



FINAL REPORT

Review of the Law Commission Report "Insolvency Law Reform: Promoting Trust and Confidence"

Submitted to

Ministry of Economic Development

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1. EXECUTIVE SUMMARY

1. Charles River Associates have been asked to provide a review of the Law Commission Report “Insolvency Law Reform: Promoting Trust and Confidence”. We have been asked to focus on the recommendations that New Zealand:
 - (i) Establish a regime for the regulation and licensing of insolvency practitioners;
 - (ii) Introduce a moratorium on creditors of insolvent companies that would allow the operation of a targeted business rehabilitation regime; and
 - (iii) Establish a new office of the Inspector General of Insolvency.
2. We are not convinced that the proposal to license insolvency practitioners will provide benefits that will outweigh the costs associated with it. In particular we have pointed out that the proposal will:
 - (i) Introduce a barrier to entry that will raise the cost of employing insolvency practitioners, provide rents to the incumbent practitioners and increase the minimum level of quality in the market above the level that may be required for some simple insolvency cases;
 - (ii) Not solve the claimed problems associated with asymmetric information about the quality of insolvency practitioners or remove the possibility that there may be practitioners with a bias towards debtors or creditors;
 - (iii) Only provide for New Zealand practitioners to operate in Australia if we adopt a system equivalent to that in Australia; and
 - (iv) Place on the court an onerous burden in overseeing insolvency practitioners who are officers of the court, even though it is not clear that the court has any special advantages in identifying high quality insolvency practitioners.
3. We have suggested that occupational regulation should normally only be introduced where it meets relatively strong tests for the demonstration of public benefits over detriments. In our opinion, more conceptual and empirical research on the magnitude of the problems identified by the Law Commission, the ability of licensing to ameliorate these problems, and the costs associated with any licensing regime are required before any licensing regime should be introduced.

4. In respect of the proposal to establish a new Office of the Inspector General of Insolvency, we have noted that the case rests largely on concerns about the current level of enforcement of insolvency law. We point out that:
 - (i) The economics literature on enforcement suggests that increasing the penalties is an alternative to increasing expenditure on enforcement but the Law Commission provides no indication that it has considered this alternative approach to the enforcement problems that it has identified;
 - (ii) Efficient enforcement action by a public agency with a budget constraint will fall short of prosecuting every case on which a conviction is possible. Adverse publicity associated with state agency prosecution of parties subsequently found to be innocent and the budget constraint will lead them to focus on litigating cases with a high probability of conviction and/or with high precedent/deterrence value;
 - (iii) Enforcement decisions by a public agency may be efficient even though they do not conform to the expectations of the media, parties who have suffered harm, or other parties not fully informed about the facts of the case and the budget constraints faced by the agency; and
 - (iv) Convictions of bankrupts for breaches of insolvency law in New Zealand are very high by international standards. With the responsibility for director disqualification now assigned to the Insolvency and Trustee Service, prosecution of these cases is now underway again.

If there is a widely-held view that enforcement of insolvency law is below the level necessary for the efficient operation of the markets, then in our view this should in the first instance be addressed by increased funding for and greater transparency in the reporting of expenditure on and priorities for enforcement by the Insolvency and Trustee Service. The appointment of an Inspector General should only be considered if this approach does not achieve the desired outcome.

5. We do not find convincing the rationale for a moratorium provided by the Law Commission, and we doubt that the target firms that they have identified actually require a moratorium to promote rehabilitation rather than liquidation when rehabilitation is efficient. Unless further work is undertaken to identify the precise market failure that any moratorium would be designed to address, there is a danger that the regime may not be appropriately designed to assist those segments of the market actually requiring it. Whatever the rationale for the introduction of the moratorium regime, and despite the existence of a statutory management regime, we consider it highly likely that a moratorium will increase the cost (defined to include all terms of the contract) of secured credit.
6. Overall, it is our view the Law Commission has yet to make a convincing case for the licensing of insolvency practitioners, alternative arrangements for the enforcement of insolvency law (including the creation of the office of the Inspector General of Insolvency) and a moratorium regime. The case for the interventions and law changes recommended by the Law Commission cannot be made without further research that is designed to:
 - (i) More precisely identify the market failures justifying the intervention;
 - (ii) Provide a basis upon which the magnitude and significance of the problems identified can be assessed; and
 - (iii) Link more directly the recommendations made to the resolution of the market failures identified.

In each case, we suggest that this analysis should include a more detailed assessment of the potential costs associated with each of the changes recommended.

2. INTRODUCTION

1. The Ministry of Economic Development requested that the Law Commission provide an advisory report on:
 - (i) The role of the state in insolvency law;
 - (ii) Whether additional provisions should be inserted into New Zealand law to deal with business rehabilitation or reorganization;
 - (iii) Whether statutory management under the Corporations (Investigation and Management) Act 1989 should be retained in its existing or some modified form; and
 - (iv) Whether it is desirable for New Zealand to enact a single statute to deal with insolvency law issues.

The advice from the Law Commission has been released for consultation as an advisory report entitled “Insolvency Law Reform: Promoting Trust and Confidence”.

2. Charles River Associates have been asked to provide a review of the Law Commission Report, focusing particularly on the recommendations that New Zealand:
 - (i) Establish a regime for the regulation and licensing of insolvency practitioners;
 - (ii) Introduce a moratorium on creditors of insolvent companies that would allow the operation of a targeted business rehabilitation regime; and
 - (iii) Establish a new office of the Inspector General of Insolvency.

We first consider the significance and role of the insolvency regime in the economy and provide an overall assessment of the approach and evidence adduced by the Law Commission in support of their recommendations before providing a detailed analysis of each of these recommendations.

