



**BELL GULLY**

# Insolvency Update

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Welcome to Bell Gully's *Insolvency Update*, a digest of the latest news from the courts and legislators.

In this issue we feature:

- **Moratorium proposals and what investors need to know**
- **Can a receiver also be appointed as a liquidator?**
- **Retention of title clauses**
- **Voluntary administration – is it working?**

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## **Moratorium proposals: what do investors need to know?**

In the second half of 2008 a number of high profile finance companies asked investors to approve moratorium proposals. In all cases, investors approved the proposals. However, whether investors were provided with sufficient information to make a meaningful comparison of the alternatives put before them has been questioned.

The Hanover Finance moratorium proposal, in particular, attracted a great deal of media attention, with some market commentators critical of the level of disclosure in relation to key aspects of the proposal. A “last minute” injunction application to postpone the investor meetings on the grounds that there was not sufficient disclosure in the moratorium documentation was unsuccessful.

At the same time, the Securities Commission, in response to the number of moratorium proposals being put to investors, issued a guidance note on the information that should be provided to investors in relation to such proposals.

### **What is a moratorium?**

In simple terms, the finance companies’ moratorium proposals provided investors with a choice between a moratorium (forgoing interest or principal repayments (or both) for a period of time) and a receivership.

A moratorium is intended to allow management to realise assets on an orderly basis. Most finance company plans promised interim repayments on specific dates, although some plans provided for payments to investors only when funds were available. The principal argument made in support of each moratorium proposal was that existing management is more likely to achieve a better return for investors than a receiver.

Moratorium proposal documents are subject to the disclosure requirements of the Securities Act 1978. In most cases, investors are provided with a notice of meeting accompanied by an independent expert’s report. Depending on the terms of the proposal, a registered (often short form) prospectus is required (but not an investment statement).

### **Hanover Finance judgment**

Much comment was made about the complexity of the Hanover Finance proposal and the perceived lack of information about key aspects of the proposal. One investor took the matter to the High Court and sought an interim injunction to postpone the investor meetings on the grounds that the lack of information in the materials sent to investors did not allow investors to make an informed decision.

The investor’s argument centred on the injection of assets proposed from the transfer of Axis Property Group Holdings Ltd (a company associated with the ultimate owners of the Hanover Group) to the restructuring programme. It was submitted that the statements made in the investor documents regarding shareholder support to be provided to Hanover Finance were over-stated and put too absolutely. Furthermore, there was a failure on the part of Hanover Finance to provide adequate information to investors of the problems with realisation of the Axis assets, when compared with avenues of potential redress against directors or others involved in the company.

Hanover Finance argued that there was sufficient qualification in the reports relating to the Axis assets as the proposal made it clear that realising the \$40 million consideration attributed to the properties was dependent on prevailing market conditions at the relevant time. The court agreed with this argument, noting that it was “not convinced that the market values [of the properties], as at the present date, would necessarily change the approach of any particular investor to the decision that needs to be made at the meeting”.

The court also expressed the view that this was not the type of case in which the court should intervene. In the court's view the nature of the motion before the investors was "quintessentially a commercial judgement for individual investors to make", namely whether to accept what has been proposed to what might be available through other means.

Although sympathetic to the investors for the lack of time that they were given to consider fully their position, the court considered that it was an issue that could be addressed by the investors making a motion at the meeting seeking an adjournment under the terms of the debenture trust deed. By granting an interim injunction, the court would be removing the ability for investors to assess whether or not an adjournment was necessary, based on the information available to them.

At the meeting, no such request for an adjournment was made and the moratorium proposal was approved by Hanover Finance investors.

### **Guidance note from the Securities Commission**

In early December 2008, the Securities Commission issued a guidance note to assist investors when reviewing moratorium documents. The Commission emphasised the need for investors to make a meaningful comparison between their options. While the total return may be likely to be less under a receivership, any returns will most likely come sooner than under a moratorium. Investors should look at the "net present value" of the amounts that are expected to be recovered under each option, as well as the expected total return. The commission also points out that where payment is deferred under a moratorium proposal, investors are in effect being asked to take a further risk on the performance of the company's assets and management.

Investors should be told what assumptions about the future value of a company's assets have been made by its directors – and how those assumptions would stack up if applied under a receivership.

