stock and accounts receivable not subject to the specific securities mentioned above would be liquidated and applied to the preferential creditors. Likewise Receivers appointment by a secured creditor are under a similar requirement to account to preferential creditors under Section 30 of the Receiverships Act 1993.

CHAPTER THIRTY THREE: CONFLICTS

But I Own It!

Many creditors are incredulous when confronted with the news that their asset has been given to a third party with better security.

It is not uncommon for these creditors to seek redress to the Disputes Tribunal, and it is not uncommon for the Disputes Tribunal adjudicators to agree with the aggrieved creditors and award the asset, incorrectly, back to the plaintiff. Often with a stern admonishment to the Insolvency Practitioner for good measure.

How does it happen? How to explain the mystery of the PPSA security regime without resorting to the parental fall back "Just Because!".

The most common conflict between security interests is where one creditor has a perfected GSA over the debtor company, and other creditors have their assets in the possession of the debtor but have not registered their security interest on the PPSR.

There are three classes of creditors who typically suffer adversely. We detail them separately.

Leasing

A lease for a term of greater than 1 year is deemed under Section 17 to be a security interest. A 'lease for a term of greater than 1 year' is defined very broadly to include:

- any leases that have resulted in the debtor having possession for a term greater than 1 year
- any lease which is renewable by one of the parties for a term of greater than 1 year
- any lease with no specific term

An exception is provided for anyone who is not regularly engaged in the business of leasing goods. It is irrelevant that the debtor company does not actually own the collateral.

The lessor will be able to enforce their rights against the company in retrieving their asset, unless any third party that has a perfected GSA will be entitled to the collateral in satisfaction of their debt.

However if the lessor registers their security interest they will obtain a PMSI in the item and be protected from the claims of a perfected GSA holder. If they do not register they will lose out. It should also be noted that under Section 73 the PMSI must be perfected within 10 working days of the debtor taking possession of the collateral.

Commercial Consignments

A commercial consignment will involve a supplier providing goods to the debtor which are paid for when the assets are sold. In situations where the two parties in the ordinary course of business deal in the kind of goods being consigned this will be again be deemed to give rise to a security interest under Section 17.

Again, if the creditor giving the consignment stock does not register their PMSI, then the holder of a perfected GSA can take the consignment stock. In this circumstance as the PMSI relates to inventory under Section 74 the PMSI must be registered prior to the debtor taking possession of the inventory.

Romalpa Creditors

Where a creditor sells goods to a debtor but retains title through a Romalpa clause in lieu of payment, they have a security interest in the unpaid for assets sitting in the possession of the debtor.

If the supplier registers their PMSI they will be protected, but if not a GSA holder will be able to lay claim to the assets. Again this PMSI will need to be registered prior to debtor taking possession if the collateral is stock, for other items it must be registered within 10 working days.

The main reason that creditors are aggrieved by the impact of the PPSA is because they have not taken the time to understand and use the tools available.

A Fine Horse Called Generous

To illustrate the operation of the above take the following case of New Zealand Bloodstock Limited v Waller. It has been widely reported, not just because of the seminal nature of the case but for the god-father undertones of the facts.

The asset at issue was a $700,000 horse named Generous. It was owned by a firm called NZ Bloodstock. They leased it to a firm called Glenmorgan. They did not register their interest in the horse. After all, it was their horse. It was only leased to Glenmorgan.

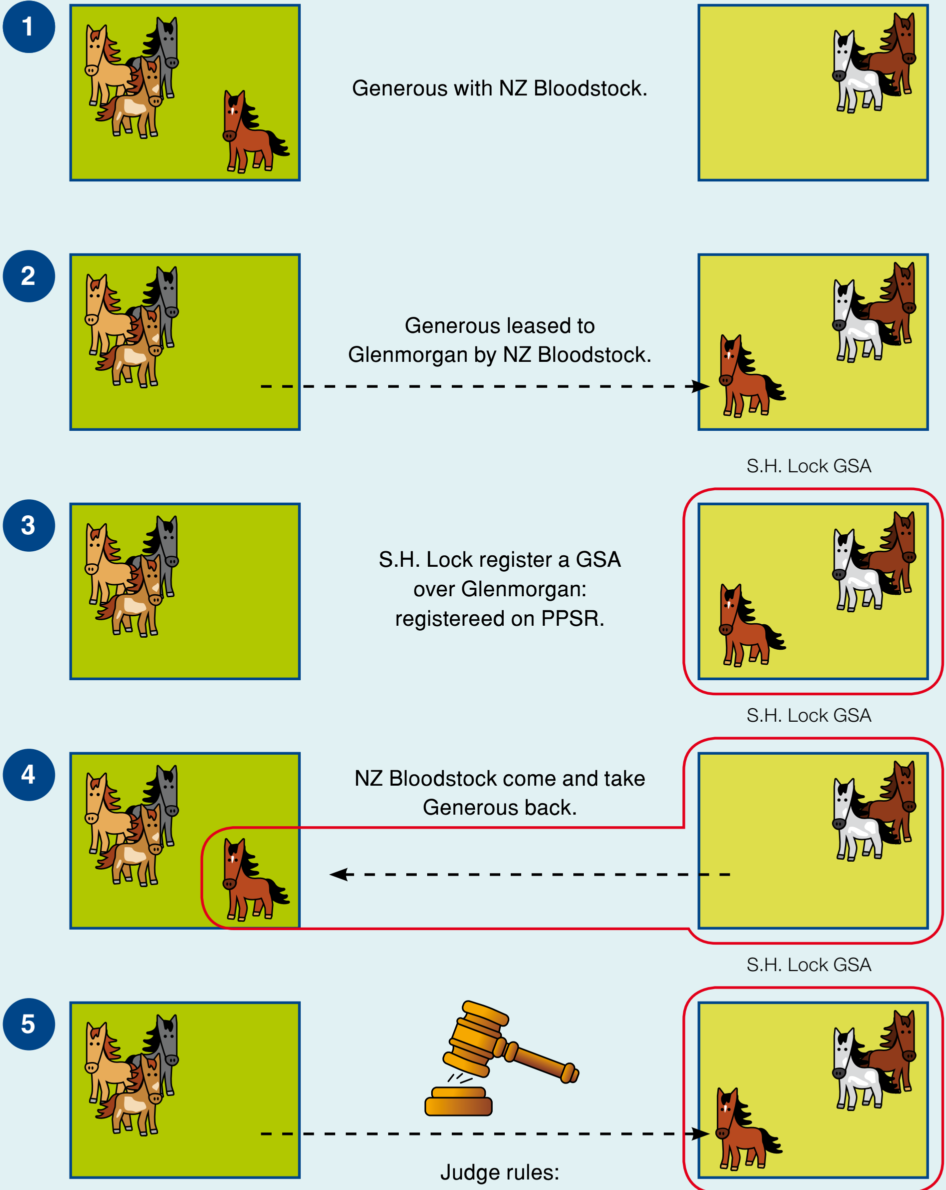
Factoring firm S.H. Lock registered a GSA over Glenmorgan after Generous had been leased. Glenmorgan defaulted on the lease to NZ Bloodstock, and NZ Bloodstock came and got ***their*** horse. Glenmorgan was later placed into receivership by S.H. Lock.

The Receivers of Glenmorgan concluded that even thought NZ Bloodstock had taken their horse back, the Glenmorgan security interest had attached and was perfected. As Generous was leased to the company for a term greater than 1 year NZ Bloodstock Limited had a security interest which should have been perfected. As it was not the GSA granted to S.H. Lock gave S.H. Lock a greater claim to the horse than that held by NZ Bloodstock.

The receivers asked for Generous back. Unsurprisingly, it went to court.

The Court of Appeal agreed with the Receivers. The perfected GSA trumped the unperfected security interest by NZ Bloodstock in Generous. It did not matter that NZ Bloodstock recovered the horse. A perfected GSA trumps an unregistered security interest. Note that in this case matters were complicated by the fact that the agreements were in place before the enactment of the PPSR. In normal circumstances if NZ Bloodstock had registered their PMSI within 10 working days of handing over possession of the horse to the company, then their security in the horse would have taken priority over the GSA.

CHAPTER THIRTY



S.H. Lock's perfected general security agreement attaches to the horse.
It does not matter that NZ Bloodstock took Generous back.
Security attaches to Generous no matter where the horse is.

FOUR: MIXED GOODS

Accessions

We now look at situations where goods subject to a security interest are added to another good. In situations where the good is added to another but still retains its identity, this good will be considered an 'accession' under the act and will be covered by Section 78-81.

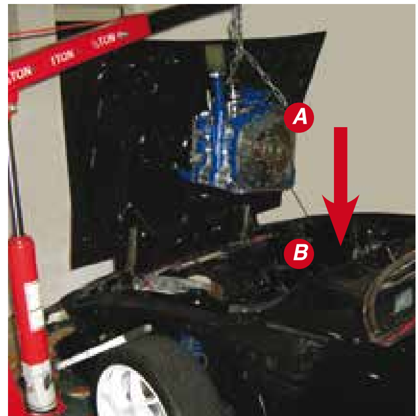
The example used in the legislation is that of an engine which is installed in a car, this engine would be an accession. This is to be distinguished from processed or commingled goods where the collateral loses its identity, for example the steel which is used to create the cars chassis.

The general rule for accessions is found in Section 78; security interests in the goods will continue in those goods after they become an accession. In the basic scenario above the holder of the security interest in the engine would be able to remove the engine from the car.

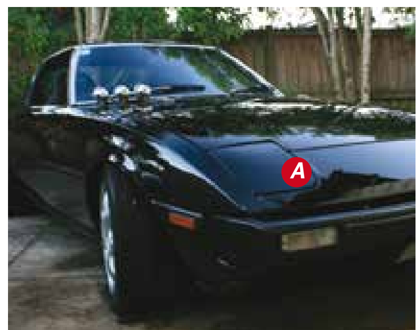
However complications arise in situations where a second party has a security interest in the whole item (the car). Under Section 79 as long as the security interest in the accession (the engine) has attached prior to the good being physically connected to the whole (the car) this security interest will defeat any pre existing security interest over the whole. Note that this only requires the security interest in the accession to be attached, it need not be perfected. The rationale for this being that the holder of the existing security interest should not get a windfall increase in their security resulting from another good being attached to theirs.

The rule in Section 80 provides for a scenario where a security is taken over the whole item after good has been affixed to it. In this

Security attached to engine by Party A.

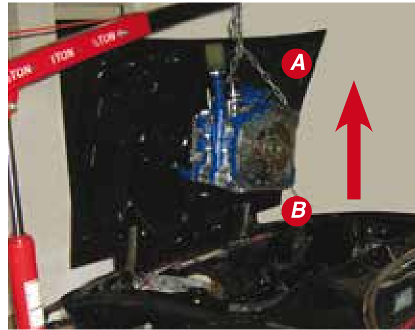


Act of accession - the engine (A) is installed into the car. Party B has security over the car but not the engine.



Security to engine: Party A
Security over car: Party B

situation unless the security interest in the accession is perfected by registration prior to a security being taken over the whole, it may be subordinated to that interest in the whole. For example in our scenario above if a person lends money to the debtor and obtains a perfected security over the car they will rank ahead of the unperfected interest in the engine. The rationale for this rule being that subsequent lender will only know of the interest in the engine if that interest has been registered, as such they should have priority to the unperfected interest.



Party A enforcing a security.

Processed or Commingled Goods

We now turn to processed or commingled goods. The rule in Section 82 provides that where goods are processed or commingled so as to lose their identity, the security interest in the input good will continue in the product. The section is unclear as to exactly what value should continue in the final good, for example in the scenario given above would the security interest in the car be limited to the value of the steel used in the chassis, or the total value of steel initially supplied? However the logical interpretation would be that the security interest in the final good would be limited to the value of input good used in its creation.

