
**INSOLVENCY PRACTITIONER
REGULATION: OPTIONS FOR CHANGE**

Discussion Document

October 2006

ISBN 978-0-478-30442-8 (Print version)
ISBN 978-0-478-30444-2 (PDF version)
ISBN 978-0-478-30443-5 (HTML version)

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First Published October 2006
Competition, Trade and Investment Branch
Ministry of Economic Development
PO Box 1473
Wellington
New Zealand
<http://www.med.govt.nz>

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1. INFORMATION FOR SUBMITTERS

Queries about the review, requests for copies of the discussion document, and submissions in response to this discussion document should be sent to either:

Email: insolvencyreview@med.govt.nz

Post: Insolvency Practitioner Regulation, Competition, Trade and Investment Branch, Ministry of Economic Development, PO Box 1473, Wellington

Fax: (04) 499 1791

It would be useful if submissions sent in hard copy or faxed were also provided in electronic form (Adobe Acrobat, Microsoft Word 2000 or compatible format).

Questions in the discussion document are intended to provide a focus for the issues. Broader comment on the issues is also welcomed.

The closing date for submissions is Friday 2 February 2007.

Publication of submissions, the Official Information Act and the Privacy Act

The Ministry intends publishing all submissions on its website <http://www.med.govt.nz>. The Ministry will not publish your submission on the internet if you have any objection. However, submissions will remain subject to the Official Information Act 1982 and may, therefore, be released in part or full. The Privacy Act 1993 also applies.

When making your submission, please state if you have any objections to the release of any information contained in your submission. If so, please identify which parts of your submission you are requesting to be withheld and the grounds for doing so (e.g. commercial confidentiality).

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2. INSOLVENCY PRACTITIONER REGULATION

2.1 Introduction

1. In April 2004, the Ministry released a discussion document entitled 'Draft Insolvency Law Reform Bill' for public consultation as part of the review of insolvency law that began in 1999 (a copy of the document is available at www.med.govt.nz). Among other proposals, the document sought comments on options for regulating the insolvency profession. This second discussion document contains draft proposals for changes to the Companies Act 1993 which seek to ensure that the regulatory framework for insolvency practitioners effectively manages the risks involved in corporate insolvency.

2.2 Problem Definition

2. Insolvency practitioners are people who are appointed to carry out a statutory corporate insolvency process, other than the Official Assignee. For the purposes of this document, this definition comprises liquidators appointed under the Companies Act 1993. The Insolvency Law Reform Bill that is currently before Parliament proposes to introduce a new business rehabilitation regime known as voluntary administration (VA). Administrators and deed administrators overseeing the VA process are also to be included in the definition of insolvency practitioners.
3. While a relatively small industry in New Zealand, insolvency practitioners carry out a skilled task which is crucial to protecting and promoting the integrity of the corporate insolvency system – the liquidation of insolvent companies; or the rehabilitation of a company, or the viable parts of a business. In order to do this effectively, insolvency practitioners must possess the requisite skills and knowledge, and exercise good judgement, on a range of matters, including:
 - having sufficient knowledge of commercial law, and more specifically insolvency law and the duties required of practitioners and the insolvency process;
 - having the necessary investigative skills to be able to quickly assess a company's financial position, often in the presence of far-from-adequate financial management systems and accounting records;
 - having sound negotiation skills and being able to balance competing priorities such as tensions between realising an insolvent person's assets at a good price, completing a liquidation quickly and efficiently, and deciding whether to trade on some or all of the business of an insolvent company;
 - deciding whether it is in creditors' interests to attempt to recoup any voidable transaction payments made by the debtor prior to the initiation of liquidation; and
 - looking at legal issues such as Personal Property Securities Act claims and considering whether there have been contraventions of the reckless trading provisions of the Companies Act 1993.
4. Despite undertaking such a crucial role in New Zealand commerce, insolvency practitioners are not required to be licensed or registered by a regulatory body with

powers to investigate possible misconduct. While some governance provisions are imposed on insolvency practitioners by statute¹, practitioners are not required to have particular qualifications or levels of education, nor are they required to belong to any professional organisation². Because of this, there is no official record of the number of insolvency practitioners, or their qualifications. This information deficiency has the potential to create problems for those appointing practitioners as they may not always know whether practitioners have the skills, competence and knowledge required to liquidate or rehabilitate companies.