The commission identified the following as key questions for investors to consider:

1. How would my rights be different under receivership?
2. How much am I likely to get under receivership, and when?
3. How much do the directors think I will get under a moratorium, and when?
4. Which is more in my interests, given my investment needs (including payout timeframes)?
5. What assumptions have the directors made if they say a moratorium will result in better returns? What are the risks compared with the risks of receivership?
6. Who would supervise a moratorium and report to the trustee or investors?
7. What is the plan to change the moratorium proposal if there are changes in the company's situation or economic conditions?
8. Do I get another chance to vote if things aren't going as expected?
9. Is there an independent expert's report and if so what does it say?
10. Have there been any independent valuations of assets?
11. If parties related to the company are contributing assets are there independent valuations?
12. What does the trustee have to say about the moratorium?
13. What are the financial and legal implications for the directors and other related parties under receivership compared with a moratorium?

### **What this means for future moratorium proposals**

While we may have completed the round of moratorium proposals by finance companies, we are likely to see more moratorium proposals as other debt issuers seek to restructure their financing arrangements.

It is clear that the Securities Commission will monitor the level of disclosure in moratorium proposal documents. Issuers should ensure that their documentation enables investors to address the issues which have been identified by the commission in its guidance note.

While the prescriptive disclosure requirements of the Securities Regulations will not necessarily require disclosure of all this information, the commission's view is that investors need to be provided with additional information. The focus should be on a comparison of the alternatives facing investors.

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## Can a receiver also be appointed as a liquidator?

Ordinarily a person cannot be appointed as a liquidator if they have been a receiver of the company being liquidated within the two years prior to liquidation. This is outlined in section 280(1)(c) of the Companies Act 1993, however the court retains a discretion to order that a receiver can be appointed as a liquidator.

There have been few decisions under section 280(1)(c) considering when it will be permissible for a receiver to be appointed as a liquidator. In light of this, the recent decision in *Hong Kong of Orient Power Holdings Limited (Receivers and Managers Appointed) (Provisional Liquidator Appointed) (Orient)* (HCCW 191/2007, 29 January 2008, Hon Kwan J) is likely to be of some interest to insolvency practitioners in assessing when such an application might be granted.

The issue was whether one of the receivers and managers of Orient should be appointed as a liquidator in conjunction with two proposed independent appointees from a different firm of accountants. Counsel for the secured creditor contended that the proposed appointment of the receiver would be akin to that of a "special purpose" liquidator, in that his powers would be strictly limited in the proposed order for his appointment so the potential for conflict would be sufficiently managed. Counsel for the Official Receiver on the other hand contended that the potential for conflict of interest in this situation was too great and would set a bad precedent.

### Discussion

The court considered that, as the interests of the receiver and the liquidator will necessarily be different and in many cases conflicting, the same person who acted as receiver will not normally be appointed liquidator. Only in rare and exceptional cases would the two offices be combined in one person.

Counsel for the secured creditor submitted that there was no bar at law for such an appointment and contended that it would be appropriate for such an appointment to be made where it could be shown that the potential conflicts arising from the appointment of a receiver appointed out of court could be managed effectively.

In the draft order submitted, the powers of the receiver as a liquidator would be curtailed in the following respects:

- The receiver's power to bring or defend legal proceedings for the company would be subject to appropriate sanction of the court and to be exercised in conjunction with the other two independent liquidators. All the powers conferred on the receiver were exercisable only with the approval of the other two liquidators, who would be in the majority.
- The receivers were to allow the liquidators full access to any books and documents relating to the company held by them in their capacity as receivers save for any books and documents in respect of which they are entitled to claim legal professional privilege, and that the receiver would not, without the consent of the other liquidators, release to any secured creditor any information relating to the company obtained by receiver in his capacity as liquidator. Thus, the receiver would not be required to undertake problematic tasks of 'self-review' into matters such as the validity of the appointment of the receivers under the debentures, the performance of the receivers' duties and their dealings with the assets of the company, and the remuneration of the receivers. Accordingly, the receiver would not be carrying out other duties for which he might be perceived to be partial towards the secured creditors.
- As for the investigation of possible claims and the bringing of legal proceedings for recovery, the receiver would exercise his powers with the approval of the independent liquidators. If

notwithstanding these measures a conflict was to arise and it was not resolved by discussion with the independent liquidators, the receiver assured the creditors that he would promptly refer the issue of conflict to the court for direction.

There was also a willingness of the creditors, secured and unsecured, to fund the appointment of two additional liquidators from an independent firm of accountants. In addition, there was unanimous support among the creditors, secured and unsecured, for the appointment of the receiver as liquidator.

