Gerry Rea Partners

WHAT HAPPENS NOW?

A Guide to Insolvency Issues for Company Directors

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What is Insolvency?

Insolvency is a word used to describe a situation where a company, or individual, are having financial difficulties and is not therefore solvent". There are two definitions of, or tests, to confirm if a company is solvent within the Companies Act, the principal statute governing the relationships between companies, their creditors and their directors and shareholders.

If a company fails either test then it is insolvent.

The first solvency test is to confirm a company's assets exceed its liabilities. This might seem a straight forward definition, but in reality there are assessments which can impact on the final determination of the answer. Assets in the company's books may for example include goodwill. The goodwill may have a value if the company is trading profitably, but if it is not then the true value of the goodwill asset is probably zero.

Other assets will in the first instance be taken at book value. But often the book values will not correspond to the true, or fair, value of assets. Capitalised research and development expenditure, for example, will only have a value if the work involved has produced an output which is producing or will produce a positive cash flow in future.

For these reasons the second solvency test is more commonly referred to and the one that most companies in financial difficulty will recognise the impact of first. That is the ability of the company in question to pay its debts as they fall due. This test is much more simply evaluated. It relates purely to the cashflow of the company. For example, in the case of a creditor applying to liquidate the company, it can be measured by whether the debt due to the creditor has been paid within a reasonable time and within the terms agreed upon. This is of course subject to the debt being one that is payable and not subject to a justifiable dispute.

Does Insolvency Always Result in Liquidation?

No. Companies can and do trade on in an insolvent position from time to time and, sometimes, for years. Obtaining additional finance, an extension of payment terms with creditors or a shareholder loan are all valid examples of how to bring a company out of insolvency. Others include a formal, or informal, restructure of the business or the sale of the business as a whole. Directors should explore the options available in conjunction with their professional advisors in a timely manner.

Trading while insolvent is not illegal but trading recklessly is. If directors continue to trade an insolvent company without taking appropriate action to remedy the situation, that could be deemed to be reckless by the court. Directors of insolvent companies should take prompt steps to rectify the situation, ideally seeking professional advice, otherwise they risk being personally liable for the debts of the Company.

Who can be a liquidator?

From the 1st of September 2020, only a Licenced Insolvency Practitioner can be appointed as the liquidator of an insolvent company. The same applies to receiverships and voluntary administrations.

There is now an online register of Licenced Insolvency Practitioners which can be found here;
https://www.companiesoffice.govt.nz/all-registers/insolvency-practitioners/

What is the Difference Between Liquidation and Receivership?

In a liquidation, the powers of the directors to control the company are passed to a liquidator. The liquidator has a statutory obligation under the Companies Act to realise the assets of the company for the benefit of all of its creditors, subject to certain priorities which are laid down in the Companies Act and the Personal Property Securities Act. It is unusual for a company to survive liquidation. Although the liquidator may decide to trade on for a short term in an endeavour to achieve a sale of part or all of the business, unless all creditors are repaid in full the liquidation of company cannot be reversed.

A receivership on the other hand may be a short term event. The receiver is usually appointed by a secured lender to the company, frequently a bank. His or her task is to realise sufficient assets to repay the secured lender before he is released. The receiver will still take over the powers of managing the business assets during the term of the receivership. But if, after the receiver has realised assets to repay his appointor, there is still a trading business remaining, it will be returned into the hands of the directors or a liquidator if one is appointed.

If the receiver is released, but there is no trading business remaining, a liquidator may be appointed by the shareholders or on the petition of a creditor. Unlike the receiver, the liquidator has a statutory obligation to review the affairs of the business and events leading up to his or her appointment.

What are the Risks for Directors?

There are risks for a director even without a liquidator or receiver being appointed. The principal risk however is being found guilty of trading recklessly, causing loss to creditors or shareholders. There is no longer a specific prohibition on trading a company which is insolvent. However incurring company debts when there is no prospect of repaying them is one of the tests of trading recklessly.

While a receiver is less likely to consider litigation against directors, a liquidator being statutorily appointed for the benefit of the creditors of a company is required to consider whether there are any causes of action against directors which could be to the benefit creditors. The costs and risks of litigation in New Zealand are high. So it is likely that any liquidator contemplating action against directors of a company would need to be well funded in order to undertake legal action. Creditors wishing for a liquidator to take legal action should discuss this with the liquidator. Claims of creditors who fund successful litigation have an increased priority in a liquidation.

A prudent liquidator will, however, always consider the cost and benefit (to creditors) of any proposed or considered litigation. If there is sufficient evidence to support a case, and funds to cover the costs, there must also be a good prospect of recovery. Otherwise, there can be no benefit to the creditors.

Probably the most common risk for directors of an insolvent company are any personal guarantees which might have been given by them in respect of obligations of the company. Such guarantees are commonly now incorporated into creditors terms of trade agreements. A director who has signed such an agreement will be liable to make good personally any shortfall which the creditor might suffer as a result of liquidation or receivership of the company in question.

Should I act on a Statutory Demand?

Most certainly. When a statutory demand, also known as a Section 289 Notice, is served on company, it has 10 working days to dispute the debt by filing an application to set aside

the demand, or 15 working days to pay the debt.

If the debt is neither disputed nor paid, then on the expiration of the 15 working days, the debtor company is deemed to be insolvent and the creditor can apply to the Court to place the debtor company into liquidation. The onus is then on the debtor to satisfy the Court that it is solvent. This will involve Court representation and the attendant legal fees. If you receive a statutory demand you should immediately consult a barrister or solicitor.

What is an Application to Liquidate?