5. Options for strengthening the regulatory framework for insolvency practitioners were included in the Ministry's 2004 discussion document because of concerns raised that the existing regulatory framework was not effectively managing the risks involved in corporate insolvency. An ineffective regulatory regime creates a risk of financial harm to the company, creditors and, more generally, to the confidence in the credit market. While difficult to quantify, the impact of this harm can be significant.
6. A total of 52 submissions were received on the 2004 discussion document, of which 35 addressed the issue of professional regulation – a significant number given the small number of practitioners who operate in New Zealand. Submissions were received from a wide cross-section of interested parties, including individuals, companies and professional associations.
7. The general signal from the submissions was that the status quo in relation to insolvency practitioners is unsatisfactory. While there was a strong theme that the great bulk of liquidations are carried out by capable and honest practitioners, concerns were expressed about the competence and integrity of a minority of practitioners, in particular that:
 - some practitioners lack the necessary skills and knowledge to carry out corporate insolvencies competently;
 - some practitioners do not carry out their role in a professional manner. The main concerns related to practitioners who favour the interests of the directors of debtor companies (“debtor-friendly practitioners”). This is contrary to the law, which states that the principal duty³ of a liquidator is towards the creditors of the insolvent company.
 - there is a risk of practitioner negligence and dishonesty, such as fraud.
8. Submitters commented that there may be as few as 50 practitioners who might truly be regarded as insolvency specialists. There are other practitioners who do some insolvency work from time to time. Submissions indicated that up to 20 practitioners

¹ The Companies Act 1993, for example, includes some restrictions as to who can be appointed as a liquidator. The Act also includes powers for the Court to enforce liquidators' duties, for example, it can order a liquidator to comply with a duty; it can remove a liquidator from office; or, make a prohibition order on a person for a period not exceeding five years if it is satisfied the person has persistently or seriously failed to comply.

² Such as the New Zealand Institute of Chartered Accountants.

³ Section 253, Companies Act 1993.

may not be up to the required standard. It is important to note that this information is anecdotal. As identified earlier, there is no formal record of the numbers of practitioners operating in the industry.

9. Similar concerns about the regulatory framework for insolvency practitioners have recently been expressed in submissions on the Insolvency Law Reform Bill (the Bill) that is currently being considered by Parliament, particularly in relation to the proposal to introduce a VA regime.
10. VA is intended to be used in a wider range of circumstances than liquidation. The regime specifically provides for VA to be commenced where a company is not yet insolvent, but appears to be heading in that direction. The reasoning behind this is that rehabilitation is not usually an option by the time a company becomes technically insolvent. Early use of the regime will provide the company, the insolvency practitioner and major secured parties with more options.
11. The VA process in the Bill will involve the appointment of an administrator who is given control of the company's business and property. When a company is under administration there will be a stay on actions against the company and its property. This stay applies to secured and unsecured creditors for a period of 28 days. The stay will prevent 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.
12. The mandatory stay preventing secured creditors from taking recovery action during the development of a rehabilitation plan is intended to help the company to re-organise with a view to returning to profitability or, help facilitate a more measured distribution of assets if re-organisation is not a viable option. A large part of the success of this process will depend on the skills and capabilities of the individuals appointed as administrators.
13. In relation to skills, the Bill proposes essentially the same disqualifications for administrators as are in place for liquidators under section 280 of the Companies Act. These disqualifications will not, however, prevent persons with insufficient skills and experience from carrying out administrations under the regime. In addition, these provisions do not address the potential for a practitioner information deficit referred to earlier.
14. An issue also exists around the ethical risks for administrators appointed by the company. Provisions in the Bill seek to address some of the concerns raised in relation to shareholder-friendly liquidators, for example: by prescribing in regulations the set of core processes that have to be undertaken by the administrator; by prescribing in regulations various reporting requirements and; by not allowing a discretion to waive core requirements. However, a potential for mischief still remains as there is no body with an explicit oversight role for practitioners.
15. A further issue exists in relation to the ability of New Zealand practitioners to operate in Australia. Australia adopted VA in 1993. The VA regime in the Bill has been designed to enable co-ordination with the Australian regime to make it easier and less costly to conduct rehabilitations for the growing number of businesses that operate on both sides of the Tasman. However, because New Zealand does not have a registration regime for insolvency practitioners (unlike Australia) the mutual

recognition principle in the Trans-Tasman Mutual Recognition Act will not apply⁴, creating a potential barrier to the effective administration of insolvencies involving companies that operate on both sides of the Tasman.