3. ECONOMIC ANALYSIS OF INSOLVENCY REGIMES

3. Investment in the creation and expansion of business enterprises constitutes the driving force of economic growth in market economies, but since not all of those investments will prove to be commercially viable, some businesses will fail. Insolvency regimes regulate the terms on which businesses that are unable to pay their debts as they fall due are liquidated or reorganized. Insolvency regimes:
- (i) Facilitate the orderly reallocation of economic resources from business investments that are not viable to more efficient and profitable activities;
 - (ii) Provide incentives that will influence the willingness of entrepreneurs to undertake risky investments in business enterprises;
 - (iii) Provides incentives that will have a material impact on the actions of the owners of declining businesses in the period leading up to the declaration of insolvency; and
 - (iv) May, through these incentives as well as through its impact on the probability of repayment and the transactions costs faced by creditors of insolvent business, affect the cost of credit for business.
4. An efficient insolvency regime should:
- (i) Encourage the dissolution of non-viable and inefficient businesses and the survival of efficient ones. ‘Filtering failure’ occurs in systems that prolong survival of inherently inefficient businesses or premature dissolution of efficient ones (Fisher and Martel 1996:15);
 - (ii) Maximise the value of liquidated assets. Independent administrators who take control of the business at the point of insolvency are responsible for winding it up and selling the assets for maximum value if it cannot be returned to viability. The imposition of stays on creditors allows a liquidator time to arrange a sale to yield the highest maximise return for the benefit of all unsecured creditors;
 - (iii) Provide for an equitable distribution of liquidated assets amongst creditors (e.g. employees, sub-contractors, suppliers, financial creditors) based on the requirement to honour the contracts associated with each one. For example, any insolvency regime that did not honour the priority rights of secured creditors would increase the cost of secured credit for business as a whole;

- (iv) Minimise the incentives and the opportunity for debtors to run down unsecured assets as the point of insolvency approaches. Owners who declare insolvency do not expect to receive any return on their equity, so at the point of insolvency high-risk investments with a small probability of returning the business to solvency but a high probability of reducing funds available to creditors will look extremely attractive. The economics literature refers to this strategy as “gambling for resurrection”. The economics literature also uses the term ‘looting’ to refer to the purposeful and self-interested actions of entrepreneurs who respond to the incentives providing by impending insolvency by diverting funds from the payment of creditors to providing higher salaries or benefits for themselves;
 - (v) Provide effective mechanisms for identifying and prosecuting any managers or directors whose illegal actions contributed to the insolvency of the firm or the extent of the losses suffered by creditors; and
 - (vi) Reduce transactions costs and disputes associated with the insolvency procedures by establishing clear and predictable processes and by providing all stakeholders with information about how the insolvency regime will operate.
5. Internationally, insolvency systems are often referred to as favouring debtors or creditors. In the US, the system is ‘debtor-oriented’. This system provides opportunities for business to restructure operations and recover from debt. However, reorganisation often fails and is prolonged, costly and does not honour credit contracts. In other countries (e.g. Australia, U.K., Canada), creditors exercise more control over the reorganisation of the business, and have greater rights to require liquidation. Systems placing an emphasis on creditor rights appear to generate better outcomes (Bickerdyke et al 2000).

4. OVERALL ASSESSMENT OF APPROACH AND ANALYSIS OF THE LAW COMMISSION REPORT

6. The recommendations of the Law Commission follow from their claim that the business community lacks trust and confidence in the current insolvency regime in New Zealand.
7. Very limited data are available on insolvency practice in New Zealand, and there are no systematic studies of the quality of the work undertaken by insolvency practitioners. Even given these restrictions, we found it difficult to assess the extent and quality of the data on which the Law Commission have developed their views and based their recommendations. Most of the problems that the Law Commission claims give rise to a lack of trust and confidence are sourced to anecdotal evidence gleaned from conversations with market participants. As a minimum it would have been helpful to have some information about the number and cumulative experience of the practitioners on whose observations the Law Commission is relying.
8. Anecdotal evidence of the type used by the Law Commission is usually not relied upon because it suffers from two problems. First, it may rest on the views of a market participant with a private interest in seeing particular regulatory changes (for example, changes that introduce a barrier to entry would in the future increase the profits of that particular participant). Second, anecdotal evidence does not provide the systematic empirical basis required to assess whether the problems identified are quantitatively large by comparison with the number of insolvencies that are dealt with each year. This is important because regulations impose compliance and other costs on the market. These costs must be assessed against the benefits to be derived from the regulations. Unless the problems identified are quantitatively large in the context of the market as a whole, the costs imposed by the introduction of new regulations may outweigh the benefits provided by the regulations.
9. In our view, the evidence provided by the Law Commission is in some cases insufficient to demonstrate that a problem has been clearly identified or that it is of sufficient importance to warrant the costs and risk associated with a change to the insolvency regime. In these cases, it is our view that further conceptual and empirical research should be undertaken before any policy recommendations or legislative changes are considered.

10. In some cases it is apparent that the Law Commission has been unable to identify particular problems with the current insolvency regime, but have recommended changes based on the idea that “Good insolvency laws should be developed in good economic times for the purpose of dealing with bad economic times”; and “Experiences with the operation of insolvency laws in good economic times do not necessarily reflect how the laws will work in bad economic times;” (para 38). The Law Commission suggests that for New Zealand the relevant benchmark for bad economic times is the period between 1989 and 1992, when there were a large number of insolvencies. However, the Law Commission does not present any systematic analysis of the record of insolvencies, or any measures of the efficiency with which the insolvency regime functioned, in that period. Neither do they provide any substantive analysis of the effectiveness of the revisions to the operation of the New Zealand Insolvency and Trustee Service that have been put in place since 1999. In both cases, we suggest that more detailed analysis of the data on insolvencies and the operation of the current operations of the Insolvency and Trustee Service are required before any legislative changes should be considered.

11. The Law Commission also bases some of its concerns about the operation of the insolvency regime on assumptions about human behaviour that are at least open to question. For example, some of their recommendations are based on the claim that creditors and debtors may not act rationally as the point of insolvency approaches and during insolvency proceedings. These claims are not supported by evidence demonstrating that in individual insolvency proceedings the irrational actions of debtors or creditors produced an outcome that was inefficient. Moreover, the view of the Law Commission is in direct contrast to the economics and business literature on gambling for resurrection which has demonstrated that this behaviour represents a rational response to the incentives facing owners of insolvent firms. It also raises questions about the focus of the Law Commission’s recommendation for a moratorium regime aimed at honest and competent but unlucky (and possibly also irrational) debtors. The Law Commission offers no evidence that will allow us to assess the proportion of entrepreneurs in New Zealand who conform to this psychological profile. Further work on the rationale for the interventions and law changes proposed would assist us in understanding exactly what gaps in the market the Law Commission is proposing to fill. In this Review we provide some suggestions for alternative ways of thinking about the problems that may motivate changes to New Zealand’s insolvency regime.