An act of commingling.

Any security interest in an input good that is perfected will be treated as having been perfected as to the final good. So in situations where a security interest in an input is competing with a security interest then taken in the final good, this will be determined by the general priority rules in Section 66. In the scenario of the car where the security interest in the steel is perfected it will defeat any subsequent unperfected interest in the finished car, and where both are perfected whichever party registers their interest first will have priority.

Under Section 84, the party with security over the input good will be limited in their claim against the whole to the value of their collateral at the time of mixing. In situations where there are multiple securities over input goods, Section 85 determines how priority is to be established in the final good. The first rule is that any security interest perfected before being mixed will have priority over any security interest in another input good which is unperfected at the time of mixing. The second rule is that in situations where both goods rank equally either by both being perfected prior to mixing, or both unperfected, then the security will abate in proportion to the input value. To

illustrate take two car inputs, steel with a value of $4000 and plastic with a value of $1000. In this scenario the total value of the car would be divided at a proportion of 4:1, with the total security of each party being the value of their respective inputs.

Once the Goods are Sold

In situations where collateral is dealt with in some way (ie sold), then Section 45 of the act provides the creditors security will continue in the collateral (unless they have authorised the transaction) and that their security will also continue in the proceeds of the transaction.

The extension of the security interest in proceeds may be simple in some circumstances. For example, where the item is traded for another physical good. In this situation the item is easily identifiable as proceeds, however where the proceeds involve cash that is deposited into the company's bank account then things can get more complicated. As there may be multiple cash deposits and withdrawals from the account, and possibly multiple proceeds of collateral being deposited then these funds will no longer be identifiable. In this situation a tracing exercise will need to be entered into to establish whether the collateral proceeds have remained in the account.

An analysis of tracing rules will not be detailed here however the initial rule used by the courts in these scenarios is that the debtor is always assumed to have spent their own funds first. Under this rule as long as the balance of the account does not fall below the value of the proceeds in the account, then the security interest remains in those funds. However where the account is drawn down to a balance lower than the collateral proceeds amount then this will reduce that security amount to that figure, even after new funds are subsequently deposited in the account. This is known as the 'lowest intermediate balance' rule.

The general rule provided in Section 45 is that a security interest will continue in collateral which is dealt with in some way (eg sold), has several exceptions:

1. Any party which buys collateral will take that collateral free of an unperfected security interest unless that buyer was a party to the original transaction which created the security interest.

2. Also excepted are buyers or lessees of goods bought or leased in the ordinary course of business, unless that party has knowledge that such an act is a breach of the security agreement. For example, the buyer of a fridge from a department store will get clean title even if the wholesaler has a perfected security interest over it.

3. Buyers of goods with a value of less than $2000 will take goods free of a security interest if they have no knowledge of the security interest and they gave value.

4. Buyers of goods which are required to have their serial numbers entered (eg cars) will take those items free of the security interest if that serial number in not correctly entered on the register.

5. Buyers of vehicles from registered motor vehicle dealers.

CHAPTER THIRTY FIVE: IMPORTED GOODS

Goods brought into the country are granted a special exemption under Section 27 and 28 of the Act.

Section 27 applies to goods imported into New Zealand, but subject to a foreign security charge. This charge existing in the overseas jurisdiction is valid for fifteen days after the overseas security holder becomes aware that their secured goods are now on New Zealand soil, up to a maximum of sixty days, and this is calendar days, not working days. This applies only to goods and not intangibles or other non-physical assets.

The overseas security holder therefore has a limited window to register their security in the asset. If they do so within the window allowed they will have a perfected security interest. If they allow their security to lapse, and register after the fifteen days, it is possible that their secuiry interest will become vulnerable to third party claims.

Imagine an example of a piece of heavy machinery imported from the United States by a New Zealand firm. The machinery is owned by a US company who specialises in such things, and a US finance house has a security registered in the US over the asset.

The asset lands in New Zealand and is put to work by a New Zealand firm. A local bank has a GSA over the firm. The US finance house becomes aware of that their asset is in New Zealand, but it takes them three weeks to sort out registration of their security interest on the NZ PPSR.

If the New Zealand company fails, the US finance house will rank behind the local bank when it comes to determining who has the greatest claim over the asset.

If there is a security held in an overseas jurisdiction but it is unperfected, the unperfected security will hold for thirty days in New Zealand, see Section 28.

CHAPTER THIRTY SIX: CHATTELS VS FIXTURES

As mentioned previously, under Section 23 the PPSA will not cover a 'creation or transfer of an interest in land'. This is a fairly widely worded exception that serves to remove from the ambit of the act basically all interests in land. These are dealt with instead by the Land Transfer Act 1952, the Property Law Act 2007, and general rules of contract and equity.

Any chattel which is sufficiently annexed to the land will normally be deemed to be a fixture; and all fixtures are deemed to be part of the land and as such their title will vest in the land owner. It will remain this way until such time as the fixture is lawfully severed from the land, in which case it will become a chattel again.

The issue of in what situations a chattel will become a fixture will not be detailed here as there is endless case law covering this issue, however the two main factors which the court will look at will be:

1. Is the chattel annexed to the land, and if so to what degree?

   and

2. For what purpose has it been annexed to the land?

If a chattel is annexed to a property that is not subject to any mortgage (or other fixed charge) then although the land owner effectively owns the fixture, the contract between the supplier of the chattel and the land owner may contain an explicit or implied term that the supplier can come and remove the fixture. If this is the case then the chattel supplier is quite entitled to exercise this right.

However in situations where the property is subject to an existing mortgage, or a mortgage is subsequently registered then the interest of the supplier in the fixture will be subordinated to that charge. In this event it is the terms of the mortgage which will determine whether the chattel supplier can come and sever their chattel (provided this is also allowed by the chattel security agreement). Typically, in situations where a mortgage contains a covenant which prevents a mortgagor from removing any improvements this will prevent the chattel supplier from taking any action to sever the fixture. In this scenario the chattel suppliers interest will remain dormant and unenforceable and remains vulnerable to being extinguished by the mortgagee exercising a power of sale.

CHAPTER THIRTY SEVEN: THINGS TO REMEMBER...

The PPSA is a complex piece of legislation and although it was drafted with the intention of making it easily accessible to the layman, many people, including those in the professions and the insolvency industry, struggle to grasp the Act in its entirety. However, there are some important points to remember which will serve to protect anyone who wants to grant credit to a company:

1. Be aware of what constitutes a Security Interest. The act covers many transactions which most people would not recognise as needing registration. The classic example is leases for a term greater than 1 year, or leases for an undefined term. These are deemed to be Security Interests by the Act and must be registered.

2. Always register a financing statement. Registration costs very little and is an essential part of the regime. Registration can take place before attachment so there is no harm in registering early.

3. Have well drafted terms of trade which can be signed by the debtor allowing a security to be registered over the collateral.

4. Take care with the entry of the financing statement on the register; ensure that collateral is adequately described, and that serial numbers and debtors names are correctly entered.

5. Know what security interest will provide the most effective security. Where possible get a PMSI, a GSA is not suited to all companies.

6. Be sure to review the PPSR before providing credit to the company to assess the strength of your security, this should be used in conjunction with credit checks to assess the debtor's risk profile.

7. Beware, registration expires automatically after five years if not renewed.

The PPSA regime may appear to be inequitable to some, however it does provide a transparent system for those wanting to provide credit, and by taking the steps above creditors can avoid being exposed to unnecessary risk.

Part Seven:
Statutory Demands

CHAPTER THIRTY EIGHT: STATUTORY DEMANDS

Minimum Requirements

A Statutory Demand (or stat. demand for short), is a formal demand for payment.

It must be in writing and include the following:

- Be for a debt that is due in full at the time of the demand
- Be served on the registered office of the company
- Require the company to pay the debt or enter into a compromise to do so, within 15 working days
- Must be for more than $1,000

A couple of key points:

A stat demand cannot be sent by fax. It must be sent in person. It is customary for the demand to include the details for paying the amount due. Although not a requirement, it is considered good practice and if the debtor can show they had no way of knowing how to pay the bill your action could, in theory, be compromised.

Further, by issuing a stat demand you are implying that there is no dispute over the amount owed.

Serving a Statutory Demand

Every company in New Zealand must have an address for service. If the company is not actually there (which is not uncommon) you can serve the company by delivering the demand to an empty office. It is up to the company to ensure their records are up to date. You can get their records from the Companies Office website.

According to the legislation, however, you can serve the company at their normal place of business, by serving an employee or director of the company. You can deliver the dreaded document yourself, or you can engage a process server (about $200) to do this for you.

It is also considered good practice to have your solicitor draw up the stat demand, although this is not commonly done and is not a legal requirement.

Challenging a Statutory Demand

A stat demand can only be set aside by the courts, and the debtor has only ten working days to do so.

The ten days starts from the next working day, (so, if the stat demand was issued on a Friday, the ten days commences on the following Monday, and ends at the end of the second Monday, assuming no public holidays.)

The company served with the stat demand must engage a lawyer and satisfy the courts that there is a genuine dispute about the existence of the debt. Completing an affidavit that there is a dispute is not enough to prove that there is a dispute. See The 290 Trap: Chapter Eight.

Is There a Dispute?

The courts take the view that a stat demand is a means of establishing a company's solvency, and not a means of collecting debt. If the court thinks that the creditor is using a stat demand to enforce a debt, the courts can hold the creditor liable for the debtors costs.

Therefore, a stat demand should only be used if there is, in fact, no substantial dispute over the money owed.

If there is a dispute, then this needs to be resolved by a court trial.

So, when faced by a company seeking to put aside a statutory demand, a judge will be looking for some evidence that the debt in dispute should be resolved by a trial. In the absence of such evidence, the judge will likely rule that the statutory demand is valid.

If the dispute is not about the debt, but only the value of the debt (or if there is some net-off) then the judge will only invalidate the statutory demand if the amount of the dispute would render the debt less than the proscribed minimum of $1,000.

Special Circumstances Regarding the Inland Revenue

The IRD sometimes has a problem, in that if a company does not complete a tax return the IRD does not know how much is owed.

The IRD solution to this is to do an assessment. The courts have found that the IRD needs a very good case to succeed in this area, and specifically needs to act in good faith, without procedural defects and making use of all of the information available to the IRD. If the IRD meets these criteria, then the company is unlikely to succeed in challenging a statutory demand on the basis that the IRD's assessment is invalid.

Liquidation

Lets summarise where we are.

Statutory Demand Issued; and Challenged

- Debtor must prove, within ten working days, that the amount owing is in dispute. The judge will need to believe that the dispute is substantial and the issue should go to trial
  or
- Debtor must prove they have a debt against the creditor company that negates the debt owing
  or
- Debtor must prove that the statutory demand was defective due to some procedural error

If the debtor is successful in stopping a statutory demand then the whole issue must go to a trial in a civil dispute. If the debt is less than fifteen thousand dollars, the disputes tribunal is usually the best option, otherwise a full court hearing is required.

Statutory Demand Issued; and not Challenged, or Challenge Unsuccessful

At the expiry of fifteen working days, assuming no successful challenge by the Debtor Company, the issuing company can apply to court to get a hearing date to proceed to liquidate the Debtor Company.

Depending on how busy the local High Courts are, this could take between two and ten weeks before a hearing date is set.