2.3 Options for Addressing Deficiencies in the Regulatory Regime for Insolvency Practitioners

16. The 2004 discussion document identified three basic options for remedying deficiencies in the regulatory framework for insolvency practitioners. These were:
- a. strengthening existing statutory measures by:
 - i. giving the Registrar of Companies explicit oversight of liquidators and increased enforcement powers; and/or
 - ii. strengthening remedies available to the Court in the event of non-compliance; and/or
 - iii. strengthening reporting requirements for liquidators to notify the Registrar of Companies where they consider that the company or any of its directors has committed an offence under the Companies Act.
 - b. introducing a voluntary accreditation regime to provide title protection and a quality mark for accredited practitioners who have demonstrated their competency to an approved organisation;
 - c. introducing a mandatory licensing regime that would restrict the practice of the profession to those who have demonstrated the necessary skills to carry out work to the required standards to an independent body.
17. While there was no consensus on a preferred option, a clear theme from submissions was that the status quo in relation to insolvency practitioners is unsatisfactory. Of the options outlined above, a majority of submitters favoured the introduction of some sort of licensing system for practitioners over strengthening existing statutory measures or voluntary accreditation.

2.3.1 Strengthening Existing Measures Via the Insolvency Law Reform Bill

18. The Bill proposes a series of amendments to the Companies Act to strengthen existing measures along the lines of the proposals in the 2004 discussion document to increase transparency and accountability of liquidators to creditors, and reduce the risk of 'debtor-friendly' liquidators being appointed. These amendments are as follows.

⁴ The Trans-Tasman mutual recognition principle applicable to occupations is that an individual who is registered in one jurisdiction for an occupation is entitled to be registered in the other jurisdiction for the equivalent occupation.

- The Bill removes the provision in the Companies Act that allowed liquidators a discretion to send specified information to creditors, shareholders and the Registrar of Companies, if returns to unsecured creditors were unlikely to obtain more than 20 cents in the dollar. The liquidator will now be required to send this report to the creditors, shareholders and the Registrar of Companies regardless of the fact that the returns to creditors are going to be under 20 cents in the dollar. Further, the Bill requires a liquidator to send a list of creditors to all creditors to assist them in organising themselves collectively.
 - The Bill also allows creditors and liquidators to seek corrective orders from the Court where voting by parties that are closely related to the company (related entity voting) has resulted in the passing of a resolution that is contrary to the interests of creditors, or a class of creditors, as a whole.
 - In order to prevent the appointment of debtor-friendly liquidators where there is a pending creditor's petition with the Court to liquidate the company, the Bill proposes that companies can only go into voluntary liquidation within 10 days of receiving notice from the Court of the creditor's application. The petitioning creditor may also apply to Court to review the appointment of the liquidator.
 - In dealing with the issue of debtor-friendly creditors, the Bill further restricts the appointment of a liquidator who has, within two years immediately before the commencement of the liquidation, provided professional services to the appointing company.
 - The Bill proposes to remove the maximum 5-year prohibition period that the Court can impose on a liquidator as this maximum ban will not always be sufficient to protect creditors and the public from incompetent and unethical practitioners.
19. While these measures will go some way to reduce the risks identified earlier, our view is that strengthening existing measures, which is in effect extending the status quo, is unlikely to be sufficient in itself to address all the concerns raised with the existing regime. For example, it will not address the issue of preventing persons with insufficient skills and experience from entering the profession and does not completely deal with the information asymmetry issue for those who are appointing practitioners. In addition, strengthening the status quo does not address the issues raised for practitioners around better co-ordination with the Australian VA regime and facilitating rehabilitations for the growing number of businesses that operate on both sides of the Tasman.

2.3.2 Voluntary Accreditation

20. Under a voluntary accreditation scheme, an agency is empowered by statute to certify that accredited individuals have satisfied particular requirements for demonstrating competence in a particular field. Other persons may practise but may not use specified titles or imply in any way that they are certified practitioners. Voluntary accreditation is usually accompanied by other obligations, such as specific governance requirements on the body that is responsible for running the accreditation system, and requirements relating to the investigation of complaints and disciplinary processes. Voluntary accreditation already exists in the accounting profession. The title 'Chartered Accountant' is protected under the Institute of

Chartered Accountants of New Zealand Act 1986. The voluntary accreditation option would add new titles for protection, in effect extending the status quo.