This is the second step toward liquidation. Where a statutory demand by a creditor (including Inland Revenue) is neither disputed nor paid by the debtor within the requisite period set out above, the creditor may apply to the High Court to place the debtor company into liquidation.

The applicant creditor must serve at the registered office of the debtor company a notice of its application to the Court to liquidate the company. This is a crucial point for the company. Unless the shareholders of the company appoint a liquidator within 10 working days of service, no liquidator can be validly appointed until the Court hears the petitioning creditors request to appoint its chosen liquidator unless the applicant creditor agrees. If a liquidator is not proposed, the Official Assignee will assume the appointment.

Is Voluntary Administration an Option?

The Companies Act provides for the appointment of an Administrator by the directors of a company. But this cannot be done if notice of an application to liquidate has been served on the company more than 10 working days prior, again, without the applicant creditors permission.

A voluntary administrator is given a period being a maximum of 5 weeks, unless extended by the Court or the creditors, to have a proposal for the future of the company approved by a majority and 75% by value of creditors voting on the proposal. The proposal is known as a Deed of Company Arrangement. It will normally set out a means by which the company is refinanced, or else parts of the business sold off and the proceeds distributed to creditors.

A voluntary administration will stop any petitions to liquidate the company being advanced, provided the 10 working days rule above has not been breached. The administration will normally result in control of the company passing to a deed administrator under a Deed of Company Arrangement, or failing this the company will be placed into liquidation or passed back into the control of the directors. Naturally, at the end of the administration period the stay on petitions to liquidate ceases.

What Happens when a Liquidator has been Appointed?

The liquidator is given full control of the assets and undertaking of the company. This control is however subject to the rights of creditors who have securities over the assets and undertaking.

The liquidator has a period of 5 working days (20 working days if Court appointed) in which to prepare a statement of the company's position and report to creditors. During this period the liquidator will normally determine whether or not to continue to trade. This decision will be coloured by the fact that the liquidator will be personally liable for any debts incurred through trading whilst the company is in liquidation.

The liquidator will take control of all assets of

the company including bank accounts, and request the bankers to dishonour all cheques subsequent to his appointment. The liquidator will either dismiss any remaining staff, or negotiate arrangements for their continued employment by the liquidator.

The liquidator has the power to disclaim any contracts which he deems to be onerous. This will normally be exercised to terminate rental or lease agreements and other contracts for the provision of services.

When the assets of the company have been realised the proceeds, after the costs of the liquidation, will be distributed to creditors in the order of priorities laid down in the Companies Act and the Personal Property Securities Act. Naturally, where assets are secured to creditors the proceeds from those assets (or the assets themselves) up to the level of the debt secured will be passed to those creditors, subject to the priority provisions of the Seventh Schedule of the Companies Act.

Employees are granted priority under the Seventh Schedule up to a designated amount for services provided in the 4 months prior to liquidation and holiday pay. The limit is amended annually by Parliament. The definition of ”employee” in the Companies Act excludes directors, or persons who were directors in the 12 months prior to the liquidation commencing. It also excludes persons who are nominees, relatives or trustees for a director of the company.

What Happens if a Receiver has been Appointed?

When a receiver is appointed, the immediate effect is similar to a liquidation. However as set out above, the receiver is more likely to continue to trade the company if this will maximise the recovery from the secured assets. Please remember that a receivers principal duty is to recover funds for his or her appointor while a liquidator or administrators duty is to all creditors.

The powers of the directors of the company are assumed by the receiver, until such time as the receiver is released by his appointor. Similarly to a liquidator, all costs and liabilities incurred during the course of the receivership are the personal obligation of the receiver.

The receiver has, however, some powers to dispense with staff within two weeks of his appointment, his personal liability for rentals on premises does not accrue for the first two weeks of receivership.

Although their powers are temporarily suspended, the obligations of the directors of the company continue after the receiver is released by his appointor.

Directors Responsibilities

Directors have certain statutory duties that they must fulfil. These are set out in sections 131 to 138 of the Companies Act 1993. Directors are required to (among other things);

1. Act in good faith and in the best interest of the Company. I.e. a director has to consider the effect on the Company before considering any other (or personal) consequences.
2. Directors must comply with the Companies Act.
3. Directors cannot allow a company to trade recklessly.
4. Directors cannot allow a company to incur obligations that they do not have a good faith basis of believing the Company can fulfil.
5. Directors must use their power for a proper purpose.
6. Directors must maintain appropriate accounting records

Directors duties do not end when an

administrator or liquidator is appointed. Directors are required to continue to hold accounting records and provide any records to the liquidator upon written request. Directors must provide reasonable assistance to the liquidator to enable them to satisfy their duties.

FAQ

Q. How do I know if my company is insolvent?
A. If the liabilities exceed the assets or the company cannot pay its debts as they fall due, then it is insolvent.

Q. If my company is insolvent, should I just liquidate?
A. The directors should take professional advise and consider the options available. Liquidation might not be the best option. What directors shouldn't do, is nothing.

Q. Am I personally liable for my company's debts?
A. Not unless you have given a personal guarantee over those debts or, in some specific examples, are found by a court to have committed a breach of directors duties. If in doubt, seek professional advice on your specific circumstances.

Q. I've been served with a Statutory Demand. What do I do?
A. Seek immediate professional advice. The clock is ticking!

Q. I am a creditor of a company that isn't paying. What do I do?
A. If polite, but forceful, requests are not working, then discuss the matter with your professional advisors and look to issue a Statutory Demand if appropriate. If that fails to get you paid then, if the debt is large enough, apply to liquidate. In our experience, 80% of all applications to liquidator end not in liquidation, but in the creditor getting paid.

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