The Process of Liquidating a Defaulting Debtor Company

Once the fifteen days have elapsed, the following is the procedure that can be used to liquidate a non-paying debtor:

A) Apply to the High Court with an application to liquidate the company

B) Serve a copy of the application on the Debtor Company. This should be at the registered office of the Debtor Company

C) Advertise in the local newspaper and the New Zealand Gazette the application for liquidation

D) Submit to the court a statement or affidavit proving the advertising of the liquidation, as well as proof that the statutory demand was served

E) On the appointed date, the court will hear your application. If successful, you may need to consider who you want to appoint as a liquidator. If not, the court is likely to appoint the Official Assignee.

In practical terms, getting a court date to liquidate the company is usually enough to prompt the Debtor Company to pay their bills. If they cannot pay at this stage, they will, in all likelihood, appoint their own liquidator and bring the process to an end.

Part Eight:

Trading Trusts

CHAPTER THIRTY NINE: TRADING TRUSTS

Basic Structure

Trusts are a tricky legal concept. If you give someone something of yours to look after, say you are going on a holiday and you leave your boat with your neighbour while you are away, this creates a 'trust'. The boat is yours. It is being looked after by your neighbour. If he goes bankrupt, the Official Assignee cannot take your boat as the boat is held by your neighbour 'in trust' for you.

A more formal trust is established if you create a legal document establishing the obligations of your neighbour, and their rights, in looking after the boat. Then the trust becomes slightly more than a concept, there is a proper entity "the trust". However, "the trust" has no formal legal standing in law. The boat, to the outside world, is owned by your neighbour.

There are two key concepts in a trust. The first is the trustee. In the above case the trustee is the neighbour. The second is the trust itself, which again in this case is the boat.

In a trust the trustee assumes all the liabilities of the trust. Thus, if you have an informal lemonade stand that you run every week at Takapuna beach, and you leave this with your neighbour, then any debts incurred by your neighbour on behalf of the lemonade stand can be enforced against your neighbour.

So, if your neighbour orders 200 bottles of mineral water for the lemonade stand, he is personally liable for this debt.

Family Trusts

Family trusts and related entities are established as separate legal entities that have three elements:

Beneficiaries:	Those for whom the trust is meant to benefit
The Trust:	The assets and liabilities of the trust
The Trustee:	The person who manages the trust assets.

The concept behind the trust is that the trust is its own entity, separate from the person who established it, and it exists for the benefit of the beneficiaries but is not owned by them (and thus cannot be claimed by the beneficiaries creditors should the beneficiary become insolvent.)

This is why, when a trust is established, the original establishment assets are gifted to the trust.

Two key points:

A) New Zealand law places a limit of $27,000 per annum on gifts, thus assets over this amount advanced to the trust are still owned by the person who gave them to the trust. This debt is an asset of the person who made the advance and can be claimed by that persons creditors

B) The trustee of the trust is personally liable for any debts of the trust.

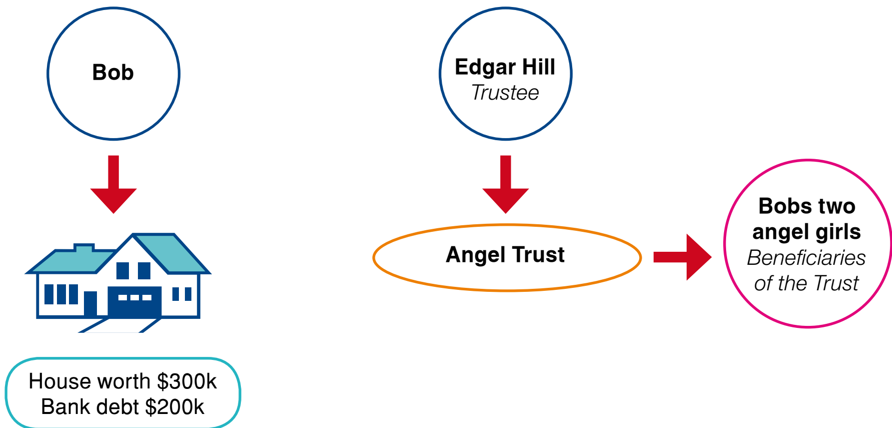
Prudence Clarifies a Tricky Point

The history of trusts in English law dates back to the crusades. Knights off to deal to the heathens in the holy land would leave their estates in the hands of others (think of Aragon). These trusted stewards were honour bound to return the estates upon the gallant knights' return.

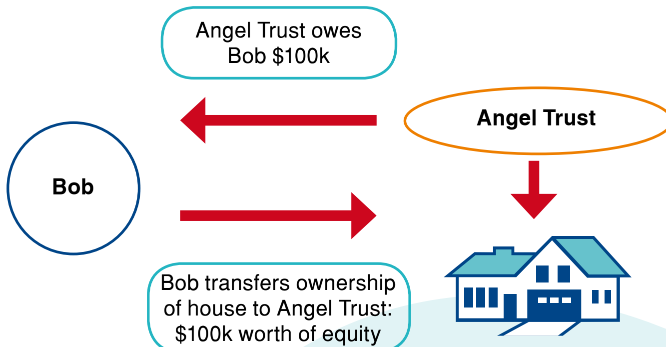
Sadly, some of these stewards proved less than honourable and the knights were required to petition the King to return their lands. The concept of holding assets 'in trust' stems in English law back to this time.

Establishment of a Trust

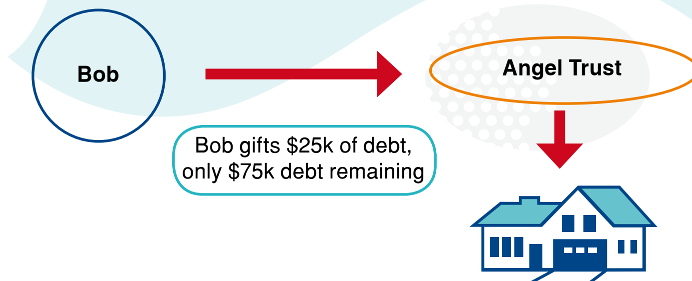
Step One: Setting Up Trust



Step Two: Transferring Assets



Step Three: Forgiveness of Debt



Now that the family home is in the Angel Trust, the only asset owned by Bob is the debt that the trust owes him, being the $75k.

If the house grows in value over time, and Bob continues to gift $25k a year to the trust, in four years Bob will be owed nothing by the trust and if he gets into trouble his creditors will not be able to take the house off him.

On the Land Registrar, the house will appear to be owned by Edgar Hill, but of course Mr Hill will not really own the house, he will simply be holding it in trust. However, Mr Hill is personally liable for the debts of this trust, but he is indemnified by the trust assets for any costs he incurs. However, if there is a shortfall, Mr Hill as trustee is personally liable.

This idea is no different from a businessman putting aside a million dollars and declaring that this money is to be used for helping sick children. He gives the million dollars to the Cancer Society but only on the condition that the money is to be spent on sick children.

Here, Bob has given his house to Edgar Hill, on the condition that Edgar will look after the property for the benefit of Bob's children.

Corporate Trustees

The next step in the evolution of trusts was the creation of the corporate trustee. Rather than having the trustee being a person, who can be sued for losses of the trust, trusts began appointing limited liability companies as the trustees. This means that if the trusts suffer a loss, the creditors of the trust can go no further than the limited liability company, which is usually an empty shell with no assets.

Trading Trusts

The final step in this process is the creating of a trust for the purpose of running a business, and the appointment of a corporate trustee to oversee the affairs of the trust. The director of the corporate trustee can claim that their responsibility is only over the corporate trust, and that he has no personal liability for the debts of the company, as is the case for any director. This poses a difficulty for creditors of trading trusts, which is the intention.

Issues

Trusts are complex creations and most of the issues relating to them are captured by the 1956 Trustee Act.

A trust is not a legal entity in itself but a promise by a party or persons called Trustees to manage some assets for the benefit of some other persons called beneficiaries in accordance with the terms of the deed of trust. This gives rise to the concept of “Fiduciary Duties” or responsibilities. It is intended that by having a corporate trustee the liability attaching to the fiduciary responsibility will be limited through the limited liability of the company. Further the Land Transfer Office and Companies Office don't recognise the beneficial ownership of trusts but do recognise the ownership of the trustee so land and shares will be held in the name of the trustee and not the trust itself.

Recently, the courts have been taking a closer look at trading trusts, and two forms of trusts in particular have come under scrutiny:

Alter Ego Trust is where all of the power or excessive power to control the trust is effectively held by one person and they exercise those powers for their own ultimate benefit. In the trading trust situation, this would be where the Director, Settlor and Shareholder is the one person, and holds powers of appointment and removal of both beneficiaries and trustees, in other words no one else has any effective ability to exercise any control or influence over any decision involving the trust. If this is the case, the courts are likely to find that in fact there is no trust. That the trust is simply an extension of the director/shareholder/settler, and any attempt by that person to escape liability is probably going to fail.

Sham Trust is where some power is held by an independent party such as a trustee who fails to exercise their power independently in the interests of the beneficiaries generally . A trust may start of as a sham or become a sham later through the way it is managed.

The Courts are becoming considerably less impressed when people hope to hide behind dubious trust structures. Such structures do make it harder for the Court to look behind the corporate vale however there appears to be an increasing willingness for the courts to grant a remedy in situations where the benefits of such a structure have been abused.

Liabilities of Beneficiaries

Personal liability for a debt can attach to a beneficiary when the beneficiary orders goods and or services on the trust's behalf and the trust is unable to meet its obligations. This is especially the case if the beneficiary is seen to be involved in managing the affairs of the trust. Thus, where the trading trust has been established, and the trustee is a limited liability company, the liquidator for the trustee company can have a cause of action against the beneficiary of the trust.

The issues the courts will look at in determining the liability of the beneficiaries was whether the beneficiaries expected a benefit from the trust, exercised control over the activities of the business the trust was running and had some knowledge of the solvency of the business.

Directors Duties

Directors of corporate trustees have a duty not to put themselves in a position of conflict in terms of their duties and responsibilities and must account for any profit arising from their position. They are bound by the companies act and come under the reckless trading provisions, like any other director.

A director of a corporate trustee needs to consider that:

A) The company has an obligation to pay all of the debts of the trading trust

B) If the assets of the trust are insufficient to allow the payment of the debts, and the company is unable to pay them, then the company is insolvent

C) A director of an insolvent company faces the risks of reckless trading

Part Nine:
Stonewater Airlines

CHAPTER FORTY: STONEWATER AIRLINES

To fully understand a concept it is often useful to have an example. Here we shall use Stonewater Airlines and we shall see how this fictional airline copes with the different insolvency options available to it.

Stonewater Airlines is a small regional airline that services the Northland Region. It is based at the Riverhead Airport, and they have seven planes:

- Three Cessna 172 Aircraft. These were purchased with money lent by Master Finance. They are worth $100,000 each, and the debt owing on them is $200,000.
- Three Piper Seneca Aircraft, owned outright, worth $50,000 each
- One Gulfstream purchased with money borrowed from Luther Finance, worth $400,000, with $300,000 of debt still owing.

The company has twelve staff and it is director is Fred Richthofen.

Fred owns 80% of the company. His business partner, Wilfrid May, owns the other 20%. Wilfrid and Fred have had a falling out over the management of the business and are no longer on speaking terms.

In addition to the aircraft, the company has debt to the Pacific Bank of $1,000,000. The bank has a GSA over the company.

It has debtors of $300,000.

Fred Richthofen had stopped taking a salary and has been taking drawings for the last two years, so he owes the company $200,000.

There were other assets totalling $50,000.