12. The Law Commission provides a review of the business environment and the structure of business enterprise in New Zealand focusing on the importance of small business for the economy and identifying the particular problems that arise when a business with a large share of the market (such as the Bank of New Zealand in 1990) become insolvent. However, neither of these features of the New Zealand economy provide any uniqueness. As the Commission itself demonstrates, the proportion of small businesses in the New Zealand economy is the same as that in the UK, while the collapse of firms with large market shares is not unknown in much larger economies (HIH in Australia provides a recent example, despite the fact that the relevant regulator, the Australian Prudential Regulation Authority, has 850 staff). Large firms with substantial customer bases and investment in brand awareness (such as the BNZ) or large infrastructure businesses are readily sold as a going concern to investors with a superior management technology. Increases in the regulation of insolvency practice and the licensing of insolvency practitioners may reduce the choice available to small businesses and drive up the cost of insolvency proceedings.
13. The views of the Law Commission appear to have been shaped by World Bank, Asian Development Bank and International Monetary Fund reports on insolvency procedures. There is enough diversity in the insolvency regimes of the US, Europe, Canada and Japan to suggest that we should develop a regime suited to commercial practice and institutional structures in New Zealand rather than seeking to adopt “best practice” from other countries. Further, some of the recommendations in these reports may have greater relevance to developing countries with well-established commercial law frameworks and substantial private sector capability to provide insolvency services. For example the impact of an economic downturn and an increase in insolvencies may not have economy-wide effects in New Zealand even though such “contagion” may be a problem in developing countries. In contrast to most developing economies, New Zealand’s economy is characterised by the absence of widespread political patronage for business enterprises, the existence of well-developed capital markets for the efficient management of risk, and stable macroeconomic policies focused on low inflation and a freely floating exchange rate.

5. LICENSING OF INSOLVENCY PRACTITIONERS

5.1. THE PROBLEMS IDENTIFIED BY THE LAW COMMISSION

14. Neither the Companies Act 1993 nor the Receiverships Act 1993 require that persons acting as an insolvency practitioner or being appointed as an administrator of a collective insolvency regime are formally qualified, registered or licensed to carry out these tasks. The Law Commission (at para 186) identifies a “Concern about whether there are sufficient regulatory safeguards in place to ensure that only properly qualified and impartial insolvency practitioners are appointed to act as an office holder in a collective insolvency regime”. In particular they note that:
- (i) “It may be necessary for New Zealand to develop an accreditation regime to provide Australian courts with confidence that they can appoint New Zealand practitioners to deal with assets in Australia notwithstanding the lack of any licensing regime in New Zealand” para 188(a);
 - (ii) “The “information asymmetry” as between the major creditors (on the one hand) and debtors and smaller creditors (on the other) about the skill and competence of those offering their services as office holders in collective insolvency regimes” – para 123(f); and
 - (iii) “It is too easy for directors or shareholders to appoint “friendly” liquidators who have no or insufficient knowledge of insolvency procedures or who do not carry out duties and inform creditors of their rights. Appointment of a “friendly” liquidator removes the assurance of impartiality on which creditors may be expected to act.” para 188(b).
15. In our view, any case for occupational regulation must be subject to a stringent test. This is because occupational regulation may be costly (in the sense of raising transactions costs and introducing a barrier to entry to the market), and it may produce unintended or even perverse consequences (such as shortages or lower quality of service). In this section we provide an assessment of the potential for licensing of insolvency practitioners to create problems of this type, and consider whether in this particular case the benefits of occupational regulation are likely to outweigh the costs.

5.2. CURRENT LEGISLATIVE PROVISIONS RELATING TO THE QUALITY OF INSOLVENCY PRACTITIONERS

16. We begin by noting that the Companies Act provides minimum requirements for the appointment of a liquidator: specifically they must be independent (must not have been a shareholder, director, creditor or receiver of the company within the previous two years) and must not have any criminal convictions. There are in addition remedies available to creditors where there is actual evidence that liquidators have not properly performed their duties or have shown demonstrable bias towards the debtor (See section 286 of the Companies Act).
17. Current legislation also contains a penalty for demonstrably poor practice by insolvency practitioners. The High Court has the power to make an order prohibiting a person from acting as a liquidator for a period not exceeding five years, if it is demonstrated to the satisfaction of the court that a person is unfit to act as a liquidator by reason of persistent failure to comply with the obligations imposed by the Act or the seriousness of a failure to comply. Similar provisions apply to acting as a receiver or a liquidator. Para 181- 182. As a minimum this suggests that if there is a problem, it could be addressed by increasing the costs for those practitioners who do not comply with the Act. In our view it would be helpful if the Law Commission could indicate whether they have considered an increase in the penalties associated with failures to comply with the obligations imposed by the Act, and if so, why they have rejected an increase in penalties as an alternative to a licensing regime for practitioners. It may be, for example, that there are practical limitations on the penalties that can be imposed which mean that higher levels of enforcement are required if higher levels of deterrence are to be obtained.

5.3. THE MARKET FOR INSOLVENCY PRACTITIONERS: PROBLEMS OF BIAS AND ASYMMETRIC INFORMATION

18. As we understand it, the market for insolvency practitioners is currently made up of staff from the major accounting firms (with PriceWaterhouse Coopers having the largest share of the market), a number of well-established firms specializing in insolvency practice, and a number of small firms or individuals who undertake insolvency work. *A priori*, it is difficult to understand how a market such as this would be inefficient. Purchasers of insolvency services will benefit from contestability and choice in the sense that this will encourage different specialisations (niches in the market) and competitive pricing. It will also provide a choice in experience and support so that (for example) it is not necessary to purchase the highest level of expertise and pay the rates demanded by large firms in relatively simple insolvency matters.

