



BRIEFING

Insolvency Law – further advice on changes to policy settings in response to COVID-19

Date:	31 March 2020	Priority:	High
Security classification:	In Confidence	Tracking number:	

Action sought		
	Action sought	Deadline
Hon Kris Faafoi Minister of Commerce and Consumer Affairs	Agree to the recommendations.	1 April 2020

Contact for telephone discussion (if required)			
Name	Position	Telephone	1st contact
Susan Hall	Manager, Corporate Governance and Intellectual Property Policy	S9(2)(a)	✓
Geoff Connor	Principal Policy Advisor	S9(2)(a)	
Natan Karon	Senior Policy Advisor	S9(2)(a)	

The following departments/agencies have been consulted (if required)
Inland Revenue, Reserve Bank of New Zealand

Minister's office to complete:

☐ Approved

☐ Declined

☐ Noted

☐ Needs change

☐ Seen

☐ Overtaken by Events

☐ See Minister's Notes

☐ Withdrawn

Comments:



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Date:	31 March 2020	Priority:	High
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Purpose

- To provide further advice and recommendations on proposals for potential changes to insolvency settings and related directors' duties [briefing 2831 19-10 refers].

Recommended action

The Ministry of Business, Innovation and Employment recommends that you:

- a **Agree** to the design the directors' duties safe harbours as specified in paragraphs 3-4.

Agree / Disagree

- b **Agree** to moratorium option 3.

Agree / Disagree

- c **Note** that there may be need to modify details following further consultation with insolvency experts and during the process of drafting the legislation.

Noted

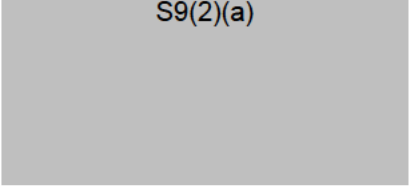
- d **Note** that we will seek further decisions from you about any material modifications.

Noted

- e **Agree** to forward a copy of this briefing to the Minister of Finance and Minister for Small Business for their feedback.

Forwarded

S9(2)(a)



Susan Hall
**Manager, Corporate Governance and
Intellectual Property Policy**

Hon Kris Faafoi
**Minister of Commerce and Consumer
Affairs**

31 March 2020

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Background

1. Following Ministerial feedback yesterday, we provide further advice on proposals for potential changes to insolvency settings and related directors' duties [briefing 2831 19-10 refers].
2. We have consulted with 8 senior lawyers/insolvency experts on this advice. We have also consulted with Inland Revenue and the RBNZ on the proposed package.

Matters for your consideration

Directors' duties safe harbour

Risks

3. Officials are recommending that a safe harbour be added in relation to the two insolvency-related directors' duties in the Companies Act (sections 135 and 136). The safe harbour (and other temporary changes) should be in place for an initial 6 months, with the potential to be extended.
4. The safe harbour would deem decisions to keep on trading, as well as any decisions made to take on any new obligations over the next six months, to be reasonable if:
 - a. in the opinion of the directors the company is facing or is likely to face significant liquidity problems in the next 6 months as a result of the impact of the COVID-19 pandemic on them or their creditors
 - b. the company was able to pay its debts as they fell due on 31 December 2019; and
 - c. the directors consider that it is more likely than not that the company will be able to pay its debts as they fall due within 18 months either as a result of trading conditions improving or being able to reach an accommodation with their creditors.
5. The decision about whether to provide a safe harbour involves a trade-off between two potentially undesirable outcomes.
6. The main argument for retaining the status quo is that a safe harbour could encourage directors to run up substantial amounts of debt instead of winding up companies which clearly have no future. It is common for the amount of debt to balloon when companies continue to trade on in these circumstances, thereby causing much more harm to creditors than would otherwise been the case had they appointed a liquidator earlier. While the safe harbour is not drafted to enable this it could nonetheless be interpreted that way by directors.
7. The main argument for a safe harbour is to encourage directors of viable businesses that are struggling due to COVID-19 to continue trading rather than prematurely closing the business because they feel unable to make an assessment of what is a reasonable business risk for them to take in the current environment. Whether real or perceived, the threat of personal liability for breaching directors' duties is providing strong incentives for businesses to be closed down. This is likely to be an increasing problem because directors will find it increasingly difficult to renew personal indemnity insurance policies when their existing cover expires.
8. We acknowledge that the safe harbours may lead to some undesirable behaviour, but we are, nevertheless, recommending the introduction of a safe harbour in relation to both duties. We consider the benefits, for the economy as a whole, of introducing the safe harbour outweighs the risks of individual abuse. It is now extremely difficult for many directors to make informed judgments about the future consequences of entering into an obligation today or whether continuing to trade will expose creditors to serious losses. Our view is that the safe harbour is needed to make it easier for directors to make better judgments. This will shift

the balance more towards keeping normally profitable businesses operating rather than closing them down prematurely. This has the potential:

- a. to substantially reduce the amount of stress and disruption for directors, shareholders, employees and their families
- b. to speed up the recovery when business conditions start returning to normal.