The company's balance sheet looked like this:

	$ Current	$ Fixed	$ Total
ASSETS			
Cessna 172 (3)		300,000	
Piper Seneca (3)		150,000	
Gulfstream (1)		400,000	
Current Account - Fred		200,000	
Debtors	300,000		
Minor Assets		50,000	
Total	**300,000**	**1,100,000**	**1,400,000**
LIABILITIES			
Master Finance		200,000	
Luther Finance		300,000	
Pacific Bank		1,000,000	
Inland Revenue	250,000		
Creditors	750,000		
Total	**1,000,000**	**1,500,000**	**2,500,000**
NET	**- 700,000**	**- 400,000**	**- 1,100,000**

The company is, as we say in the insolvency profession, Upside Down. Making matters worse for the company is that its current assets, being its debtors at $300,000, are much lower than the current bills that need to be paid.

Stonewater Airlines: (In Liquidation)

The Inland Revenue issued a statutory demand on the 1st of July for the tax arrears. After consulting his advisors, the director, Fred Richthofen, decides to place the company in liquidation. Unfortunately, this is a shareholder decision. If all the shareholders agree the company can be placed in liquidation by a written resolution. If not, the company must call a special shareholders meeting, usually having to wait two weeks before having the vote.

Because Wilfrid May will not co-operate, Fred must call the meeting, notify Wilfred and wait the two weeks. At the meeting, which Wilfred does not attend, Fred placed the company into liquidation.

Two things happen straight away.

First, the liquidators immediately take over the affairs of the company. They do the following things:

- Call a staff meeting. Ask the staff to stay on until the liquidators can figure out what to do
- Contact the bank, cancel all outgoing money
- Search the PPSR registrar, contact all secured creditors

Sometimes liquidators close a business down, sometimes we try and keep it going.

In this case the liquidators work out what would happen if they closed the business and sold the assets. The company has a GSA to the bank, which means that all of the airlines assets (except the debtors and assets specifically secured to someone else) all belong to the bank.

- The Cessna's are secured to Master Finance, so when they are sold for $300,000 there will be $100,000 left. This will then go to the bank.
- The Piper's are not secured, but they are covered by the bank General Security Agreement, so the bank will get all of the money.
- The Gulfstream is secured by Luther Finance, so they will get their $300,000, the remaining money will get paid to the bank.
- The minor assets are also covered by the bank's GSA, and they will get those.
- The Debtors, however, are not covered by the banks' GSA, as per Schedule 7 of the Companies Act. This money can be used to pay liquidators fees, staff holiday pay, and the IRD.

Prudence Says:

Under Schedule 7(2)(1)(b), a GSA holder does not have first claim on a company's debtors or stock in trade. These assets are to be used for paying staff wages, and the IRD. If there is anything left over after paying the IRD, then the GSA holder will get what is left. Only if the GSA holder is paid out in full will the unsecured creditors gain anything.

If they were to close the business down, the following would happen:

ASSETS	**$ Asset (Book Value)**	**$ Less Security**	**$ Balance Realised**
Cessna 172 (3)	300,000	200,000	100,000
Piper Seneca (3)	150,000		150,000
Gulfstream (1)	400,000	300,000	100,000
Current Account*	200,000		100,000
Debtors*	300,000		200,000
Minor Assets*	50,000		20,000
Total	**1,400,000**		**670,000**

* Assume actual money recovered is less than book value.

Distributed to....

ASSETS	**Liquidators**	**Staff**	**IRD**	**Bank**	**Total**
Cessna 172 (3)				100,000	
Piper Seneca (3)				150,000	
Gulfstream (1)				100,000	
Current Account				100,000	
Debtors	40,000	20,000	140,000		
Minor Assets				20,000	
Total	**40,000**	**20,000**	**140,000**	**470,000**	**670,000**

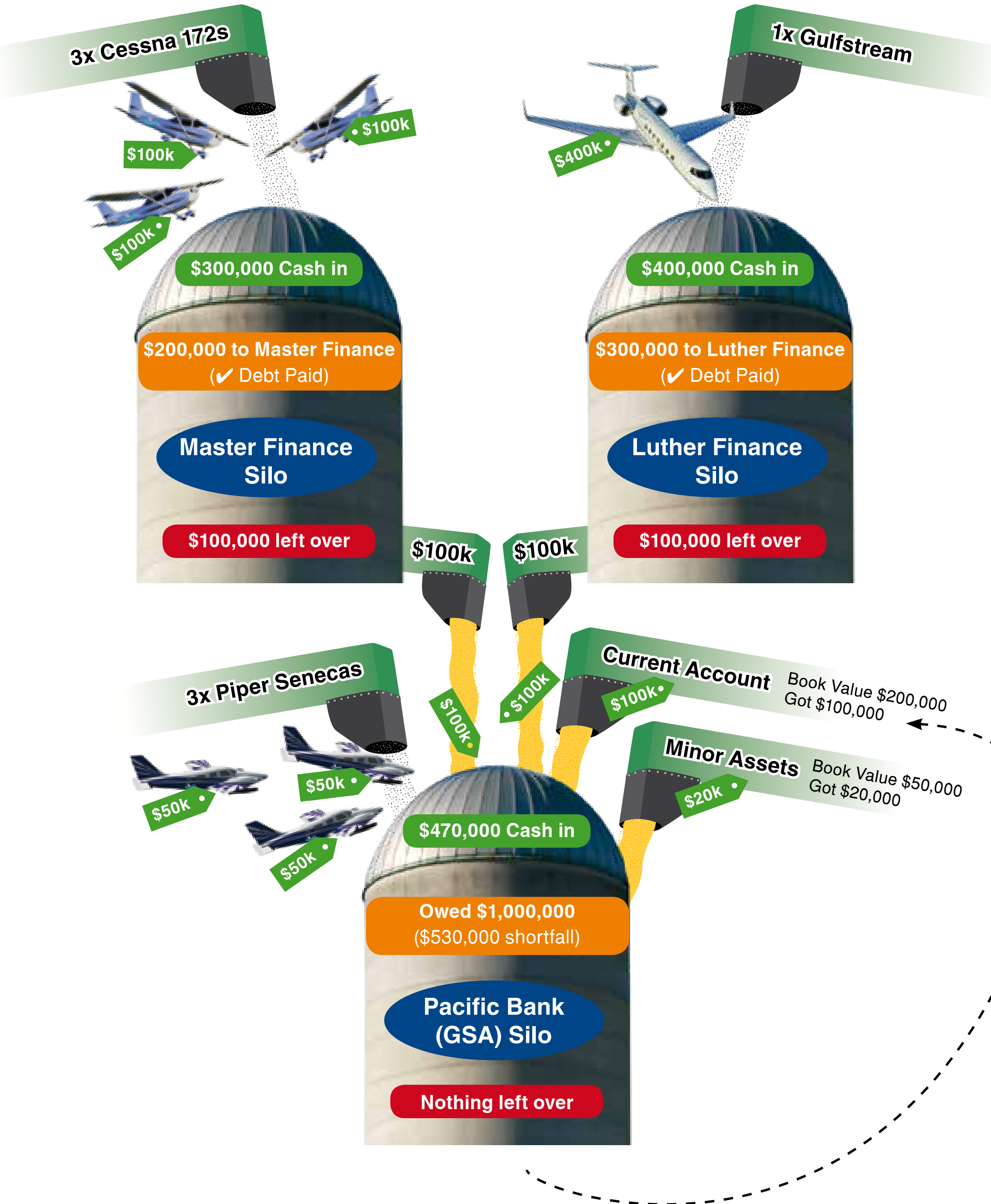
To see what would happen if the bank did not have a GSA, but instead were simply an unsecured creditor like everyone else:

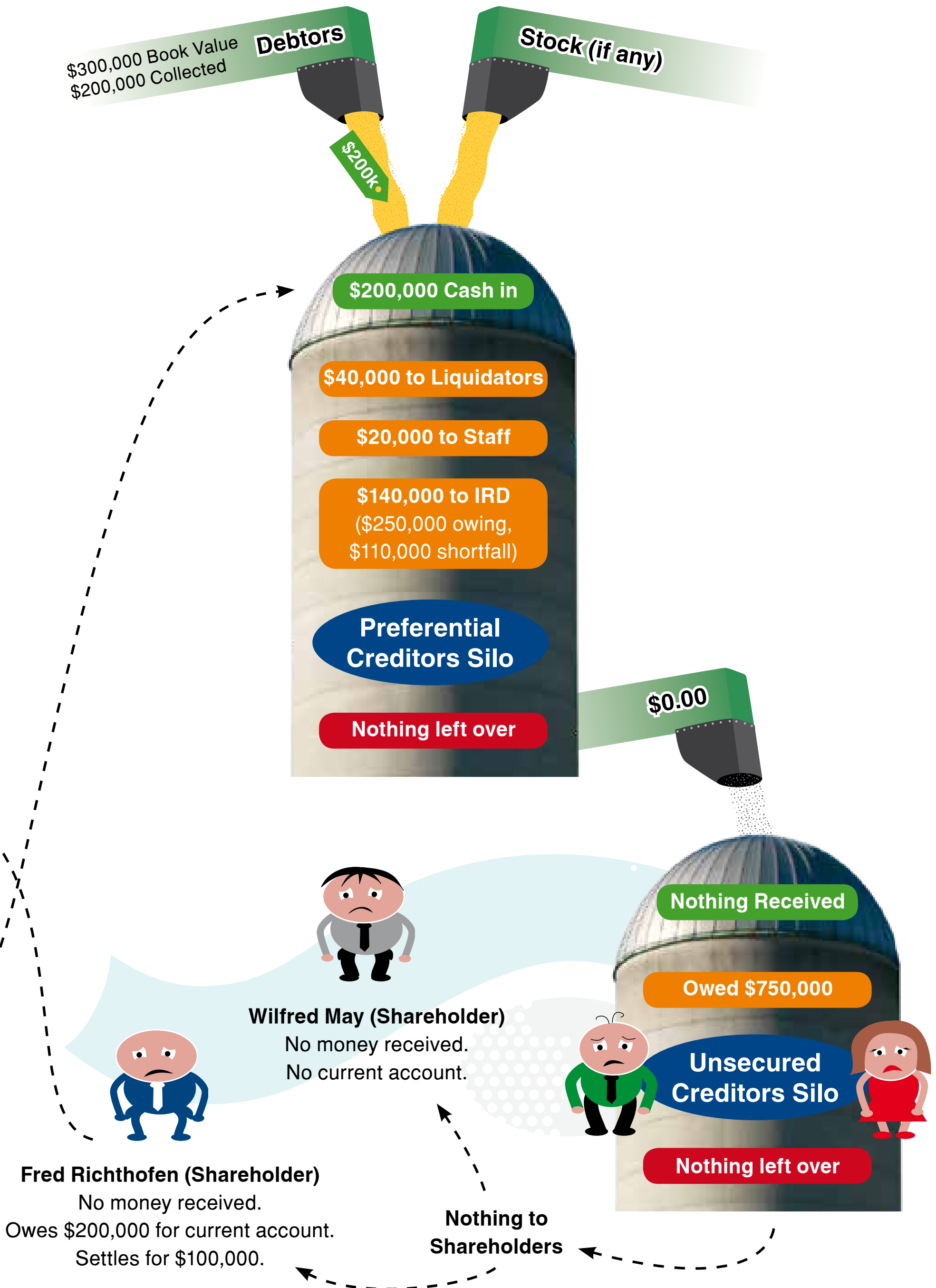
Distributed to....