19. This market of insolvency practitioners also provides the benefits of having some firms with substantial reputational capital at risk in the quality of the work that their insolvency practitioners undertake. Purchasers of insolvency services who choose to employ a sole practitioner or a new entrant to the market for insolvency practice presumably make a rational choice to purchase those services in contrast to those associated with one of the large firms. In our view it is simply not credible to argue that businesses that appoint an inexperienced insolvency practitioner do not understand the risks and the cost that are associated with that choice. It may be that in some smaller centres it is difficult to obtain the services of an insolvency practitioner, and only low-quality practitioners are available. Even if this claim is true, it is not clear how a licensing regime will solve the problem: by putting in place a barrier to entry for small practitioners licensing may mean that there are no insolvency practitioners at all in these centres.
20. It would be inefficient for any insolvency regime to tolerate practitioners who were demonstrably biased towards the debtor or creditor. The Law Commission expresses concerns about the impartiality of some insolvency practitioners but they do not indicate how licensing would define and test for impartiality. In our view it would be impossible and probably also inefficient to attempt to eliminate legitimate professional differences in view among insolvency practitioners: in most cases it is extremely difficult to distinguish these differences in view from bias. For example, despite the requirement that expert witnesses be impartial, some doctors almost always appear as experts for the plaintiff in medical liability cases, and some registered valuers always appear as experts for the lessee in rental rate arbitrations. In these cases there is no market failure because the particular views of different practitioners are known or relatively easily discovered by lawyers, accountants and other advisors to debtors and creditors in insolvent firms.
21. In our view, the key issue in respect of the possible bias of insolvency practitioners is the *ex ante* test associated with an absence of prior association (which is enshrined in current legislation). Any test designed to assess whether *ex post* actions demonstrate independence will be virtually impossible to reflect in the criteria associated with a licensing regime, and in cases where actions are demonstrably not independent court action is already possible.
22. Information asymmetry is ubiquitous in all human interaction, but only rarely requires legislation to deal with it. The economics literature uses as examples markets for durable assets where there is a marked difference between the knowledge of the seller and the potential buyer about the quality, performance and past investment in maintenance of the asset. Markets find different ways of dealing with this information asymmetry, ranging from the terms of contracts to investment in brand and reputation, and these market solutions are usually more efficient and more effective than regulation.

23. Even the most poorly informed of small creditors will be aware of the investment in reputation that is associated with the major accountancy practices and the largest specialist insolvency practitioners. In these firms, internal quality control mechanisms provide the assurance of quality that the Law Commission seeks because it would be inconsistent with the long-term development of the brand for these firms to allow staff to manage insolvencies unless they possessed the necessary skills, knowledge and balance of the interests of creditors and debtors. It is not clear to us how it is possible to justify on efficiency grounds regulations that would prohibit a conscious choice for an inexperienced insolvency practitioner as an alternative to these larger (and more expensive) firms. This is particularly true because all businesses have advisers (lawyers and accountants) who can assist with the identification of appropriate insolvency practitioners.

5.4. BARRIERS TO ENTRY

24. The use of experience as a criterion for obtaining a license to operate in the market has many potential problems. Introducing a requirement for experience introduces a barrier to entry into the market for insolvency practitioners. It represents a barrier to entry of the strongest kind in the sense that it is clearly a cost for entrants to the market that the incumbents did not have to bear.

25. A requirement for experience begs the question “how is experience to be acquired”? A requirement for experience may result in potential entrants having no choice but to work for incumbent practitioners for some time before they establish their own practice. It is likely that this will create economic rents for existing practitioners.

26. The issue then is whether the reduction in efficiency resulting from the barrier to entry is smaller than the reduction in efficiency claimed by the Law Commission to result from the lack of a regulatory regime. Licensing may have the benefit of ensuring greater knowledge of relevant law and practice among insolvency practitioners in New Zealand. However, it may also result in an increase in the cost of insolvency services as a result of the barrier to entry that licensing creates, and it may be inefficient in its requirement that all insolvent firms use practitioners of this standard when a practitioner who was prepared to charge a lower price would be acceptable to all parties. Overall, it is not clear that the efficiency of the market for insolvency practitioners would be improved by an experience-based licensing regime.

5.5. INSOLVENCY PRACTITIONERS AS OFFICERS OF THE COURT

27. The Law Commission proposes that “all persons appointed as administrators of a collective insolvency regime (whether appointed by the debtor or by the court) should be deemed to be officers of the court with all the duties attendant to that.” This would mean that the court could:

- (i) Exercise supervisory jurisdiction over all such insolvency practitioners; and
 - (ii) Require insolvency practitioners to certify experience and non-disqualification to the court.
28. This proposal appears to be designed to screen insolvency practitioners and to provide a faster means of sanctioning practitioners do not meet acceptable standards. It is, however, unclear to us that these benefits warrant the resulting increase in the workload and responsibilities of the court. Making insolvency practitioners officers of the court puts the court in an invidious position given that it is not clear that the courts have as much information as the market about the qualifications of these individuals. In our view the court should not take on this responsibility for insolvency practitioners without the resources to properly fulfil the responsibility. Further, insolvency practitioners already have the opportunity to refer issues to the court or seek the guidance of the court without being officers of the court.

5.6. THE LICENSE REQUIREMENT FOR PRACTICE IN AUSTRALIA

29. The Law Commission has suggested that a licensing regime would have the added benefit of allowing New Zealand insolvency practitioners to practice in Australia. Our approach to this issue is to say that it could be addressed in two ways. First, New Zealand practitioners could acquire accreditation in Australia if they wished to practice there but not otherwise. This would offer the advantage of being low cost (avoiding the need for licensing in New Zealand) and offering an added market signal about the investment in reputation that individual insolvency practitioners were prepared to make. Second, New Zealand could introduce a licensing regime equivalent to that of Australia. We say equivalent because the Australian authorities need not recognise New Zealand qualifications where they are not equivalent to the qualification required in Australia. This means that only a regime that imposes similar requirements to that of Australia would offer any advantages, and in effect suggests that New Zealand should either adopt the Australian model for licensing and accreditation of insolvency practitioners, or not have a licensing regime at all.

5.7. SUMMARY

30. We are not convinced that the proposal to license insolvency practitioners will provide benefits that will outweigh the costs associated with it. In particular we have pointed out that the proposal will:
- (i) Raise the cost of employing insolvency practitioners by establishing a barrier to entry that will allow provide rents to the incumbent practitioners and by increasing the minimum level of quality in the market above the level the may be required for some simple insolvency cases;

- (ii) Will not necessarily solve the claimed problems associated with asymmetric information and bias, and will only provide for New Zealand practitioners to operate in Australia if we adopt a system equivalent to that in Australia; and
 - (iii) Place on the court an onerous burden in overseeing insolvency practitioners who are officers of the court, even though it is not clear that the court has any special advantages in identifying high quality insolvency practitioners.
31. We have suggested that occupational regulation should normally only be introduced where it meets relatively strong tests for the demonstration of public benefits over detriments. In our opinion, consideration of any proposal for licensing should be preceded by more evidence relating to the magnitude of the problems identified by the Law Commission, the ability of licensing to ameliorate these problems, and the costs associated with any licensing regime.

