

REGULATORY IMPACT STATEMENT - BUSINESS REHABILITATION

Nature and Magnitude of the Problem and the Need for Government Action

New Zealand's presently limited business rehabilitation regime contained in Part XIV of the Companies Act 1993 allows company directors, among others, to seek a moratorium or stay on debt proceedings against the company while a proposal to enable rehabilitation of the company is being developed. This stay is not automatic, but is granted at the discretion of the High Court on a case by case basis. The stay does not apply to secured creditors.

The Part XIV procedure has not been greatly used and anecdotal evidence suggests it is not well understood. There are only on average 20 compromises with creditors each year under the Part XIV procedure, compared with the approximately 600 to 800 liquidations and 200 to 400 receiverships registered with the Companies Office each year.

There are two key problems with the current Part XIV procedure:

Individual v Collective Creditors Interests

The lack of an easily initiated general moratorium or stay, prohibiting all debt recovery attempts by individual creditors, means that the current regime prevents rehabilitation from occurring except in those cases where all parties agree. This means there are situations where a minority of creditors, in seeking to recover their debts, can put their interests ahead of the majority.

Inhibitive Transaction Costs

The expense of seeking to have statutory demands set aside will often be enough to deter an individual creditor from acting for the collective benefit of all creditors and seeking rehabilitation.

In addition to the problems identified above, there are a number of other reasons why the Part XIV procedure needs to be reformed.

New Zealand's current business rehabilitation regime differs from that of Australia and the absence of a workable reorganisation procedure in New Zealand means that our regime does not conform with international best practice. This represents an impediment to economic activity. Overseas investors may be deterred from investing in New Zealand if they perceive differences between New Zealand's insolvency regime and that of other countries.

A lack of co-ordination with the Australian approach to business rehabilitation, Voluntary Administration, also means that it is technically difficult and costly to conduct rehabilitations for the growing number of businesses that operate on both sides of the Tasman. This is significant as Australia is New Zealand's largest trading partner.

The lack of an automatic stay on all debt recovery measures within the current regime effectively inhibits business rehabilitation except in those few cases where all parties agree. Therefore, in effect, the current regime promotes liquidation. This means that New Zealand presently does not accrue the economic benefits of having an effective business rehabilitation regime consistent with international best practice.

Statement of the Public Policy Objectives

The public policy objectives for the proposed reform of New Zealand's current business rehabilitation regime are:

- To enhance business confidence;
- To ensure that overseas investors are not deterred from investing in New Zealand;
- To ensure that New Zealand adopts international best practice in business rehabilitation law; and
- To ensure that New Zealand's insolvency law regime is co-ordinated with that of Australia.

Statement of the Feasible Options

Option One - Preserving the Status Quo

Preserving the status quo would mean that New Zealand continues to have business rehabilitation regime that promotes liquidation. The benefits of a regime which favours liquidation are that it:

- Encourages individual creditors to monitor debtors and to act early when repayment issues arise;
- Encourages the movement of resources from poorly performing management and firms to more efficient firms (economic efficiency); and
- Is in the case of some businesses shorter, administratively cheaper and simpler than business rehabilitation.

The key cost (or disadvantage) of a regime that favours liquidation is that New Zealand will not reap the economic benefits of an effective business rehabilitation regime.

Option Two - Education Programme

A programme to educate stakeholders in the use of the current procedures was considered, but has been discarded. This option would be ineffective in addressing one of the fundamental problems with the current regime, which is the lack of an automatic stay binding all creditors.

Option Three - Amendments to Strengthen the Current Law

This option would involve retaining the status quo (i.e. no stay against secured creditors), but also proposes introducing an automatic stay against unsecured creditors. Part XIV of the Companies Act 1993 could be strengthened to reduce opportunities for a minority creditor to defeat the interests of the majority by including an automatic rather than a court-ordered stay on actions by unsecured creditors.

As option three does not include a stay against secured creditors it is considered that it will be a less effective than option four as form of business rehabilitation. Under option three the actions of secured creditors seeking to recover their debts would likely mean that the opportunity for rehabilitation of businesses is diminished. A New Zealand regime that is not

co-ordinated with the Australian Voluntary Administration regime could also prove problematic in the instance of the rehabilitation of a business operating on both sides of the Tasman.

Option Four - Co-ordinate with the Australian Voluntary Administration Regime

This option would involve co-ordinating the New Zealand regime with the Australian Voluntary Administration regime.

The Australian regime involves the appointment of an Administrator who has control of the failing company's business and property. When a company is under Administration there is a stay on actions against the company and its property. This stay applies to secured and unsecured creditors for a period of 21 or 28 days. The stay prevents the company from being wound up and from charges being enforced against the company by creditors seeking to recover their debts. Within the period of the stay the Administrator must convene a meeting of creditors to decide and vote on the company's future. The options are a deed of company arrangement is executed, the administration ends or the company is wound-up. If a deed of company arrangement is executed it is binding on all creditors and officers of the company.