ASSETS	**Liquidators**	**Staff**	**IRD**	**Unsecured**	**Total**
Cessna 172 (3)			100,000		
Piper Seneca (3)			150,000		
Gulfstream (1)				100,000	
Current Account				100,000	
Debtors	40,000	20,000		140,000	
Minor Assets				20,000	
Total	**40,000**	**20,000**	**250,000**	**360,000**	**670,000**

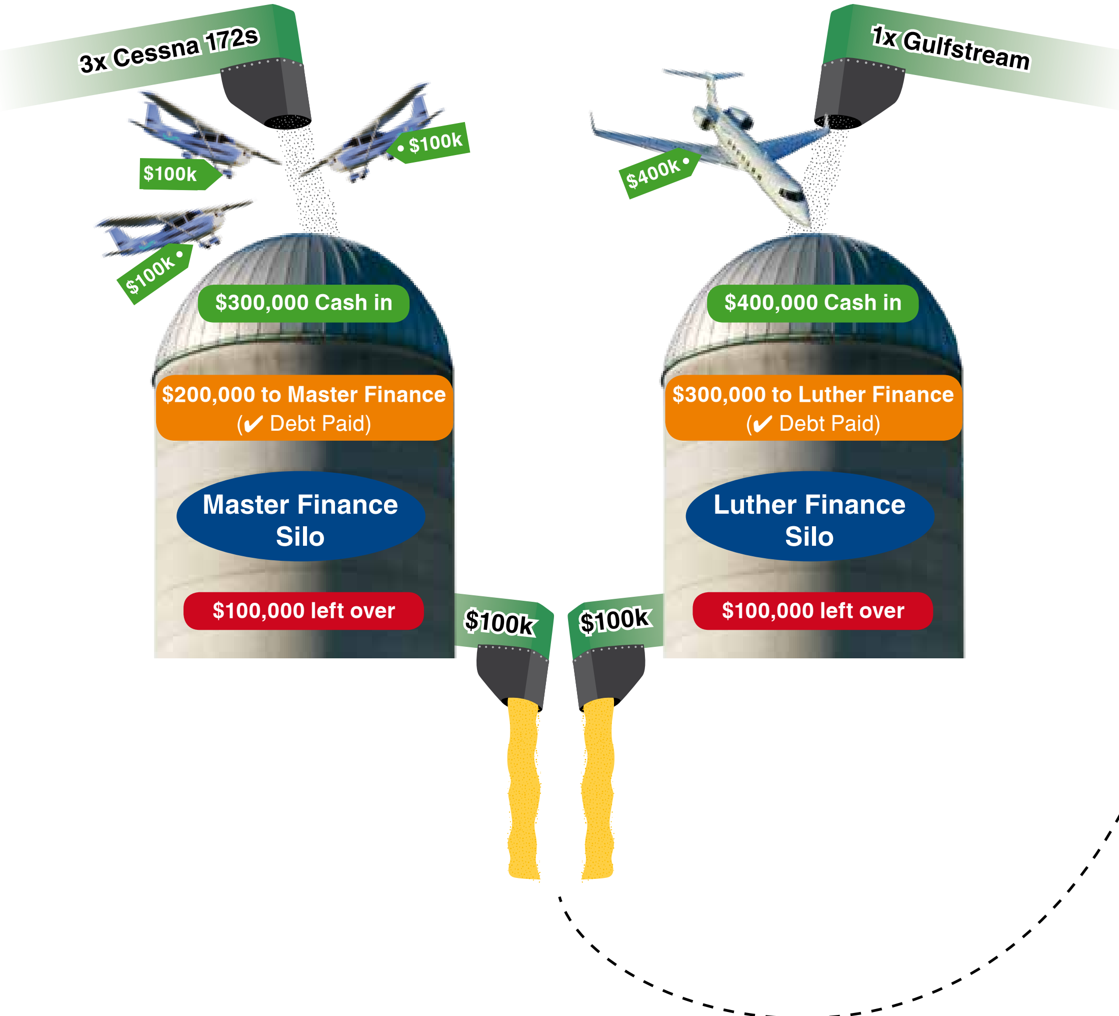
Things change rapidly. Now, instead of any surplus going to the bank, it goes to the pool for un-secured creditors.

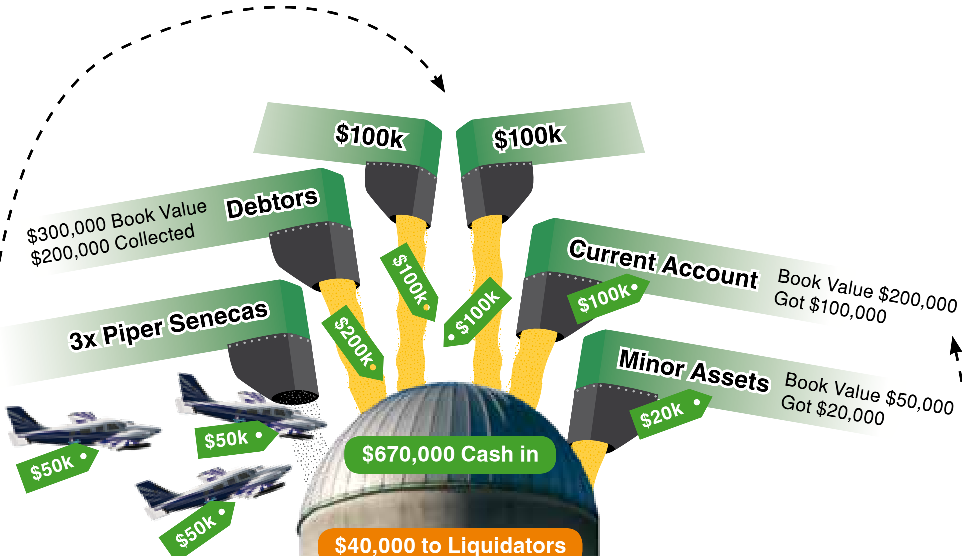
With a Bank GSA




$300,000 Book Value
$200,000 Collected
Debtors
Stock (if any)
$200k
$200,000 Cash in
$40,000 to Liquidators
$20,000 to Staff
$140,000 to IRD
($250,000 owing,
$110,000 shortfall)
Preferential Creditors Silo
Nothing left over
$0.00
Nothing Received
Owed $750,000
Unsecured Creditors Silo
Nothing left over
Wilfred May (Shareholder)
No money received.
No current account.
Fred Richthofen (Shareholder)
No money received.
Owes $200,000 for current account.
Settles for $100,000.
Nothing to Shareholders

Without a Bank GSA





$40,000 to Liquidators

$20,000 to Staff

$250,000 to IRD
(✔ Debt Paid)

$360,000 paid to
Unsecured Creditors

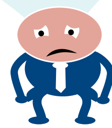
Pacific Bank	$1,000,000
Other	$750,000
	$1,750,000
Paid	$360,000
Shortfall	$1,390,000

Unsecured & Preferential Creditors Silo

Nothing left over

Wilfred May (Shareholder)
No money received.
No current account.

Nothing to Shareholders



Fred Richthofen (Shareholder)
No money received.
Owes $200,000 for current account.
Settles for $100,000.

The liquidators take the surplus from the sale of the Cessna and the Piper aircraft to pay off the debt to the IRD. The balance is now available for all unsecured creditors, including the bank.

Now, with $360,000 to pay out, the distribution looks like this:

	Creditors	Distribution
Bank	1,000,000	205,714
Creditors	750,000	154,286
Total	**1,750,000**	**360,000**

Prudence reminds us of two things:

In the above example all of the IRD debt is shown as preferential. In fact only the GST and PAYE components of the IRD debt would be preferential. In most liquidations up to half of the IRD debt is made up of penalties and interest, or for past income tax. This tax obligation is unsecured, and will not be paid out before the other unsecured creditors.

Once the company goes into liquidation the liquidator will often cancel the lease. Most lease contracts give the landlord the right to then claim against the company the full term of the lease. So if the company has two years to go on its lease, and the annual lease was $45,000, then the landlord can claim $90,000 as an unsecured creditor in the liquidation.

Stonewater Airlines: Compromise with Creditors

Rather than seeking to liquidate, Fred decided to try and do a deal with his creditors, under Part 14 of the Companies Act.

Under this section of the Act, the company can call a meeting of its creditors and put a proposal to their creditors. If 75% of creditors by dollar value and a simple majority by number agree, then the deal is considered fixed and binding on all parties, including those who did not support the proposal.

Fred Richthofen puts a deal to his creditors, saying that the company will pay only 20c in the dollar to all creditors. He finds the process does not interfere with the day to day running of his company. Creditors call him asking for an explanation and he has to deal with the insolvency firm on a daily basis but other than that he is left to run his business as normal.

There are two important rules to understand when looking at a Part 14 compromise:

- It is class specific: ie: Preferential Creditors, Secured Creditors and Unsecured Creditors are three separate classes of creditors. Therefore, this deal is not binding on the Inland Revenue's preferential debt, as this debt is in the same class as the staff holiday pay. The company could call a meeting of its preferential creditors but does not do so. If the proposal is passed, the IRD will still be owed its $250,000.

- A secured creditor can waive some or all of their security, to become an unsecured creditor and therefore vote. The proposal does not affect personal guarantees. The bank decide that the value of the assets are only worth $100,000. They have a security over Fred Richthofen's house, so they waive $900,000 of their secured debt to become an unsecured creditor and decide to support the proposal.

After the Pacific Bank waive part of their security, the numbers look like this:

LIABILITIES	Secured	Unsecured	Preferential
Master Finance	200,000		
Luther Finance	300,000		
Pacific Bank	100,000	900,000	
Inland Revenue		50,000	200,000
Creditors		750,000	
Total	**600,000**	**1,700,000**	**200,000**

At the meeting, however, four creditors vote against the deal, and their votes come to just over 25%, so the proposal is not successful, despite getting a majority of creditors on board.

		For	Against
Prop Supplies	125,000		125,000
Riverhead Autos	1,000	1,000	
Aero Fuel Limited	275,000		275,000
Axel Accounting	20,000	20,000	
Riverhead 4 Square	1,000	1,000	
Northern LPG Suppliers	1,000	1,000	
Z-Box Stationary	1,000	1,000	
Nylon Printing	15,000		15,000
Inland Revenue	50,000	50,000	
Kumeu Cellars	3,000	3,000	
Riverhead Airfield	35,000	35,000	
Auckland Travel	195,000	195,000	
Centro Electricity	13,000		13,000
Landlord	35,000	35,000	
Bank	900,000	900,000	
Harderse Legal	30,000	30,000	
Total	**1,700,000**	**1,272,000**	**428,000**

Required	**1,275,000**
Result	**FAIL**

Stonewater Airlines: (In Voluntary Administration)

After the failure of the Compromise, the company's options are running out, Fred tried a new strategy, Voluntary Administration.

Voluntary Administration is a more involved process than a compromise with creditors. It involves the Voluntary Administrator taking control of the company for a brief period, and taking on personal liability for the debts incurred by the company whilst it is under their administration. Once again, the minority shareholders prove difficult, but Voluntary Administration is driven by the board, so Fred is able to put the company into Voluntary Administration without seeking the consent of his minority shareholders, and this he does. He appoints experienced insolvency firm Baron, Rouge and Partners.

Messers Baron and Rouge take control of the business in much the same way a liquidator would. The bank accounts are frozen. The staff are called for a staff meeting, secured and unsecured credits are called.

For Fred this process has a much greater impact on his business. The Administrators are on site. They are in charge of the business and the staff are reporting to them. He is still allowed to come into the business but with the decisions being made by the Administrators he finds he has little to do. After a week he finds himself being asked to become a pilot again, and he agrees, having little else of relevance to do.

The Administrators, once in office, move quickly and take the following steps:

- They Call an initial creditors meeting, which they must do within eight days of their appointment.
  - This meeting has only two functions, to see if the creditors wish to replace the Administrators, and if they wish to elect a creditors committee. The creditors meet, and they elect to leave the Administrators in place and not to elect a creditors committee.

- They run the business as a going concern, all the while they are incurring personal liability for each expense incurred by the business.

- A statement of financial position is obtained from the director, in reality prepared by the accountant and signed by Fred, and circulated to the creditors.