6. ENFORCEMENT

6.1. CONCERNS IDENTIFIED BY THE LAW COMMISSION

32. The Law Commission identifies enforcement action designed to promote compliance with the rules necessary for the orderly operation and good governance of markets as a public good. It notes that “The public enforcement function can be performed either by creating an incentive for a debtor to act in a particular way, or by applying sanctions for irresponsible commercial behaviour or dishonest conduct. This public function is independent of the recovery of money for the benefit of creditors” (para 140).
33. The Law Commission states that “The most constant criticism levelled against State involvement in the insolvency process by members of the commercial country (sic) with whom we consulted informally, was the perceived lack of enforcement action by regulatory authorities to act as a deterrent to irresponsible or undesirable commercial behaviour” (para 139).

6.2. RELATIONSHIP BETWEEN PENALTIES, ENFORCEMENT AND ECONOMIC EFFICIENCY

34. The modern economics literature on the optimal level of enforcement is summarized in Becker (1968), Garoupa (1997) and Polinsky and Shavell (1998a and 1998b). To consider the optimal level of enforcement in respect of insolvency proceedings, we begin by defining damage, penalties, enforcement and deterrence.
- (i) Damage or harm is measured as the loss in economic efficiency resulting from a specified action in a defined market;
 - (ii) Penalties are costs imposed on those whose crimes are detected and prosecuted;
 - (iii) Enforcement is the probability that an individual who has committed a crime will be detected and prosecuted; and
 - (iv) Deterrence is the use of penalties and enforcement to influence behaviour so as to maximise social welfare.
35. If a party is certain to be found guilty each time that they breach the Companies Act, then the proper magnitude of the penalty is the harm that the party has caused. If penalties equal the harm caused, then parties will have socially correct incentives to avoid actions that may breach the Companies Act and to consider the frequency with which they undertake activities that may risk breaching the Commerce Act thus reducing the likelihood that their firm will become insolvent.

36. Penalties provide incentives for compliance with the law. The stronger the incentives for compliance, the fewer resources will need to be allocated to monitoring compliance with the law. Penalties should be set at a level that will ensure that potential perpetrators of an offence will take into account the damage to the market that they may cause when they consider taking actions that may be illegal. Penalties set in this way will result in individuals internalising the potential damage of possible illegal acts.
37. If there is some positive probability that any given breach of the Companies Act will go undetected, then for any individual who is risk-neutral, penalties set at the level of the harm will not provide the efficient level of avoidance by firms. To correct for this problem, the penalty should be set so that it is equal to the harm multiplied by the reciprocal of the probability of detection. Thus, where h = harm and p = the probability of detection, the penalty should be:

$$h \times (1/p) = h/p$$

This implies that the higher the probability of detection, the closer to the value of the harm that the party has caused will be the efficient penalty.

38. Where individuals are risk-averse, the combination of enforcement and penalties need not be set at levels that provide an expected penalty equivalent to the level of harm: a smaller expected penalty may provide the optimal level of deterrence.
39. Where damage can vary as a result of factors that are beyond the control of the perpetrator (for example, macroeconomic shocks may influence the likelihood that any action will result in insolvency) a distinction between actual and potential damage may be drawn. Actual damage must always be no greater than potential damage. Potential damage is the relevant quantity for penalties, because even if actual damage is relatively small, the behaviour that induced this damage may have carried with it the potential for much greater damage. It is the greater damage that the penalty system seeks to see potential perpetrators impound into their decision-making. Where there are no factors bearing on the damage to the market that are outside the control of the perpetrator, then the expected penalty should be based on the actual level of the damage to the market.
40. When the level of detection or investment in enforcement can be varied, high sanctions may be optimal, for this allows a relatively low level of investment in enforcement to be employed, saving on enforcement costs. For risk-neutral individuals, the optimal fine is theoretically speaking the limit of their personal wealth. If individuals have no personal wealth (are bankrupt) then long prison sentences may allow savings in enforcement costs, though here the costs of incarceration have to be weighed against the benefits from deterrence that are obtained.

41. The probability of detection of a breach of the Companies Act or the Securities Act is high because all creditors who face losses have an incentive to make available information that might identify illegal acts, and both the liquidation and reorganization have, as costless by-products, the production of information about the past actions of officers of the company that are relevant to its attaining an insolvent position.

6.3. ENFORCEMENT DECISIONS OF A PUBLIC ENFORCEMENT AGENCY

42. A key feature of the crimes referred to here is that the alleged perpetrator is known: the object of investigation is the evidence to support a criminal conviction and the preventative value of obtaining a conviction in that case. The key question then is, does the Insolvency and Trustee Service have the incentives to make the correct decisions about the resources employed in enforcement vs. the resources employed in insolvency management? This means considering both the precedent value of enforcement (since enforcement now will result in less criminal activity in the future) and the balance between expenditure on enforcement and expenditure on insolvency management.
43. While it is possible to argue that it should be for Parliament to assess the appropriate level of enforcement by allocating a specific appropriation for this purpose, the alternative view (and the one on which we would place most weight) is that the decision is best made by an agency that is close to the market and has the opportunity to consider the best use of resources available to support enforcement and a range of other aspects of the Insolvency and Trustee Service. This assumes that in aggregate the agency is funded at an appropriate level: if it is not (as many people in the commercial community appear to believe) then the allocation may be optimal given the available resources but enforcement will be below the optimal level. There may in addition be scope for improving the focus that the Service places on these issues through the performance objectives of the senior staff in the Service and the annual budget round, and through greater transparency in reporting on expenditure on enforcement and the priorities driving that expenditure.

44. At any point in time a public enforcement agency with a limited budget (unrelated to the number of convictions or the fines obtained) will face a large number of cases in which they could bring prosecutions to the court. The cost that the agency bears is the resource cost of investigation and litigation and the potential negative publicity should they lose. The latter is particularly important in the case of public enforcement, since the use of the power of the state to bring charges against people who are subsequently found innocent generates very negative publicity. Against these costs the enforcement agency will weigh the probability of obtaining a conviction and the value of any conviction obtained as a precedent and in making credible the threat of punishment for those who might consider similar breaches of the law in the future. Notice in particular that the combination of their budget constraint, and the potential negative publicity flowing from charges brought that are not upheld by the court, means that the public enforcement agency will choose to litigate only those cases with the highest benefit to cost ratio, primarily those with high probabilities of obtaining a conviction and high precedent/deterrence value. This is because each case that they lose may bring considerably scrutiny on whether the resources invested in prosecuting the case were invested wisely.
45. Consequently, the agency may choose not to litigate cases where the probability of conviction is low and the precedent value is low, even though that case may be widely discussed by the public and media. Alternatively, the agency may choose to litigate cases where the precedent value and/or the probability of a conviction are high, even though these cases may appear trivial to the public and the media. In both cases there is likely to be public criticism of the enforcement agency, but this does not mean that the actions of the enforcement agency are inefficient (Posner 1992: 603).
46. Finally, we note that the Law Commission does not provide any explicit consideration of private enforcement as a complement or supplement to public enforcement. Given the important role for private enforcement in other areas of commercial law such as the Commerce Act, it would be helpful if the Law Commission could indicate precisely where private enforcement is ineffective in respect of breaches of insolvency law.