21. Voluntary accreditation would deal with some aspects of the information asymmetry problem, in that persons appointing insolvency practitioners will be able to choose practitioners that have been accredited as 'qualified' to undertake the work. However, as accreditation would be voluntary, this option would not deal with the issue of preventing persons with insufficient skills and experience from entering the profession and is therefore unlikely to significantly reduce the risk of financial harm to the company, creditors and, more generally, to confidence in the credit market. For these reasons, our preliminary view on this option is that it should not be pursued.

2.3.3 Licensing

22. Licensing regimes typically prohibit all but licensed people from undertaking certain functions. The granting of a licence is usually dependent on a person meeting and maintaining certain prescribed standards. These often include education requirements, standards relating to character or fitness, minimum levels of experience, and mandatory insurance or bonds. A licensing regime would also require an assessment body, and a body to supervise and enforce the requirements on practitioners.
23. Licensing systems can have the effect of excluding many persons who may not meet the required competency because they will not be able to gain the educational, training or experience requirements to obtain a licence. Licensing systems can also be designed to promote ethical standards as well as skills development and would help to reduce information asymmetry issues for those appointing practitioners.
24. While licensing systems have many advantages, no matter how well designed they are, they cannot completely eliminate the risk of incompetent practitioners becoming licensed as some individuals may meet the entry criteria even if they are not good practitioners. In addition, licensing systems are not good at excluding unethical practitioners at the time they enter the profession because a lack of ethics rarely becomes evident until an individual gains their licence and starts practising. A further issue is ensuring practitioner competency over time. Recent licensing regimes, such as that to be introduced for building practitioners under the Building Act 2004, have sought to introduce on-going competency requirements to help minimise the risk of practitioners losing competency over time by not keeping up with developments in the profession, however that risk cannot be eliminated.
25. There are a variety of approaches to licensing. Usually licensing includes various features which make it a high fixed cost regulatory option. These features are illustrated by considering the Australian licensing system.
 - a. The Australian Securities & Investments Commission (ASIC) operates three registers of licensees. These are listed below with the numbers of each type of practitioner as at 30 June 2005 in brackets:
 - i. Registered Liquidators (762);
 - ii. Official Liquidators (367); and
 - iii. Registered Company Auditors (6,173).