- A Deed of Company Arrangement is proposed:
  - All creditors will receive 30c in the dollar.
  - The Inland Revenue to be classed as a normal creditor, so they lose their preference.
  - Payment is to be over two years.
  - After discussions, the Director signs a Deed undertaking personal liability.

- A creditors list is drawn up, and all creditors either turn up or send in a proxy vote at the creditors meeting.

After a heated discussion, and the IRD declaring that they will not be supporting this proposal, the votes are tallied:

		For	Against
Prop Supplies	125,000		125,000
Riverhead Autos	1,000	1,000	
Aero Fuel Limited	275,000		275,000
Axel Accounting	20,000	20,000	
Riverhead 4 Square	1,000	1,000	
Northern LPG Suppliers	1,000	1,000	
Z-Box Stationary	1,000	1,000	
Nylon Printing	15,000		15,000
Inland Revenue	250,000		250,000
Kumeu Cellars	3,000	3,000	
Riverhead Airfield	35,000	35,000	
Auckland Travel	195,000	195,000	
Centro Electricity	13,000		13,000
Landlord	35,000	35,000	
Bank	900,000	900,000	
Harderse Legal	30,000	30,000	
Staff (Twelve)	20,000	20,000	
Total	**1,920,000**	**1,242,000**	**678,000**

Required	**1,440,000**
Result	**FAIL**

The vote does not get over the 75% threshold. Although it has the support of the overwhelming number of creditors, the opposition of Aero Fuel Limited, Prop Supplies and the IRD have sunk the proposal on the creditors vote.

However, at this stage the two administrators declare that they will be supporting the proposal. They exercise their casting vote, and the DOCA is confirmed as being passed. Fred is delighted. He signed the DOCA the next day and is given back control of his company.

Fred Richthofen: Stonewater Airlines Director: Personal Compromise with Creditors

After the dust has settled on the successful Voluntary Administration Fred is forced to face his own delicate personal situation.

Separate from the business he owns one house in his own name. It is worth $450,000, and it has $400,000 of debt on it to the Riverhead Building Society.

He also owns his $5,000 car, and some shares in Telecom, worth $40,000.

Beloved spaniel, Blackie.

Two years ago he lost a lot of money in a real estate project that went bad. He borrowed $300,000 from his wife's brother, Carlos Pitcher, to try and prop up the deal but to no avail.

However, Fred's marriage had gone bad earlier in the year after a misunderstanding concerning an (very) attractive photocopier sales person, tequila, a camera phone, a small spaniel called Blackie and a suspicions fire that resulted in the tragic death of the beloved spaniel.

Carlos Pitcher called up the loan and has got judgement in court for the full $300,000. He is seeking to bankrupt Fred and has a bankruptcy date set by the High Court.

Fred has $50,000 of other debt owned to various creditors, and as a result of the Voluntary Administration he has also personally guaranteed half of all the company's debts in the VA.

Fred also has a development company, Red Earth Limited (REL). The company shares are actually owned by the Family Trust. This company has a large development in Riverhead, and it is going really well. The land is worth $1,700,000, the debt to the finance company, Zil Finance, is $1,500,000, and once the subdivision is complete, the land will be sold for $2,000,000, leaving the company with a nice profit. However, there is no cash in the company, so no way to pay the $300,000 to Carlos. Fred has personally guaranteed the debt to Zil Finance.

All attempts to settle the loan to Carlos Pitcher are rebuffed. Often with harsh references to the circumstances of Blackie's demise.

Fred turns back to the insolvency firm Baron, Rouge and Partners for help.

Once again Messers Baron and Rouge come up with a proposal. Fred is required to sell his Telecom shares to split on a pro-rata basis between the $300,000 he owes to Carlos and the other $50,000 of creditors. In addition the trust that owns Red Earth Limited signs a deed that in 18 months it will chip in another $120,000 to go to the creditors.

It is proposed that the following creditors get nothing:

- There is no provision made for the guarantee that Fred has given to the creditors of Stonewater Airlines.

- There is nothing for the Riverhead Building Society, who has the mortgage over his house. They get to keep their security, and Messers Baron and Rouge, after talking to the building society have convinced them that as the value of Fred's house is more than his debt, that they do not need to worry.

- There is also nothing in the proposal for Zil Finance. They know they will get paid when Fred's completed the land development so they are supportive of Fred.

All the creditors are notified, as they can all vote.
The creditors total $4,370,000.

Stonewater creditors	$1,920,000
Carlos Pitcher	$ 300,000
Zil Finance	$1,700,000
Riverhead Building Society	$ 400,000
Minor creditors	$ 50,000

As part of the compromise proposal, it is necessary for the trustee to be appointed. Normally the insolvency firm making the proposal would appoint one of their staff to be the trustee. However, in this case, because Baron, Rouge and Partners are the Deed Administrators of Stonewater Airlines, they decide there is a perception of conflict. Thus, whilst they are happy to do the work for the proposal, it is agreed that Fred's lawyer shall undertake the job of being the trustee.

If the proposal is ultimately confirmed, then Fred's lawyer will be placed in charge of Fred's assets as per the compromise (ie: the shares in Telecom, and the receipting of the cash from Red Earth Limited).

Carlos, however, is relentless. He refuses to agree to a delay in his bankruptcy hearings so the creditors can vote on the proposal. Fred's lawyers attend the bankruptcy application and the judge stands down the matter for two months, to allow the creditors to vote on the compromise proposal.

Needless to say, Carlos is unhappy. At the creditors meeting a week later his outrage is driven to new levels as he discovers that Zil Finance, and the Riverhead Building Society, despite having security greater than their debts, are allowed to vote their total debt.

In fact, other than Carlos, all of Fred's creditors support the compromise proposal or do not bother to turn up. Despite being entitled to attend, none of the Stonewater creditors attend the meeting, but the Pacific Bank send in a postal vote in favour of the proposal.

The vote is:

	Yes	No
Pacific Bank	$1,000,000	
Carlos Pitcher		$ 300,000
Zil Finance	$1,700,000	
Riverhead Building Society	$ 400,000	
Minor creditors	$ 15,000	
Total	$3,115,000	$ 300,000
	91.22%	

The compromise is passed.

Once the deal is agreed, the provisional trustees, Fred's lawyer, sends the document to the High Court for approval.

Despite being approved by the creditors, a personal compromise with creditors must be approved by the High Court. In this respect, a personal compromise is significantly different from a company compromise of Voluntary Administration, which does not require court approval.

Ever vigilant, Carlos Pitcher instructs his lawyer to oppose the compromise when it gets to court.

The lawyer puts up three reasons why the court should not approve the proposal:

1) If Fred was bankrupt the Official Assignee would sell his house, releasing $50,000 in equity, a better short term deal than that being proposed.

2) It is unjust that Zil Finance is allowed to vote, as they stand to lose nothing and have no exposure.

3) Due to the close working relationship between the insolvent and Zil Finance, (It appears that Fred's family trust owns 50% of Zil Finance, something not revealed to the other creditors) that Zil Finance should be declared a related party and their vote discounted.

The court disagrees on all three points, and all the deal is passed.

To Fred's delight, none of this is required to be publicly advertised (such as in the NZ Gazette). However, Veda Advantage can include this information as an Insolvency on Fred's personal credit report if they become aware of it. Fortunately for Fred, they do not, and his credit rating is safe.

Stonewater Airlines: (In Receivership)

It was not anyone's fault. These things just happen. Or at least that was what director Richthofen said after his pride and joy, the Gulfstream, executed what the Air Safety Investigator delicately described as a 'controlled flight into terrain.'

The Media described it as "Beauty Queen and her Beau perish in Mile High Quest!" The story was fuelled with lurid details of the late beauty queen's past amorous adventures, raunchy Facebook pictures and details of her high profile father, his latest business successes and more recent divorce and drink driving conviction.

The stories just never seemed to end. The 'Evening Amour Experience' has seemed like a marketing winner when he launched them six months earlier, but one upside down Gulfstream into a Coatesville paddock put paid to all that. The fact that a pet horse had met a ghastly end contemporaneously with the Gulfstream did nothing to dampen the media's fascination, as the grief-stricken cherub-cheeked owner sobbed in front of anyone with a camera.

The media were now calling Stonewater Airlines "Air Disaster Limited", recalling an earlier spate of maintenance problems a couple of years earlier. Passenger traffic was down. Bookings were cancelled. It was looking grim.

Pacific Bank had a General Security Agreement over Stonewater Airlines. They read the papers. They came to visit Fred Richthofen in his offices at the Riverhead Airfield.

It was sad, the manager of Pacific Bank admitted. No one's fault, but the bank was owed one million dollars, the last interest payment due at the start of the month had been missed. This was a breach of the loan agreement, and once there was a breach, the bank had the right to ask for all of their money. The loan had gone from a ten year term loan, to now being on-demand. And they were here making that demand.

Fred admitted he could not meet the interest payment, and had no means of repaying the loan. Sadly, the Pacific Bank manager declared, they were putting Stonewater Airlines into receivership. The reputable firm of Wrench and Tear were appointed, effectively immediately.

Other than the nature of the appointment, the process of a receivership is almost identical to that of a liquidation. Therefore, the creditors, staff and debtors of Stonewater Airlines would notice no difference between the manner that Messers Wrench and Tear act as receivers as opposed to those of Messers Baron and Rouge who were appointed as liquidators in an earlier example.

The distribution of funds occurs in an almost identical manner, almost. One difference between a receivership and a liquidation is that the receivers costs are borne by the assets covered by the GSA holder. A liquidators costs are borne by the assets that would have been available by the unsecured creditors, (stock and debtors.)

Using the example below the difference can be seen. The liquidators must take their fees from the unsecured assets. Any assets secured under the GSA belong to the Pacific Bank and cannot be used to pay liquidators fees. However, if the Pacific Bank appoints a receiver, then the receivers

fees can come out of the assets covered by the Pacific Bank's GSA.

The net result in the insolvency of Stonewater Airlines is that the IRD does better in a receivership by an amount equal to the receivers fees (assuming that liquidators and receivers charge the same amount!)

UNDER RECEIVERSHIP

Distributed to....

ASSETS	**Receivers**	**Staff**	**IRD**	**Bank**	**Total**
Cessna 172 (3)	40,000			60,000	
Piper Seneca (3)				150,000	
Gulfstream (1)				100,000	
Current Account				100,000	
Debtors	-	20,000	180,000		
Minor Assets				20,000	
Total	**40,000**	**20,000**	**180,000**	**430,000**	**670,000**

The receivers, Wrench and Tear, decide to run the airline for a short period. At the staff meeting called by them they advise the staff that their existing contracts have been terminated, and new contracts have been issued for them to sign.

This is followed by a heated discussion by the staff concerned about their holiday pay and the prospect that they will be paid their wages now that the Airline is in receivership. The receivers advise the staff that as the company is in Receivership, that the Receivers are personally liable for all costs incurred, including their wages going forward, but that under the law, if they do not cancel their existing employment agreements, then the receivers will be personally liable for their existing contracts, including redundancy and holiday pay elements.

The receivers also advise all creditors who supply to Stonewater Airlines (In Receivership) that they can be confident about getting paid, because the receivers are personally liable for all costs incurred in the receivership, and that this is mandated by the Receiverships Act.

Within a short period, it is decided that the Airline can be sold.

In addition to the realisation of the assets as listed above, the receivers manage to get a further $200,000 for goodwill when they sell the business to an Australian investor.

This payment is considered part of the assets of the business, it is covered by Pacific Bank's GSA, and the money is paid to Pacific Bank.

Some of the main differences between a receivership and liquidation are:

Section 310
Does not apply in a receivership. Thus, Axel Accounting can net off the bill $5,000 over six months, and the $25,000 bill under six months off the $40,000 that the owe Stonewater Airlines in Receivership. In liquidation, however, they can only net off the $5,000 bill that is over six months old.