9. Communications and educational material should however emphasise:

- a. the duties on directors to act in the best interests of the company and exercise the care, diligence, and skill
- b. the penalties that can be applied if a director seriously breaches their duty to act in good faith and in best interests of company or dishonestly incurs an obligation. We are doing further work to consider whether any changes to the existing penalties are required to ensure they capture bad faith abuse of the safe harbour – this will be in the Cabinet Paper.

Options for providing directors and businesses with time to assess their viability

- 10. As noted, we have been assessing options to enable businesses to essentially defer their liabilities to give them time to assess their viability in the current circumstances. The aim, as with the proposals above, is to reduce the number of unnecessary liquidations.
- 11. MBIE's preferred option is option 3 (see table at paragraph 13 below).
- 12. The overarching reason for this is that option 2 can inevitably involve only a short shutdown/moratorium period (1 month) because the creditors have not had a chance to have their say. The directors therefore will have to act again within a month in all cases. This will, in turn, result in considerable pressure and the need for considerable professional advice in a short timeframe for very many businesses.
- 13. The benefit with option 3 is that it incorporates the moratorium on the enforcement of debts but provides directors with 6 months of breathing space and justifiably so, because the creditors have agreed.

Option	Pros	Cons
Option 1 (MBIE's original proposal) Directors assess if they meet threshold test (not final wording): (1) in the opinion of the directors the company is facing or is likely to face significant liquidity problems in the next 6 months as a result of the impact of the COVID-19 pandemic on them or their creditors (2) the directors consider that it is more likely than not that the company will be able to pay its debts as they fall due within 12 months, either as a result of trading conditions improving or being able to reach an accommodation with their creditors. (3) the directors consider it is in the best interests of the company and its creditors for the company to enter a standstill period rather than be liquidated.	s9(2)(g)(i)	

<p>If yes, directors ask creditors to vote within one month on whether to allow business to go into Covid Business Standstill (CBS)</p> <p>50% creditors (by number and value) vote to put business into Covid Business Standstill (CBS).</p> <p>No moratorium on enforcement of debts until vote completed.</p> <p>If vote is successful, business goes into CBS for [6 months]. Moratorium commences.</p> <p>In that period directors are able to make an assessment as to whether the business can resume trading as normal, propose a formal compromise to creditors, enter into administration, or decide to liquidate the company.</p>	<p>s9(2)(g)(i)</p>
<p>Option 2 (RITANZ proposal)</p> <p>Automatic moratorium on enforcement of debts determined by vote of directors and notified to creditors (all creditors are prohibited from taking enforcement action in relation to pre-existing debts).</p> <p>Again there would need to be a test/threshold before directors did this (could be the same as above)</p> <p>Directors have [1] month to decide on next course of action (e.g. voluntary administration, compromise with creditors, liquidation, etc) and have to consult with creditors /notify from that date.</p>	

<p>Option 3 (hybrid – MBIE’s preferred option) Directors assess if they meet threshold test (above)</p> <p>Directors ask creditors to vote within 1 month on whether to allow business to go into COVID Business Standstill (CBS)</p> <p>50% creditors (by number and value) vote to put business CBS</p> <p><i>Moratorium on enforcement of debts goes into place once directors give notice to creditors of vote</i></p> <p>If vote is successful, business goes into CBS for 6 months.</p> <p>In that period directors are able to make an assessment as to whether the business can resume trading as normal, propose a formal compromise to creditors, enter into administration, or decide to liquidate the company.</p>	<p>s9(2)(g)(i)</p>
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14. Some points are common to each option:

- a. Creditors may stop supplying debtor company while a proposal is being developed.
- b. To account for this (under all options) we propose a removal of the voidable transactions (clawback) provisions for new payments once the process has started.
- c. We also propose the package as a whole needs to be accompanied by strong messaging for companies not to hoard cash and stop payments in bad faith.
- d. Under each option, the moratorium would not apply in respect of any new debt incurred.
- e. Some directors may access the process in bad faith (knowing there is no chance of recovery) – we consider this the least bad option when compared by excessive unnecessary liquidations.

Statutory demands

15. We wish to amend our advice on the proposals to change the threshold and time limit relating to statutory demands. We consider that these changes should not go ahead.
16. This is based on commentary from Australia overnight on the weakening nature of those changes in that jurisdiction, and feedback from the Institute of Directors that they do not think those changes are essential.
17. We consider the package above provides enough protection (subject to any potential adjustments to the penalties as indicated above).

Outstanding matters

18. We are in discussions with the Ministry of Justice about how CBS could be used as a trigger to prevent commercial landlords from taking enforcement action under pre-existing leases.
19. We have received comment from the Reserve Bank on our CBS proposal. They note that where an otherwise viable business is facing temporary liquidity problems, as a result of COVID-19, they would expect banks and other creditors to consider options to make credit available before CBS became necessary. The most likely approach, and the one that the RBZ would encourage banks and businesses to follow would be to make use of the Business Finance Guarantee Scheme (extending a (Government-guaranteed) working capital loan to the firm to tide them over their liquidity issue).

Next steps

19. We are preparing a Cabinet paper for approval, for you to take to a meeting of CVD Ministers this week.

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