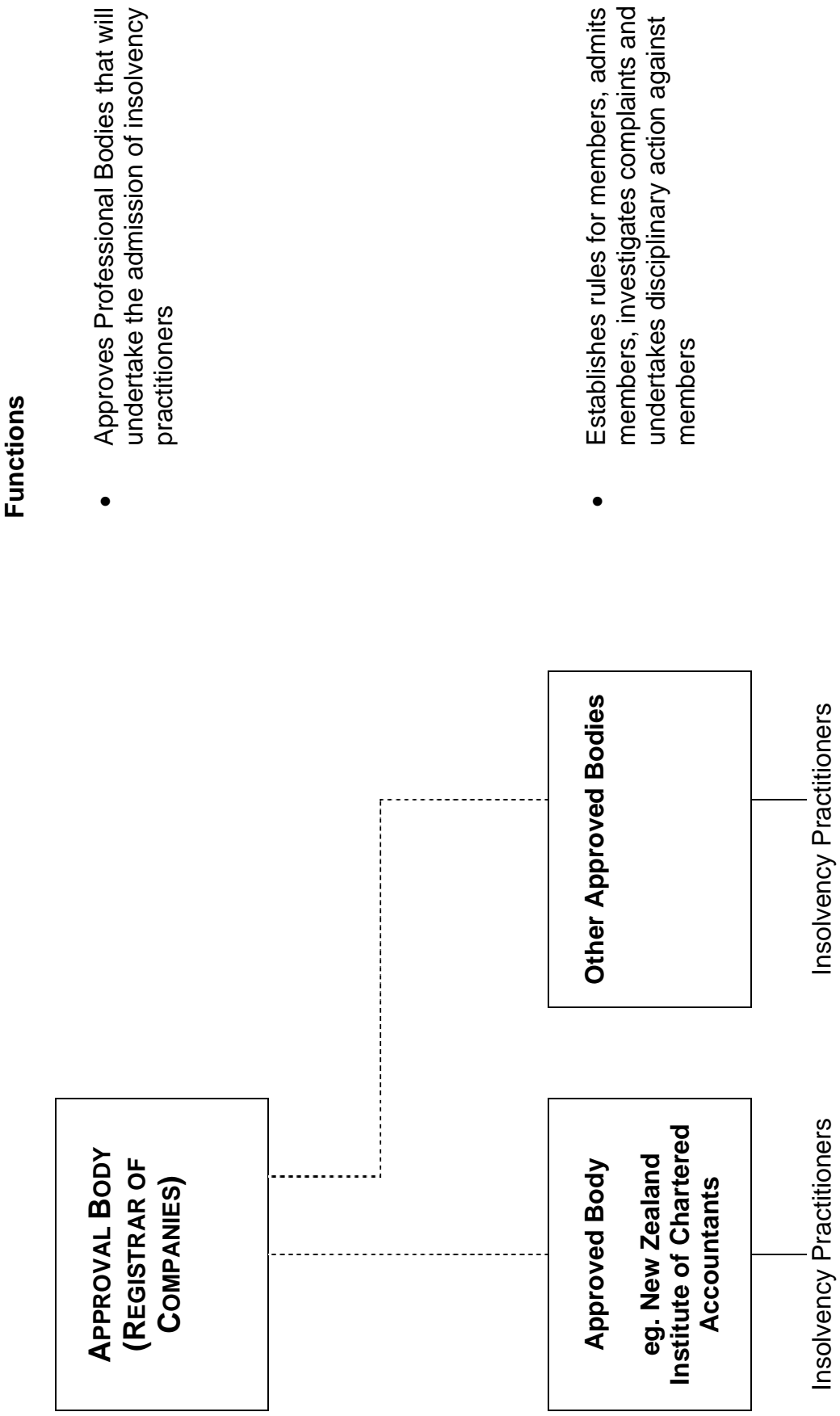
- b. There are entry and ongoing requirements to be licensed as a Registered Liquidator comprising:
- i. Membership of an accounting or other recognised body;
 - ii. A recognised qualification;
 - iii. Practical experience in the winding up of bodies corporate under the supervision of a Registered Liquidator;
 - iv. Ongoing professional development requirements; and
 - v. Mandatory indemnity insurance cover and/or bond deposit requirements.
- c. Certain disqualifications apply based on such things as criminal record, solvency status and mental health.
- d. An investigation, discipline and appeals system is used to deal with licensed persons who are alleged to have behaved in an inappropriate way.
- e. Mandatory professional indemnity insurance/bond requirements are imposed.
26. The Australian system is characterised by high levels of independence. It is independent of the professional bodies. The investigation, hearing and appeal roles are split between three different bodies, thereby promoting impartiality and fairness. ASIC carries out the investigations and takes cases to the hearing body. The Companies Auditors and Liquidators Licensing Board (CALDB) is the hearing body. Appeals against decisions made by the CALDB are heard by the Administrative Appeals Tribunal (AAT).
27. In addition, ASIC operates a “Watchlist”, an intermediate measure for dealing with conduct which in ASIC’s opinion is not sufficiently serious to warrant formal enforcement action.
28. If New Zealand were to adopt this model of licensing it would be necessary to:
- allocate the licensing function to an existing independent body (such as the Registrar of Companies);
 - establish a new disciplinary body; and
 - have appeals considered in a way that is consistent with the New Zealand legal institutional framework. There is no equivalent of the AAT in New Zealand. Appeals would be considered by the High Court.
29. This particular model, with its various features, including a high degree of independence, is likely to fall within the high fixed cost category.
30. The high fixed cost issue is particularly significant in the New Zealand context because of the low number of insolvency practitioners over which to spread the costs. The total cost of a licensing scheme for insolvency practitioners could be considerable per practitioner per year (i.e. several thousands of dollars) and the benefits would have to be very significant to justify the level of cost.

31. The costs of a licensing regime was implicitly recognised by some submitters on the 2004 discussion document. Several stated that the insolvency profession was too small to self-fund a licensing system. It was suggested that it could be funded by, for example (a) levying each insolvent estate, or (b) utilising funds such as the Liquidation Surplus Account. However, the source of the money is not the main issue. What matters most is whether the benefits outweigh the costs of a licensing system. Tolerating a small number of shareholder-friendly practitioners may impose a lower cost on the economy than a mandatory licensing system given the small size of the industry.
32. While introducing a licensing system for insolvency practitioners of the type discussed above would contribute to increasing the standard of insolvency practice, a licensing system is likely to have a very high cost per licensed practitioner because of the small size of the industry. For these reasons our view is that the costs of introducing such a scheme are likely to exceed the benefits and that this type of licensing system should only be adopted if there are no other effective ways of dealing with the identified problems.