In this case, the court considered that if the principle of avoiding the appearance of lack of impartiality was to be strictly adhered to, this would be “making the perfect the enemy of the good”. The court was satisfied that the conflicting loyalties of the receiver could be effectively managed with the proposed terms of appointment. However, the court also emphasised that the circumstances in this case were special and each case would be closely scrutinised to ensure the liquidator appointed is acting in the best interests of all persons interested in the winding up.

### **Summary**

The Orient decision shows that a court may be willing to allow a receiver to be appointed as a liquidator if:

- ‘independent’ liquidators are appointed alongside the receiver; and
- the terms of the order provide those liquidators with the ability to control areas in which conflicts between the duties of a receiver and the duties of a liquidator may arise.

For each future case, a court will need to assess whether the appointment is in the best interests of those involved in the company’s liquidation.

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## Retention of title clauses under the microscope

Suppliers of goods often try to protect their goods by including retention of title (ROT) clauses in supply agreements with customers.

In a series of recent court cases the receivers of Service Foods Manawatu Limited (In Receivership and Liquidation) (Service Foods) and New Zealand Associated Refrigerated Food Distributors Limited (NZARFD) have been disputing the effect of a ROT clause.

Previously, both the High Court and the Court of Appeal determined that NZARFD obtained a Purchase Money Security Interest (PMSI) in relation to the goods which it had supplied to Service Foods through its ROT clause. In the most recent case, the court looked at how to value NZARFD's PMSI.

Its judgment will be of some concern to those who supply goods pursuant to ROT clauses. Based on the court's judgment, the protection provided to suppliers under ROT clauses may not go as far as may have been thought.

### Background

In mid-2004 NZARFD became a supplier to Service Foods. It was November 2004 before a trading account was established, and terms of trade were not agreed to until December 2004.

Through the terms of trade NZARFD obtained a PMSI in the goods which it supplied to Service Foods. NZARFD registered this security interest on the Personal Property Securities Register in December 2004.

In 2005, Service Foods was placed into receivership and liquidation. The receivers and liquidators of Service Foods refused NZARFD's attempts to retake possession of the stock which it had supplied, but not yet received payment for.

### The arguments put forward

Service Foods relied upon a number of pre-Personal Properties Securities Act (PPSA) cases to argue that the onus was on NZARFD to determine which of the goods it supplied had been paid for, and which had not. The court accepted this, holding that the introduction of the PPSA did not alter the approach previously taken.

The court, looking at the particular circumstances of the case, noted that Service Foods routinely paid NZARFD as and when it could. This meant that Service Food was consistently in arrears on the payments due to NZARFD, both before and after NZARFD's PMSI had been perfected.

In the absence of any other agreed terms, the court inferred that any payments made by Service Foods were to pay the oldest debts first. However, Service Foods argued that if this presumption applied, there needed to be a "ruling off" of the indebtedness that existed at the time the PMSI was perfected and all payments received thereafter applied to liabilities incurred after that date. In making this argument, Service Foods relied on sections 293(4) and (5) of the Companies Act 1993 which provide that any charge given by a company within a specified period, payments received after that time are deemed to have been appropriated towards payment of the actual price or value of property sold on or after the giving of the charge.

While on contractual terms section 293 did not apply, the court stressed the need to achieve symmetry in the way that the PPSA and the Companies Act operate. In the interests of consistency

the court held that all payments after 23 December must therefore be treated as paying for the stock supplied from that date, on the basis of "first supplied, first paid for". This meant that based on a simple calculation as to the amount of the goods supplied by NZARFD between December 2004 and June 2005, less the payments made or credits given during that period, the amount which the receivers were required to account to NZARFD was just a fraction of Service Foods' total indebtedness.

### **Effect of the case**

As the court noted, it seems unlikely that NZARFD appreciated this limitation on the utility of its ROT clause when it agreed terms of trade with Service Foods. Suppliers in the same situation may be forced to stipulate for a PMSI from the very outset of the trading relationship in order to protect their interests. Where there is a history of unsecured supplies, suppliers will have to devise other strategies to recover, or to secure payment of, the debt outstanding at the time a PMSI is put in place.

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## Voluntary Administration – Is it working?

It is over a year since voluntary administration was introduced into New Zealand. Based on the first year's experience, some will be questioning just how well the regime is working.