Voidable Transactions
Do not apply in a receivership. These can only be clawed back by a liquidator.

Disclaiming Assets
A receiver cannot disclaim onerous contracts. Only liquidators have this right.

Interviewing Under Oath
A liquidator can interview directors, staff, shareholders, lawyers etc under oath. This is a power that is not available to receivers.

Reckless Trading
A liquidator can hold a director to account for reckless trading; a receiver is limited to suing for overdrawn accounts.

Personal Liability Of Receivers (like Voluntary Administrators)
Personally liable for the debts incurred by the business whilst it is in receivership. This is not the case for liquidators.

Appendix 1

Directors' duties

131 A director of a company must act in good faith and in the best interests of the company

132 A director may make a decision in favour of employees even if that decision conflicts with the section above.

135 A director of a company must not agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors;

or

Cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

136 A director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

137 A director of a company must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, The nature of the company;

138 A director of a company may rely on reports, statements, and financial data prepared or supplied on professional or expert advice given, by employees of the company whom the director believes on reasonable grounds to be competent, professional advisers or expert which the director believes on to be within the person's professional or expert competence, any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority.

Appendix 2

Part 14

Compromises with creditors

228 The following may propose a compromise: The Board, a receiver or a liquidator. Creditors and shareholders can also propose a compromise but needs the courts permission.

229 The person making the proposal must prepare a list of creditors and the amount they are owed and their voting entitlement at a creditors meeting, and must give notice and a statement outlying the nature of the compromise and how it will affect each creditor.

230 If approved at a creditors meeting is binding on all creditors, including those who did not support it. To pass a creditors meeting the proposal needs both a majority in number and at least 75% by value of creditors support (but only of those creditors who actually vote.) Also, all classes of creditors must vote in favour (ie: preferential creditors, and unsecured creditors; both classes vote separately and both groups must vote in favour.)

231 A compromise, once approved by creditors, may be varied either in accordance with any procedure for variation incorporated in the compromise or by a new creditors meeting.

232 The Court may stay proceedings in court against the company or prevent a creditor enforcing a debt, except that any secured creditor may still enforce their rights. The court may also order that a creditor who did not receive proper notice is not bound by the compromise.

233 Once a compromise is approved the Court may, on the application of the company; a receiver or any creditor or shareholder of the company order that the compromise will, if the company is put into liquidation, continue in effect and be binding on the liquidator of the company.

234 The costs incurred in organising and conducting a meeting of creditors for the purpose of voting on a proposed compromise must be met by person proposing it.

Glossary of Terms

Action	A Court proceeding where a person seeks an order for the enforcement of their rights.
Address for Service	The address at which legal documents to the company must be served at.
Administrator	A person appointed under the Voluntary Administration Legislation to run the affairs of the company, call creditors meetings, report on the affairs of the company and prepare a DOCA.
Adjournment	Suspension of legal or other proceedings.
Affidavit	A statement by a person, typically sworn before a lawyer in which the person declares that to the best of their knowledge the facts in question are true.
Agent	A person who has received the power to act on behalf of another. A director is automatically considered an agent of the company, as is a liquidator. A receiver is an agent unless there is a liquidator appointed.
Application	The formal legal request to a Court for an order. Ie; an application to review a liquidators actions, or an application to place a company in liquidation.
Appointment	The act of designating or accepting responsibility for a role or duty. Shareholders can appoint a director, directors can appoint a Voluntary Administrator, etc.
Arbitration	An independent third party is appointed to resolve a dispute. The process is covered by the Arbitration Act 1996 and is usually included in contracts as a means of avoiding protracted legal disputes between contracting parties.
Arrears	Overdue amount owed, not total amount owed.
Asset	A tangible, physical good (property, vehicle, stock) or intangible (contractual rights, good will, intellectual property) owned by a company, person or trust.
Assign	Giving the rights or obligations possessed by one party to another.
Bailiff	A person appointed under law to act or assist in the repossession of items for the person or company who has a right or interest in them.

Bankrupt A person is bankrupt following an order made by the Court or declares them self bankrupt voluntarily. Their assets and in some cases income are controlled by the Official Assignee (OA) for the benefit of creditors. A bankrupt cannot travel overseas without the permission of the OA, must not run a business, be a director, and is subject to a number of other commercial constraints for the duration of the bankruptcy, usually three years.

Beneficiary The recipient of an asset or contractual right.

Bill of Exchange A legal contract where one party in writing specifies that a third party will pay a specific sum of money to the other party. A cheque is a Bill of Exchange, and the bank is the third party.

Bona Fide An act done honestly and in good faith.

Case Law Where parliamentary legislation is silent or unambiguous, court decisions are used to provide precedents that have the effect of law.

Caveat Latin for warning, a legal notice setting out an interest. Typically refers to a legal notice placed on land giving a notice that someone is claiming an interest in the land. A caveat in land is removed automatically if the land is sold by way of mortgagee sale carried out under the formal process governed by the Property Law Act. It is not removed when the land is sold normally.

Charge A security over an asset. It can be over a specific good, or over the entire company (such as a debenture or more commonly today called a General Security Agreement).

Chattel Movable assets not fixed to land or real property.

Chose In Action The right of to enforce through the courts the payment of a debt or some other specified right.

Collateral Assets pledged by a lender as security for a debt, and which can be taken by the creditor if the debt is not repaid as per the terms of the of the loan agreement. Typically property is used as security by people borrowing money and the lender can take the property if the borrower defaults.

Company Guarantee Where a company guarantees the debt of another party.

Completion Date Date on which the transfer occurs or the agreement settles.

Compromise with Creditors Governed by Part 14 of the Companies Act, this is the arrangement with creditors following a formal proposal. The compromise requires a 75% in value and a majority in number support of creditors voting.

Consideration Value given in an exchange for acquiring some goods or services

Constitution Document covering the rules of the company. Should be lodged on the Companies Office website.

Contingency Fee Success fee for taking some action or undertaking. Typically refers to lawyers taking a percentage of collected winnings from a court case.

Contract An agreement between parties containing an offer, acceptance of that offer, and consideration (usually money) for the offer.

Conveyance The transfer of property from one party to another.

Creditor A party owed money by another party. In a liquidation a creditor can be secured (retains an interest in an asset), unsecured, or preferential (gets paid before unsecured.)

Current Account The amount of money invested by the shareholders into the company. If the current account is ‘overdrawn’ this means that the shareholder owes this money back to the company.

Creditors Claim A claim made by a creditor against a company in liquidation. Unsecured creditors’ claims must be in the prescribed form, usually available from the liquidator. Secured creditors do not need to lodge a claim but can enforce their rights.

Crystallization What the debt position becomes known. i.e.: when an asset is sold, the loss or profit crystallises.

Damages Monetary compensation awarded by a Court to offset losses or suffering caused by parties negligence or breach of contract or other obligations.

Debenture More commonly now called a General Security Agreement, (GSA) a debenture is security over the assets of a company. A debenture normally includes a provision for the appointment of receiver.

Debtor A party who owes money, goods or services to another person or company.

DOCA	Deed of Company Arrangement, end process of a successful Voluntary Administration. A DOCA is a binding compromise between a company and its creditors, approved by a creditors meeting and usually allows the company to pay its debts off over a certain period of time.
Defalcation	A wonderful old English word meaning Theft
Default	Failure to perform contractual or other obligations.
Discharge	To cancel or relieve a party of an contractual or legal obligation or responsibility, usually referring to a debt.
Disclaim	The act of renouncing or repudiating an interest in some item. Liquidators typically disclaim a lease on a premises, meaning they waive their contractual rights and obligations in the lease.
Director	A person named as a director and on the Companies Office Register, or alternatively some who is covered by section 126 of the Companies Act, including people who, as outlined by Section 126 "A person occupying the position of the director by whatever name called...". Thus, someone who acts as a director, even if they are not names as one, can be considered a director.
Distraint	Seizing another parties properties because of some obligations that they have not performed Typically refers to a landlord seizing a tenants chattels for breaching the lease. Landlords lost this right in the changes to the Property Law Act in 2008
Drawings	Money taken from the company by the shareholders. This money is not treated as income to the person receiving the money but rather as a loan, which will need to be paid back. If a company continues to trade this loan is often turned into income and tax is paid on it and expensed through the company. If a company fails before this occurs the shareholder will be asked by the liquidator to repay the money.
Equity	The unencumbered value of an asset, the value of the asset less the debt owing on it.
Escrow	Holding of money or a written document (share certificate etc) until contractual conditions are met.
Essential Services	Electricity, gas, water and telecommunications services. Suppliers of these services cannot refuse supply to a liquidator or receiver. They cannot force the liquidator to provide a personal guarantee for the provision of these services. However, they are entitled to get paid before any pre-insolvency creditors are paid.

Ex Parte — The term Ex parte refers to legal proceedings where one parties has not received notice and therefore is neither present nor represented at the Court Hearing.

Examination — Where one party examines the other party, usually under oath, for the purpose of investigating matters. The Liquidator has the power to examine directors, staff, creditors, professional advisors and any other person who has knowledge of the affairs of the company. Those being examined do not have the right to silence, but any thing that they say under such an examination cannot be used for the purposes of a criminal trial (except for perjury) but it can be used for civil recovery.

Discovery — A formal investigation governed by court rules that is conducted before a trial. Discovery allows one party to question other parties, obtain documents and even interview witnesses.

Fair Market Value — The value of an asset that would be commanded given a willing purchaser and a willing vendor in a normal market (and not a forced sale).

Fee Simple — Unrestricted ownership of an asset, usually land.

Fixed Charge — A form of security granted over specific assets. A secured creditor has a first claim on the proceeds of sale. If the asset is sold without consulting the creditor the creditor can usually still enforce their rights over the asset.

Fixtures — Assets attached to, or forming part of a building, or are fixed to land.

Floating Charge — A security over non-specific assets. Typically refers to stock and debtors. A GSA cannot attach to floating charges ahead of claims by preferential creditors.

Gazette — A weekly government publication listing all liquidations, receiverships and notices of court actions, creditors meetings etc. Available online at: http://online.gazette.govt.nz

Goodwill — Non tangible asset of a business arising from the reputation or market power or some other intangible that attaches to the business.

GSA — General Security Agreement. A charge over all of the company's assets.

Guarantor — A party who promises to pay a certain debt of a debtor if the debtor defaults.

In Specie — The distribution of an asset in its present form, rather than selling it and distributing the proceeds from the sale. In a liquidation it refers to the liquidator distributing the assets of the company to the shareholders.

Indemnity — A contract where one party guarantees protection, against losses of a third party.. An insurance policy is an indemnity, where the insurance company indemnifies the customers against losses. An indemnity can be capped or open ended.

Insolvent — A person or entity that fails the solvency test (see below) and is not able to pay debts as they become due. Often refers to a person seeking an arrangement under part five of the Insolvency Act 2000.

Insolvent Liquidation — The company is unable to pay its debts. A Liquidator, appointed by the Court or the company shareholders (or in rare cases the directors if provided for in the Constitution) assumes control of the affairs of the company. The Official Assignee can only be appointed by the Court. The creditors have the right at a creditors meeting to replace appointed Liquidator. If the Liquidator was appointed by the courts the replaced liquidator must go back to court to advise the court of the change.

Interest on Claims — Interest payable on creditors claim up to the date of liquidation where such a provision was contracted for in the original agreement. After liquidation interest is payable on all admitted claims at rate set by the Judicature Act 1908. Such claims rate as unsecured, even if the originating debt was secured.

Interim Dividend/Distribution — A dividend paid to creditors before the liquidation is finalised.