2.4 An Alternative Approach – Competitive Licensing

33. A variant on the government-run licensing model described above, and not discussed in the 2004 discussion document, is competitive licensing. In essence, this approach would require all persons carrying out corporate insolvency processes to be members of a professional organisation that is approved by an approval body.
34. The approval body would have to be satisfied that a body seeking approval has the systems and capability to undertake admissions, complaints, investigations, disciplinary action and appeals to the required standard and ensure that these standards will be maintained over time. The approval body would have the power to suspend or withdraw recognition from an approved body. The Ministry's preliminary view is that the Registrar of Companies is the appropriate approval body for insolvency practitioner regulation in New Zealand because the Registrar has well developed skills and knowledge in insolvency practice and procedure and has close links with the Official Assignee.
35. Approved bodies would develop rules for and regulate their own members, including undertaking admissions, investigating complaints and undertaking disciplinary action against members.
36. The proposed approach is represented diagrammatically in Figure 1 (over page).

Figure 1: Competitive Licensing



37. The type of bodies that could be approved under a competitive licensing system for insolvency practitioners might include:
- a. The New Zealand Institute Chartered Accountants (NZICA) or other accounting professional bodies, including overseas bodies; and
 - b. The New Zealand Law Society (NZLS). This would recognise that there are practising lawyers who also have the accountancy qualifications and skills to carry out liquidations, receiverships and administrations.
38. The benefits of a competitive licensing approach are that:
- a. compared with the status quo (with the addition of the proposals in the Insolvency Law Reform Bill) and voluntary accreditation, all insolvency practitioners would have their skills and competencies tested and be subject to investigation and disciplinary processes; and
 - b. compared with government licensing, the system would have a considerably lower cost, because existing professional bodies' rules, including investigation, disciplinary and appeals institutions and processes could be used.
39. The main risks associated with this option are the same as the government licensing option, with the exception of the high cost risk. This proposal will however result in greater costs for insolvency practitioners compared to the status quo because it will restrict the practice of insolvency work to members of approved professional bodies. These costs will ultimately be borne by insolvent estates and creditors.
40. Another possible risk of this approach is that it would not reserve insolvency practice to those with proven specialist insolvency skills and knowledge. This is in contrast to the situation for auditors. The expectations of auditors are clear because NZICA has a comprehensive set of audit standards against which auditors' conduct can be judged. No professional body in New Zealand has an insolvency practitioner brand, although NZICA has a Service Engagement Standard for the performance of insolvency engagements and a Guideline on Insolvency Practice.
41. In a general sense, NZICA's and NZLS's rules require practitioners to have the skills and knowledge appropriate to the work they do. Chartered accountants can be disciplined for failing to meet the general standards of performance and conduct referred to above. The NZICA also has a Code of Ethics which includes a section on ethical behaviour for members in relation to charging fees. In addition, all insolvency practitioners are public practitioners and they are, therefore, subject to NZICA's practice review systems. NZLS does not currently have similar practice review requirements.
42. Considering the overall risks and benefits associated with a competitive licensing system, our preliminary view is that such a scheme is likely to be the most cost effective approach to regulating the profession because it provides most of the benefits of a full government licensing system, addressing the competency and ethical issues identified earlier, but at considerably lower cost to the economy and practitioners.

Questions for Submission

1. Do you think that a competitive licensing system, in addition to the measures already contained within the Insolvency Law Reform Bill, will effectively manage the risks associated with corporate insolvency in relation to competence and professionalism of practitioners? If not, why not? What other factors should be considered?
2. What impact (positive and negative) do you see might be associated with such a scheme?
3. In terms of entry requirements, what key features would you expect to see in the licensing systems of approved professional bodies and why?
4. Should on-going professional development or on-going competency testing be a mandatory feature of an approved body's systems and processes? If so, do you have any views on the form this requirement should take?
5. Do you have any other views on variations to the proposals that could be used to manage risks effectively?

2.5 Transitional Arrangements

43. A key issue with adopting a scheme that restricts the practice of a profession to certain individuals is how existing practitioners are to transition to the regime.
44. Because entry is not automatic under such a regime, the transition to the new regime must be carefully managed so that it does not significantly reduce the number of practitioners who can undertake insolvency work, particularly in the short term. This issue is particularly important given the small numbers of practitioners operating in the insolvency industry in New Zealand.
45. Due to these factors, a lead-in time is proposed before the introduction of the restriction that only persons registered with approved professional bodies can undertake liquidation or administration work.

Questions for Submission

6. What would be the appropriate lead-in time that would ensure a smooth transition to the new regime?
7. Are there any other factors that you consider to be relevant to the transitional arrangements?