6.4. SUMMARY ON ENFORCEMENT

47. To summarise the views expressed in this section:
- (i) The economics literature on enforcement suggests that increasing the penalties is an alternative to increasing expenditure on enforcement but the Law Commission provides no indication that it has considered this alternative approach to the enforcement problems that it has identified;

- (ii) Efficient enforcement action by a public agency with a budget constraint will fall short of prosecuting every case on which a conviction is possible. Adverse publicity associated with state agency prosecution of parties subsequently found to be innocent and the budget constraint will lead them to focus on litigating cases with a high probability of conviction and/or with high precedent/deterrence value;
- (iii) Enforcement decisions by a public agency may be efficient even though they do not conform to the expectations of the media, parties who have suffered harm, or other parties not fully informed about the facts of the case and the budget constraints faced by the agency;
- (iv) Convictions of bankrupts for breaches of insolvency law in New Zealand are very high by international standards. With the responsibility for director disqualification now assigned to the Insolvency and Trustee Service, prosecution of these cases is now underway again; and
- (v) The issues identified by the Law Commission do not provide compelling evidence that enforcement is currently below the optimal level, and do not justify any change in the current enforcement regime.

7. INSPECTOR GENERAL OF INSOLVENCY

7.1. THE PROPOSALS OF THE LAW COMMISSION

48. The Law Commission proposes that to deal with the claimed problems of lack of trust and confidence and lack of effective enforcement there should be established within the Ministry of Economic Development three business units, at least one of which (the Inspector General) would receive direct funding from a Parliamentary appropriation. These three business units would be:
- (i) The current Insolvency and Trustee Service, which would provide operational services through the Official Assignee in matters relating to consumer bankruptcies and under the Proceeds of Crimes Act;
 - (ii) The Registrar of Companies which would continue to operate the Companies Office, carrying out “functions of an archival nature ... and some quasi-judicial functions”; and
 - (iii) A new independent office of an Inspector-General in Insolvency, which would take over “all public enforcement functions cast upon both the Official Assignee and the Registrar of companies, as well as the investigative functions currently cast upon the Registrar”.(para 193).

7.2. THE QUALITY OF THE EVIDENCE IN SUPPORT OF THE LAW COMMISSION PROPOSAL

49. The evidence supporting the Law Commission’s view that changes to the structure of the New Zealand Insolvency and Trustee Service are required comes from statements made in the context of informal consultation and judicial criticism of the Official Assignee in respect of two different cases dating from the mid-1990s.

50. In respect of information obtained during informal conversations, the Law Commission report does not include enough information to make it feasible for us to provide an independent assessment of the quantum and significance of the concerns expressed. In particular, the absence of benchmarks (for example, similar evidence in respect of a system that the Law Commission considered to be effective) makes it very difficult to know how to interpret the information. For example, since insolvency processes are about the application of the law and the exercise of judgement in the allocation of losses among those harmed by an insolvency, it is likely to be difficult and acrimonious no matter how professional the insolvency practitioner is. We wonder, for example, how many criticisms of judicial judgement would emerge if we surveyed all unsuccessful plaintiffs or convicted defendants in civil actions!
51. In respect of judicial criticism of the Official Assignee, the Law Commission cites the decisions of two senior members of the judiciary in two different cases dating from the mid-1990s. Since no system managed by human beings is perfect, this evidence would in our opinion only be compelling if it could be argued that it was indicative of systemic failures rather than errors of judgment by individuals associated with those particular cases. In this respect, we note that:
- (i) In 1993/4 and 1994/5 the Official Assignee administered 790 and 651 liquidations, and that since that time the number of liquidations administered in each year has been in the range 600 – 790;
 - (ii) In 1999 the New Zealand and Insolvency and Trustee Service was restructured to improve administration procedures and increase the effectiveness of its enforcement functions; and
 - (iii) Recent clarification of the respective roles of the Securities Commission and the Insolvency and Trustee Service for disqualification proceedings involving directors of companies has removed past barriers to these proceedings.

We consider that the cases cited by the Law Commission should be set in the context of this information if they are to provide a basis for public consultation on the issues.

52. In the absence of any clear evidence that the operations of the Official Assignee and the Insolvency and Trustee Service have been subject to systemic failure, that a significant number of liquidations result in successful legal action against or judicial criticisms of the Official Assignee, or that any past problems are inherent in the new structure adopted by the Insolvency and Trustee Service, we do not find the evidence for change to be compelling. In particular, it would not in our experience meet the standards of evidence that are normally expected to support proposals for legislative change or new regulatory structures emanating from the civil service.

7.3. GOVERNANCE AND INCENTIVE ISSUES

53. The proposal for the creation of the Office of the Inspector General gives oversight of the operations of the Official Assignee, and thus oversight of all licensed insolvency practitioners and insolvency actions, to the office that is responsible for all public enforcement functions currently assigned to the Official Assignee and the Registrar of Companies. In our view this raises concerns about the governance arrangements and the incentives established for the insolvency regime.
54. The primary function of the Official Assignee and private insolvency practitioners is to provide for orderly liquidations or reorganizations of companies to maximize returns to creditors. They are in the business of providing a customer service, albeit motivated by statutory obligations. Breaches of the law warranting prosecution arise in only a small number of the approximately 1000 liquidations occurring in New Zealand each year. This focus is currently recognized in the strategy of the Insolvency and Trustee Service, but might be lost with an Inspector focused on enforcement and breaches of insolvency law.
55. Giving the Inspector General oversight of the Official Assignee and private insolvency practitioners is akin to giving the police oversight of the hospital and ambulance service on the grounds that doctors and ambulance staff are obliged to report any injuries which may result from criminal actions (such as child abuse). This example makes the potential problems with this regime readily apparent. Oversight of the Official Assignee by an office responsible for prosecutions will reduce the flow of information to the Assignee because of concerns that it may be used in prosecutions. This will reduce the efficiency with which the Official Assignee functions, while not necessarily increasing the effectiveness of enforcement. In our view, the Official Assignee and the enforcement function should operate within the same organization, but should be parallel and distinct business units within that organisation, not in a hierarchical relationship. This suggests to us that the current structure of the Trustee and Insolvency Service is superior to the proposal of the Law Commission.