Option four is the preferred option. A regime with a mandatory stay preventing secured creditors from taking recovery action during the development of a rehabilitation plan may result in earlier action, a more orderly wind-up of companies and higher returns to creditors. A stay of this type would likely result in greater use of the business rehabilitation procedure and possibly a higher percentage of successful rehabilitations of economically viable companies. Co-ordinating the New Zealand regime with that of Australia will also mean it would be easier and less costly to conduct rehabilitations for the growing number of businesses that operate on both sides of the Tasman.

Statement of the Net Benefit of the Proposal

A business rehabilitation regime with an automatic stay that binds all creditors (option four) would have a number of benefits and costs for different stakeholder groups. These are outlined below.

Businesses

Benefits

- The regime could provide some failing, but viable, businesses with an opportunity to develop a plan so they can trade on. This would assist in preserving the economic value of that business (for the benefit of all stakeholders).

Costs

- There would be costs to businesses in using the new regime. However, these costs would be no greater than those currently faced by businesses in liquidation and receivership procedures. The costs to small to medium sized businesses in using the Voluntary Administration procedure in Australia are on average between \$20,000 to \$50,000 AUS. These costs result from paying Administrators and legal fees.
- The cost of allowing a company to trade on which, in some cases, may further erode its value. However, such inappropriate application of the regime could be avoided through

certain design features, such as the ability of creditors to petition the Court to end the rehabilitation procedure.

Creditors

Benefits

- The regime could provide for a more measured distribution of the assets of a company if it does eventually fail (as compared to liquidation and receivership procedures), thereby increasing overall returns to creditors.
- The regime could lead to increased returns for creditors. Australian studies suggest that Voluntary Administration produced an average return to creditors of between 21.5% to 10%, compared to an average return of 7.35% in company wind-ups.
- The regime could minimise the loss for creditors and others who deal with the insolvent company from having to re-establish business relationships with another entity.

Costs

- A possible increase in the cost of credit as a result of the inability of creditors to enforce contractual rights during a stay on proceedings against the company. However, this effect has not been observed in Australia due to the operation of Voluntary Administration.

Employees

Benefits

- The new regime could protect workers jobs and provide redundant workers with more time to find employment elsewhere.

Costs

- The operation of the regime could mean that employees would have to at least wait for the period of the stay to end before they receive their entitlements. However, this delay would unlikely be any longer than that experienced by employees in liquidation and receivership procedures. This cost to employees could also be avoided through certain design features, such as giving employee entitlements a special priority.

The Economy

Benefits

- Business rehabilitation provides a more managed and orderly wind-up of insolvent businesses and therefore can minimise the social and economic impacts and negative flow on effects of business failure. Business rehabilitation can assist in mitigating against any domino effects of business failure in the economy, where the failure of one business leads to the failure of other dependent or connected firms.
- Business rehabilitation could improve the overall operating environment for New Zealand businesses.

Costs

- An increase in the costs of credit (as described above) could have an inflationary effect, although this has not been observed to date in Australia.

After considering the potential benefits and costs of option four, it appears that the co-ordination of New Zealand's business rehabilitation regime with the Australian Voluntary Administration regime would have a net benefit.

CONSULTATION

The following government agencies have been consulted on the policy proposals discussed in this RIS: The Treasury, Department for Courts, Ministry of Consumer Affairs, Ministry of Justice, Inland Revenue Department, Te Puni Kokiri, Ministry of Social Development, Department of Labour and the Department of Prime Minister and Cabinet. Their views and comments have been integrated into this RIS.

Consultation was also undertaken on the policy proposals discussed in this RIS on the basis of a public discussion document on business rehabilitation, which was released in May 2002. A total of 18 submissions were received on this discussion document from government departments and business sector groups. There were no substantive issues raised in the submissions and the majority of submissions were supportive of New Zealand co-ordinating with the Australian VA procedure (as per option four).

There have previously been other discussion documents on business rehabilitation prepared by the Law Commission and an insolvency law specialist at Victoria University on which the Ministry of Economic Development has received public submissions and comments.

Two consultation seminars were held with key stakeholders with an interest in business rehabilitation and credit management issues in Auckland on 17 July 2002 and in Wellington on 22 July 2002. The aim of these seminars was to solicit stakeholders views on the policy proposals for the reform of New Zealand's business rehabilitation presented in this paper.

Consultation on the policy proposals for a reformed business rehabilitation regime presented in this paper has also been undertaken with officials from the Australian Treasury and other key government and occupational agencies in Australia with an interest in insolvency and business rehabilitation issues. These Australian stakeholders do not perceive any substantive problems in co-ordinating New Zealand's business rehabilitation regime with the Australian Voluntary Administration regime.