Interim Order — A temporary Court Order intended to be of limited duration, allowing the Court time to hear the full case and making a Final Order.

Joint and Several — The liability and responsibilities of more than one person for which all may be sued for the entire amount of the damages, or in the case of liquidations, can refer to two people accepting a liquidation and both act with all rights.

Judgement — A formal decision from a Court.

Leasehold — A right to occupy a land or a building for a given period of time, where this right is granted by the owner of the land. A lease hold is different legally from a tenancy where the right is given for a periodic period, such as weekly or monthly.

Liability — An obligation of one party to another arising from past transactions, which can include an obligation to provide some future service, i.e.; debts not yet due which will become due in the future (contingent liabilities).

Lien — A right of possession over goods or property belonging to another, with a right to retain possession until debts due to the possessor are paid. A “workers lien” is a right to hold an asset, such a vehicle, that work has been but not paid for.

Liquidation — Liquidation commences on the appointment of a Liquidator.

Liquidator — The person responsible for dealing with the liquidation of a company. Often two people are appointed as liquidators and can act jointly and severally. Section 280 specifies who cannot be a liquidator, and includes those who formerly been directors or professional advisors of the company.

Liquidation Regulations — Gazetted regulations that supplement the company’s act. The specify things like the minimum amount a statutory demand can be for and forms for making claims in a liquidation. They can be changed without recourse to legislation.

Liquidator’s Reports — Reports that must be sent to all creditors within 5 working days of appointment, 10 for court liquidations. The report should include a Statement Of Affairs, proposal for conducting the liquidation and expected completion date, a notice of calling a meeting of creditors or the reasons why such a meeting should not be called. Further reports are due every six months. A final report is required at the completion of the liquidation.

Litigation — A dispute that results in Court action.

Meeting of Creditors — In liquidations and Voluntary Administrations these are statutory proscribed events governed by schedule five of the Companies Act. There are very specific rules around voting, proxies and the discretion of the chairman.

Mortgage — A security given on real property to guarantee the payment of a debt.

Mortgagee — The person in whose favour a mortgage is issued; e.g. a bank.

Mortgagor — The person issuing the mortgage; e.g. a company or individual.

Official Assignee	The Official Assignee is an employee of the Ministry of Economic Development appointed under the Insolvency Act 1967. They deal with the administration of all Bankruptcies, and they can be appointed by the court to act as a company liquidator where no private sector firm is willing to undertake the work.
National Enforcement Unit	A department of the Companies Office that arranges for the prosecution of company directors and others for certain breaches of the Companies Act.
Pari Passu	The equal division of an asset. In liquidation it refers to how creditors who are all entitled to a distribution, but where there are insufficient funds to cover all of their debt, are paid out in equal percentage of their debt.
Personal Guarantee	Where an individual guarantees the payment of another party's debt. Usually this is where a director guarantees the debts of his company.
Petition	An application to the court, can refer to a petition to liquidate a company.
Plaintiff	The party initiating a legal action in Court.
Possession Date	Mutually agreed time the person buying property will take ownership, control or possession of it.
PPSA	The Personal Property Security Act is legislation that formalises the process by which securities in assets are registered. The PPSA requires a creditor to register any interest they have in an asset on the PPSR, (Personal Property Security Register; www.ppsr.govt.nz). If such a security is not registered, the security is still valid but it ranks behind a registered security.
Preference	A transaction that has the effect of putting a creditor of a company (or an Individual) in a better position than would have been the case in the event of a subsequent Liquidation or Bankruptcy.
Preferential Creditors	Creditors that rank ahead of unsecured creditors, as defined in the Seventh Schedule of the Companies Act 1993. The two most important are employees for wages and holiday pay and the Inland Revenue Department for GST and PAYE.
Pro Rata	To divide proportionately amongst people having a claim.

Proofs of Debt — Claim made by creditors in a liquidation. Where there is going to be no distribution these are not typically examined too closely. Where there is going to be a distribution liquidators will usually demand greater proof of a genuine debt owing.

Proper Accounting Records — The requirements are set out in both the Companies Act 1993 and the Financial Reporting Act 1993. If a company does not maintain proper accounting records, then on the application of the Liquidator the Court may declare the directors personally liable for the debts of the insolvent company. However, the Liquidator must first prove that the lack of proper accounting records caused the failure of the company.

Proxy — A written authorisation from a creditor appointing another person to vote on their behalf at a creditors meeting. A proxy must be in writing and must be recieved by the liquidator two working days before the creditors meeting.

Prudence C Grant — The C is for cat. A stuffed cat with her own facebook page and more international travel than the North Korean foreign affairs minister.

Public Notice — Public Notice, as defined under Section 3 of the Companies Act, is given by publishing the notice in the Gazette as well as in one issue of a newspaper circulating in the area of the company's place of business, or the principal place of business, or the registered office in no place of business.

Promoters — Someone who takes an active part in the promotion of the business.

Quantum — The Amount.

Quorum — Minimum number of creditors that must be present, either in person or by proxy, at a meeting of creditors before the meeting is considered to be valid. The minimum number is 3, or all of the creditors if the total number of creditors is less than three.

Realisation of Security — Recovery by a secured creditor of their asset. Usually refers to seizing of an asset or appointing a receiver.

Realisation — The amount of money received from the sale of an asset.

Receiver — A person appointed either by a secured creditor, usually a GSA holder, or on rare occasions by the Court, to take control of an assets. Often the terms of the GSA will allow the appointed receiver to act as an agent of the company. This right ends if the company goes into liquidation, unless the liquidator gives the receiver rights to act as the agent of the company.

Receivership	The status of a company once a receiver has been appointed.
Reckless Trading	Technically, breaches of section 135 and 136 of the Companies Act, where a company director continues to trade despite knowing that the company cannot pay its bills (or where, if the director did not know, he should have known.) If proved guilty of reckless trading a director can be personally liable for the losses of a company.
Registered Office	The address given by the company to the Companies Office. It is the address where legal papers can be served.
Registrar of Companies	An office run by the Ministry of Economic Development that maintains records of all registered companies. Companies must complete an annual return that confirms all relevant information, including details of directors, shareholders etc.
Removal from Register	Removal from the register where the company no longer trades. Either prompted by the Register where there has been no annual returns or by the company liquidator where the liquidation process has been completed.
Respondent	The party whom legal action is being against, the person of company being sued.
Retention of Title	Also known as “A Romalpa Clause” where a party supplying goods includes in their terms of trade a clause where the ownership of the goods being supplied does not pass to the purchaser until the goods have been paid in full.
Romalpa Clause	See Retention of Title
Secured	Where a debt attaches to a specific asset, making that debt ‘secured’ against the asset. This allows the creditor to seize the asset to recover their debt.
Secured Creditors	A creditor is one who has a security over an asset. In a liquidation secured creditors may realise (seize, sell, appoint a receiver over) the property subject to the security. They may also value the property and claim the balance as unsecured debt. This entails advising the liquidator of the value of the asset in question but leaving the asset with the liquidator. The balance of the debt then becomes an unsecured debt in the liquidation.
Security	Where a debt is linked to a specific asset, person or company.

Service of Documents

The legal process by which certain documents are delivered on companies or persons subject to legal action. For companies, service is normally effected by the company at their registered address but can also be achieved by serving the director(s) personally or their lawyers if they accept that they have the power to accept service for their clients. Where it is not possible to find the a person, service can be done, with the permission of the court, by advertising by way of a public notice.

Shareholders Rights

Statutory rights of shareholders to take action against the directors for certain breaches of duty.

Solvency Test

As outlined in Section 4 of the Companies Act 1993, the solvency has two limbs: A company must be able to pay its debts as they fall due and the value of its assets must be greater than the value of its liabilities (including contingent liabilities). A certificate needs to be signed by the directors ascertaining that the company passes this test before the company can do a number of things, including paying out distributions to shareholders.

Solvent Liquidation

The voluntary liquidation of a company that can pay its debts. The board must pass a resolution within 30 days before the appointment of the liquidator that the company will be able to pay its debts and the directors voting in favour must sign a certificate to that effect.

Special Resolution

A resolution approved by a majority of 75% of the total value of shares (or higher if required by the companies constitution) entitled to vote, and voting on the resolution. This is the level required for a liquidation of a company. A special resolution must be at a properly called shareholders meeting, giving two weeks notice and outlying the resolution to be passed. If all shareholders sign the need for a shareholders meeting is waived.

Specific Charge

A security in a specific piece of property, ie: a vehicle or a piece of plant or equipment.

Statement of Affairs

A document prepared by the Liquidator or Receiver on appointment setting out the affairs of the company.

Statutory Demand

Legal demand made by a creditor requiring the debtor to pay a debt. The debtor has ten days to seek a judicial review of the demand, (disputing the debt) or pay within 15 working days or enter into a Compromise with Creditors. Failure to satisfy a statutory demand is evidence of the insolvency of a company and is used as evidence to liquidate company. A statutory demand must be only for an undisputed debt. Issuing a demand for a disputed debt risks significant court costs being awarded against the issuer.

Stonewater Airlines	A (fictional) regional airline with a dubious past and highly uncertain future.
Struck-off	A company removed from the registrar of companies, either by the liquidator at the end of the liquidation process or by the Register for failing to return or complete annual returns
Subrogation	The legal right that a party has when they pay someone's debt to recover that money from the debtor.
Summary Judgement	An application is made to the Court to obtain a judgement against a debtor. Once obtained, this can speed the process of putting a company into an Insolvent Liquidation.
Ten Day Rule	Restriction on a company appointing their own liquidator or Voluntary Administrator where they have received notice of legal action that could lead to the liquidation of the company. The company has ten working days, not including the day served, to appoint their own Liquidator or Voluntary Administrator. Any appointment made after the ten days is considered null and void.
Title	Formal ownership of an asset.
Transactions at Undervalue	Where a transaction was done (typically the sale of an asset) where one party did not receive fair value. If the party disadvantaged subsequently goes into liquidation, the liquidator can sue to recover the lost value from the party that received the benefit.
Trading Trusts	A business trading as a trust rather than as a company or as a sole trader. A trust needs a trustee, and trustees are liable for the debts of the trust. As a result it is common to find a trading trust has a limited liability company as their trustee.
Unsecured Creditor	A creditor is a creditor who lacks any security over the assets of a company in liquidation.
Usury	Excessive interest rates. Usually found in Shakespeare.
Vesting Order	An Order by the Court that gives to a person, possession, control or title of property.
Vexatious	Usually refers to Vexatious Litigant. An act done in order to annoy or otherwise aggravate someone. A veracious litigant is someone, usually without legal training, who uses legal process to harass their victim. Every good liquidator has at least one.

Insolvent Charges A charge given by the company within a specified period prior to a liquidation where no valuable consideration has been given. A liquidator can declare this charge voidable and unwind it, making it null and void.

Voidable Transactions See also Insolvent Transaction. A transaction made when a company is insolvent, in 24 months prior to the liquidation of the company (or in the case of a court appointment, the 24 months prior to the legal proceedings) leading to the liquidation. Usually refers to a payment but can also refer to a sale of an asset. A liquidator can recall money paid in this manner.

Voluntary Administration (VA) The formal process where an insolvent company enters into an arrangement with its creditors to repay debt, or a portion of that debt. See Chapter 12: Voluntary Administration.

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Waterstone is an Auckland based Insolvency Practice. We undertake liquidation, receivership and Voluntary Administration appointments for firms, and Personal Compromises assignments for individuals. We also have a specialist debt recovery and negotiation team to deal with large and complex debt issues. By the nature of what we do, we have a very deep understanding of a very narrow area of New Zealand's commercial life. If you need assistance, information or guidance in that area, we would like to hear from you.

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