7.4. COST OF THE OFFICE OF THE INSPECTOR GENERAL

56. We have been asked to estimate the cost of the proposed office of the Inspector General. The cost of this office would be determined to a large extent by the exact responsibilities and powers that were set out in the legislation, and is therefore very difficult to estimate at this time. Our estimate is that to monitor the activities of the 85 staff engaged by the Insolvency Service and liaise with the Companies Office, Securities Commission and other relevant agencies, would require the Inspector, 5 staff at senior policy analyst level, and 2 assistants. To provide base costs we estimate that the Inspector would receive remuneration of around \$200,000 per annum, five senior analysts would average \$85,000 and the assistants would average \$40,000. Assuming that the total cost of employment (including benefits, the cost of office space and consumables) is two times salary, this would suggest that the office of the Inspector General would cost \$1.2 million - \$1.3 million per annum. This appears to us to be a large amount given that we cannot discern any tangible benefits that will flow from the creation of the Office. Consequently, we consider it important that this recommendation of the Law Commission be assessed once other changes to the Insolvency Service (including increased funding for enforcement) have been considered and in the light of the emerging evidence on the effectiveness of the structure put in place by the Insolvency Service in 1999.

8. BUSINESS REHABILITATION

8.1. ISSUES RAISED BY THE LAW COMMISSION

57. The Companies Act and the Insolvency Act in New Zealand provide procedures whereby companies and individuals may enter into binding compromises or arrangements with their creditors, but unlike many schemes in other jurisdictions these procedures do not:

- (i) Impose an automatic moratorium on claims;
- (ii) Enable the company to continue to operate without interference while a plan is being formulated; and
- (iii) Provide for an independent administrator to be appointed.

The Law Commission was therefore asked to advise whether New Zealand should introduce a business rehabilitation regime (akin to voluntary administration and incorporating some of these missing elements) into its insolvency laws.

58. Central to the approach adopted by the Law Commission is the view, expressed in paragraphs 218 – 220, that a key rationale for the introduction of a rehabilitation regime flows from the fact that, faced with insolvency, “... it would be unrealistic to expect debtors and creditors to act ... rationally in the absence of stern sanctions or incentives to bring about that result”. Specifically:

- (i) The stresses brought on by the prospect of business failure or the possibility that living standards may need to be reduced tend to make most people act irrationally at such times;
- (ii) Creditors may, in the absence of efficient and effective state enforcement of debtor conduct infringing acceptable bounds of commercial morality, be tempted to decline an economically reasonable offer to settle in order to exact some retribution against the debtor and demonstrate that others dealing with the creditor should not regard it as a soft touch;
- (iii) Staff from the creditor organization may prefer a liquidation to a reorganization because they will not look forward to explaining their lending decision to their superior, while “a liquidator will rarely examine lending conduct of a creditor in the course of his or her duties.

59. The Law Commission notes that “At first sight there would appear little point in introducing different rehabilitation regimes to New Zealand given that none of the practitioners with whom we have consulted with (sic) consider that the lack of a stay against secured creditors is a problem” (para 233). In addition, the large number of small businesses (for which rehabilitation administration is not likely to be cost effective) and the small pool of insolvency practitioners reduce the apparent utility of such a regime. Nonetheless, the Law Commission considers that “... there are justifications for introducing a targeted rehabilitation regime in order to improve the law in this area”. These justifications are:

- (i) Voluntary administrations provide incentives for debtors with financial difficulties to face their creditors earlier;
- (ii) In good economic times laws should be developed that can cater for periods in which insolvencies may increase in number, especially in larger businesses controlling strategic local or national assets where a standstill period may be helpful in assessing whether there is a better outcome than liquidation;
- (iii) The desire to have a flexible range of remedies available to fit different circumstances; and
- (iv) A rehabilitation scheme which targets businesses run by honest and competent management may produce a reduction in the range of circumstances in which management of a debtor may wish to invoke statutory management (under the Investigation and Management Act 1989) for rescue purposes.

60. The Law Commission proposes that a new rehabilitation regime be developed, the target of which would be large businesses such as state-owned enterprises or utility companies which are run by “honest and competent management”, but be applicable to smaller companies which can meet the following entry criteria:

- (i) The company is insolvent;
- (ii) There is a real prospect that the creditors will agree to some proposal;
- (iii) The proposal is “likely to achieve some purpose such as the rehabilitation of the company, or the realization of its assets at a higher price than in liquidation”; and
- (iv) Once the proposal is implemented, the firm would be solvent.

Entry to the regime would require that an appropriately qualified insolvency practitioner issue a certificate to this effect (para 276 – 279).

61. Upon receipt of the appropriate certificate, the Law Commission envisage that the court would grant a moratorium against secured and unsecured creditors for a period of 14 days, with an ability to extend the moratorium for a further period of 14 days if the insolvency practitioner certifies that there is a reasonable likelihood that the creditors will approve the proposed restructuring.
62. The Law Commission envisages the insolvency practitioner being given power of veto in respect of management decisions but the management of the business remaining, for the duration of the stay, under the control of the existing management. The stay, itself, would also prohibit management from using bank accounts so an injection of new capital would be required on any view if this regime was to be implemented” (para 284).

8.2. ISSUES RAISED BY THE PROPOSED REHABILITATION REGIME

63. The regime proposed by the Law Commission has the advantage that it would provide in New Zealand an option for rehabilitation that is more consistent with the insolvency regimes used by our major trading partners. By offering a formal mechanism for attempts at rehabilitation it may also encourage more voluntary agreements on rehabilitation. The question then is, how great are these advantages, who is most likely to use the regime, and what are the costs?
64. The personal profile of the business managers that the Law Commission is attempting to assist is not one commonly found in economic analysis. To be clear, we are asked to contemplate a regime for business people who may not act rationally in the period leading up to insolvency, but are otherwise “honest, competent but unlucky”. We find in the report of the Law Commission no estimate of the actual number of business people fitting this description who populate our insolvency statistics, and we doubt that such statistics can be gathered given the difficulty of identifying these people. The difficulty of identification raises further concerns about how people who are neither honest, nor competent, or perhaps acted entirely rationally in choosing a path to insolvency, are to be screened from the pool of potential entrants to the regime. Finally we are unclear whether the Law Commission considers honesty to be a component of rationality: if it is, we are not clear why honest debtors and creditors would not reach an accommodation before the point of insolvency and /or without the need for the formal moratorium proposed by the Law Commission.