### Statistics

In the first year approximately 20 companies were placed into voluntary administration – only a tiny fraction of the number of companies placed into receivership and liquidation in New Zealand during the same period. By contrast use of the creditors compromise provisions under Part 14 of the Companies Act appears to have increased over the same period. Not only has the voluntary administration procedure been rarely utilised, it also appears there has only been one case where a rescue plan in the form of a deed of company arrangement (DOCA) has been approved as a result of voluntary administration.

These statistics compare unfavourably with the experience in Australia, from where the New Zealand regime was largely copied. In Australia hundreds of companies are placed into voluntary administration every year. Australian statistics show that voluntary administration results in a rescue plan in the form of a DOCA being approved in approximately one third of all cases.

These statistics do not necessarily show that voluntary administrations are not working. It must be remembered that the Companies Act states that the objective of the voluntary administration regime is:

“to provide for the business, property and affairs of an insolvent company to be administered in a way that:

- (a) maximises the chances of the company, or as much of its business, continuing in existence; or
- (b) if it is not possible for the company or its business to continue in existence, results in a better return for the company's creditors and shareholders that would result from an immediate liquidation of the company.”

So the fact that a company does not execute a DOCA does not mean that the voluntary administration was a failure. However, even taking this into account, experience to date suggests that voluntary administration is not yet working well in New Zealand.

### The role of the Inland Revenue

This apparent lack of success will not come as a surprise to some. Prior to its enactment there were many who predicted that the regime would not work. However, the reason given as to why the regime would not be a success by most of these people does not appear to have been a factor to date.

In introducing the regime the government retained the Inland Revenue's status as a preferential creditor in liquidations. This differs from Australia where the Inland Revenue no longer has priority in the company liquidation for tax instalment deductions from salaries and wages. Many have argued this means that the Inland Revenue has no incentive to support a rescue plan by voting in favour of a DOCA as, in most cases, it will be able to recover all or most of its debt as a preferential creditor in the liquidation.

This has not been the reason for the regime's relative lack of success so far. There do not appear to have been any cases where a rescue plan has been voted down by the Inland Revenue. In the one case where a DOCA was put to creditors, the Inland Revenue voted in support of it.

While it has not been a significant factor in administrations to date, the preferential status given to the Inland Revenue could remain a stumbling block to the success of voluntary administration in New Zealand in the future. Reform may yet become necessary if voluntary administration is to succeed.

### **Failure to act early**

Australian experience suggests that a key factor in the success or otherwise of an administration is how early directors act to invoke the procedure. An effective business rescue plan is much more likely when directors act early. Failure to act early may have played a factor in the administrations in New Zealand to date.

Some of the incentives for directors in Australia to invoke the procedure early are missing under the New Zealand regime. In Australia, in return for the Inland Revenue losing its preferential creditor status company directors have been made personally liable for the company's tax liabilities if not paid by the company itself. Directors can avoid this personal liability if they have appointed an administrator.

The New Zealand Government refused to accept that company directors should have personal liability for their company's tax liabilities if they fail to put the company into administration. Directors therefore do not have the same incentive to put companies into voluntary administration.

If the preferential creditor status of the Inland Revenue does prove to be a stumbling block to the success of voluntary administration in New Zealand, making directors personally liable for tax liabilities if they do not place the company into administration should be considered as part of any reform.

### **The reaction to voluntary administration by secured creditors**

So far it appears the main reason rescue plans have not successfully been put together in more cases has been the response to voluntary administration taken by secured creditors.

An important feature of the regime is the moratorium placed on creditor claims while the company is in administration. However, secured creditors with a security interest in substantially the whole of a company's property can avoid this moratorium if they enforce their security by appointing receivers within the first 10 days of a company being placed into administration. Typically the receivers then move quickly to realise the assets of the company for the benefit of the secured creditor. By the end of that process there is often no business left to be rescued. As a result, rather than voting to approve a DOCA, creditors will instead vote to place the company into liquidation.

This has been a notable feature of the voluntary administrations in New Zealand so far. Receivers have been appointed in the majority of administrations, including the two most high profile administrations to date, that of the listed group of companies, ICP Bio, and Icon Digital Entertainment Limited, the company behind the Sounds and Blockbuster stores.

How secured creditors react to voluntary administration will be key to how successfully the regime is utilised in the future. If secured creditors who have a security interest in substantially the whole of a company's property continue to reject administration and appoint receivers, then voluntary administration will only ever have limited value. However, as general awareness of voluntary administration in New Zealand increases, and secured creditors become more comfortable with the

process, we anticipate that the regime will successfully be utilised in a much greater number of cases than seen in the past year.

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