

PHOENIX COMPANIES - REGULATORY IMPACT STATEMENT

Statement of the Problem and the Need for Government Action

A phoenix company is a business that has been sold as a going concern to another company or to its directors and/or managers usually soon after its failure. Provided the business is sold at market value, the phoenix arrangement will be in the interests of creditors, including employees. However, where the sale price is less than could have been realised outside the phoenix arrangement, the legitimate interests of creditors will be compromised.

The magnitude of the problem cannot be established because there are no statistics kept on how many new companies are phoenix arrangements. However, there is a perception within the business community that the laws dealing with phoenix companies are not adequate because they are open to abuse and the penalties for contravention of these provisions are too lenient. Therefore, action is required to avoid an adverse impact on business confidence, although it is challenging to address this issue without stifling entrepreneurial spirit.

Statement of the Public Policy Objective

The objective of the proposals is to show that the government is taking action in response to the perception within the business community that the laws dealing with phoenix companies are not adequate. More specifically, the objectives of the proposals are to reduce the potential for phoenix company arrangements to be abused.

Statement of Options

The options identified are:

- Option one - status quo:

There are already a number of provisions in the Companies Act which attempt to prevent the use of phoenix companies to defeat the legitimate interests of creditors. These include:

- provisions stating the duties of directors when they exercise powers or perform duties;
- a provision dealing with transactions for inadequate or excessive consideration with directors or certain other persons;
- a provision dealing with the repayment of money or property to the company by certain persons, including past or present directors; and
- a provision dealing with the prohibition of directors.

- Option two - imposition of criminal penalties where directors have acted in bad faith in an attempt to defeat the interests of creditors:

The purpose of criminal penalties would be to increase deterrence by making directors significantly worse off in the event they have initiated a transaction in a deliberate effort to defeat creditors legitimate interests and to give the government, through the Registrar of Companies, primary responsibility for enforcement effort, in comparison to the current reliance on private action.

The main disadvantage of this option is that increasing penalties runs the risk of discouraging directors from taking sensible business risks, perhaps to the point where it disadvantages the company and its creditors.

- Option three – a restriction on the re-use by directors of the names of companies in liquidation:

This restriction would prevent directors of companies in liquidation setting up phoenix companies re-using the name of a company in liquidation, so as to avoid the possibility that creditors of insolvent companies might believe that they continue to deal with the former business.

An advantage of this restriction on company names is that it is easy to enforce. However, a disadvantage of the restriction will be that any value in a company name will be lost at the point of insolvency. Though not significant, this may be a factor in a purchaser's decision to rehabilitate the business.

Options two and three are preferred. Legislation providing for criminal penalties to be imposed where directors are shown to have acted in bad faith to defeat the legitimate interests of creditors and creating a restriction on the re-use by directors of names of companies in liquidation, combined with the existing provisions in the Companies Act, is seen as the best way to change the perception within the business community that the laws dealing with phoenix companies are not adequate.

Statement of the Net Benefit of the Proposal

The benefit of these proposals is that it could be seen that the government is taking action to deal with the perception that the laws dealing with phoenix companies are inadequate.

The first proposal is the introduction of a restriction on the re-use by a director of a company in insolvent liquidation of the name of that company. This will also reduce the risk of the value of the business being lost to the directors (through the non-payment of goodwill associated with the company name). By reducing or eliminating the potential benefit to directors, there is less incentive for them to abuse the phoenix company arrangement.

The only cost of this proposal is that a director of a company in liquidation will not be able to re-use the name of the company. There may be a cost to companies in liquidation because they will lose the goodwill (if any) in their company name if a director of the liquidated company is involved in the new company. This is a one-off cost because it will only arise when a company goes into liquidation. Even then the loss of goodwill will only be incurred if there is in fact any goodwill in the company name and if a director of the company in liquidation is involved in the new company.

It is difficult to provide an estimate about the impact that this cost may have. There are no figures kept on how many directors of companies in liquidation begin a new company using a name similar to that of the company in liquidation.

The second proposal is that criminal penalties be available to the courts where directors are shown to have acted in bad faith to defeat the legitimate interests of creditors. This

would be likely to increase deterrence by making directors significantly worse off if they have initiated a transaction in a deliberate effort to defeat the legitimate interests of creditors. It would also give the Government (through the Registrar of Companies) primary responsibility for enforcement, as opposed to the current reliance on private action.

The disadvantage of this option is that it may discourage directors from taking sensible business risks, perhaps to the point where it disadvantages the company and its creditors. Another disadvantage is that the number of successful prosecutions may be low because of the requirement to prove facts beyond reasonable doubt. There may be extra costs imposed on the Companies Office, but it has not been decided whether these costs will be absorbed or whether the Ministry of Economic Development will seek additional funding.

These proposals will not, by themselves, eliminate the abuse of phoenix company arrangements, but they will assist to reduce the potential for such abuse.

Statement of Consultation Undertaken

A public discussion document relating to phoenix companies was released by the Ministry of Economic Development in January 2001 as part of tier one of the insolvency law review (although the phoenix companies topic was then deferred to tier two). Thirteen submissions were received from organisations, individuals and government departments with an interest in insolvency issues.

The public discussion document did not refer to the idea of imposing restrictions on the re-use by directors of the names of insolvent companies, although three submitters still referred to their support for restrictions on the re-use of the names of insolvent companies.

Most submitters were in favour of the availability of criminal penalties when a director is shown to have acted in bad faith to defeat the legitimate interests of creditors. However, three submitters were against the idea. The reason given by one was the difficulty and cost involved in proving an offence, another considered that it was pointless if they were rarely pursued, and the third considered that the existing criminal penalties were sufficient to deal with the more serious offences committed by directors. The Ministry of Economic Development considers that even if it would only be rarely pursued, it would still be beneficial to have an additional criminal offence available for situations where the Registrar of Companies decides to take action against a director.

A draft copy of the phoenix companies Cabinet paper was sent to the Ministry of Consumer Affairs, Inland Revenue Department, the Department of Labour, the Ministry of Justice, the Department for Courts, the Treasury, Te Puni Kokiri, and the Department of the Prime Minister and Cabinet. All suggested changes identified by these stakeholders have been taken into account. The Department of Labour remained unconvinced that the proposals "will have any clear positive impacts for creditors or on the behaviour of directors".

The draft copy of the phoenix companies Cabinet paper that was sent to the departments listed above proposed that criminal penalties should not be available where a director is shown to have acted in bad faith to defeat the legitimate interests of

creditors. The Ministry of Economic Development has since changed its view. The Ministry of Justice was asked if it still supported the availability of criminal penalties where a director is shown to have acted in bad faith to defeat the legitimate interests of creditors, but no reply was received.

Business Compliance Costs

The proposals do not involve compliance costs.