65. An alternative approach to the search for gaps in the insolvency regime is to consider whether there are some insolvencies where rehabilitation would be maximize the value of the firm but where secured creditors refuse to bear the costs of rehabilitating the firm and force liquidation instead. It is at least plausible that in the case of some small firms, such a scenario could have some relevance: Since secured creditors bear substantial costs associated with the monitoring of rehabilitations, the benefits from rehabilitation of small firms may be outweighed by the costs. In this case, any moratorium regime would simply be a means of imposing on creditors costs that they would not normally be willing to bear. Efficiency will only be improved by this action if the social benefits from rehabilitating the firm as a going concern outweigh the costs imposed on the secured creditors.
66. A further possible rationale for a moratorium is that it would provide a mechanism for dealing with problems arising from actions of individual secured creditors that were detrimental to the interests of other secured creditors. An example might be that one secured creditor refuses to agree to a rehabilitation plan in the hope that this will force the other secured creditors to buy out its interest on favourable terms. A legal framework which gave the court the power to make a rehabilitation regime binding on all secured creditors might assist in overcoming this type of strategic behaviour.
67. Overall, it is our view that the lack of clarity about the precise nature of the problems that have motivated the suggestion for a rehabilitation regime mean that the Law Commission has not yet made the case that such a regime is needed. The proposed regime may be too costly for most small firms, while large firms (especially large infrastructure firms) should not need it. In large infrastructure firms such a high proportion of the value of the firm is made up by the cash flow that can be generated by tangible assets, it is relatively easy to achieve a “going concern” sale of such a business. If, during an insolvency proceeding, a decision was made to split up such a business, it is most likely to be because technological change has altered the optimal scope of firms in that industry. In this it would not be efficient to preserve the existing business under management that had failed to address the implications of technical change for the business.

8.3. INCENTIVES PROVIDED BY THE PROPOSED REHABILITATION REGIME

68. The Law Commission argues that “Competent and honest management of a debtor should be given incentives to face up to creditors as early as possible so that the fear (whether justified or not) of precipitate action by a major creditor does not dissuade management from trying to salvage the business where appropriate” (para 287). Incentives are critical, as the Law Commission points out, but focusing only on incentives for managers of firms at the point of insolvency may result in a regime that provides much less efficient incentives overall.

69. Consideration of incentives should start with the incentives that exist for the managers of all firms to take actions that will minimize the probability that any exogenous change in economic conditions could bring them to the point of insolvency. Incentives need to be in place to provide for a business to be restructured or sold to superior management long before it reaches the point of insolvency, and a moratorium is not required for that. The more favourable to debtors is the insolvency and rehabilitation regime that we put in place, the weaker are the incentives to act before that point and the higher will be the cost of capital. For example, a soft landing in the insolvency and rehabilitation regimes may increase the incentives for management to gamble for resurrection rather than sell at a loss as the financial position of a business deteriorates.

8.4. IMPACT ON THE COST OF CREDIT

70. The Law Commission argues that its proposed rehabilitation regime will not increase the cost of credit because there are already provisions for a stay of action by creditors under the statutory management regime (para 281). In our view, the existence of the statutory management regime does not mitigate the potential impact on the costs of credit that results from the introduction of a new and more widely accessible regime providing for a stay of action by creditors. While the Law Commission proposal is to reduce the scope of the statutory management regime and increase the potential for rehabilitation, it is likely that the rehabilitation regime will become much more widely used than has been true for statutory management.
71. We have suggested that it is plausible that the true rationale for the introduction of a moratorium or rehabilitation regime is the imposition on secured creditors of costs that will impact on the terms on which they are prepared to make secured loans. This will certainly raise the cost of secured credit. This increase in the cost of secured credit across the whole market for business finance (i.e. across every secured credit transaction in the economy) must be assessed against the benefits derived from the relatively small number of rehabilitations facilitated by the moratorium.
72. The potential impact on the cost of credit is enhanced by particular features of the rehabilitation regime proposed by the Law Commission. During the moratorium the management would be prohibited from using the bank accounts, which means that new capital would need to be raised to finance operations during the moratorium. The injection of new capital will have an effect on the cost of credit, because that new capital will only be available if it is a priority claim on the assets of the firm.

73. The impact on the cost of credit will to some extent be determined by the liability of the insolvency practitioner. From time to time insolvency practitioners will inevitably sign the certificates to allow firms to enter the insolvency regime in error, imposing losses on creditors as a result. In these cases, creditors would naturally look to sue the practitioner for damages. Assumption of this liability by the state would reduce the care that insolvency practitioners took in signing certificates, increase the number of firms entering the regime and thus raise the cost of credit. Similarly, any move to use the statute to limit the liability of the insolvency practitioner will also increase the cost of credit.

8.5. SUMMARY

74. We do not find convincing the rationale for a moratorium provided by the Law Commission, and we doubt that the target firms that they have identified actually require a moratorium to promote rehabilitation rather than liquidation when rehabilitation is efficient. Unless further work is undertaken to identify the precise market failure that any moratorium would be designed to address, there is a danger that the regime may not be appropriately designed to assist those segments of the market actually requiring it.

75. Whatever the rationale for the introduction of the moratorium regime, and despite the existence of a statutory management regime, we consider it highly likely that a moratorium will increase the cost (defined to include all terms of the contract) of secured credit.

8.6. CONCLUSION

76. In our view, the Law Commission has yet to make a convincing case for the licensing of insolvency practitioners, alternative arrangements for the enforcement of insolvency law (including the creation of the office of the Inspector General of Insolvency) and a moratorium regime. The case for the interventions and law changes recommended by the Law Commission cannot be made without further research that is designed to:

- (i) More precisely identify the market failures justifying the intervention;
- (ii) Provide a basis upon which the magnitude and significance of the problems identified can be assessed; and
- (iii) Link more directly the recommendations made to the resolution of the market failures identified.

In each case, we suggest that this analysis should include a more detailed assessment of the potential costs associated with each of the changes recommended. The potential costs associated with licensing, the Office of the Inspector General and the moratorium regime require closer scrutiny since it is at least plausible that they will outweigh the benefits associated with the changes recommended by the Law Commission. An alternative, which may involve much less risk of inefficient outcomes, would be to provide the Insolvency and Trustee Service with more funding for enforcement, and to minimize other changes until the impact of this funding could be assessed.

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