COVID-19 – Recently announced insolvency law changes

David Broadmore, David Perry, Jan Etwell, Kelly Paterson, Scott Abel, Scott Barker, Willie Palmer, Peter Niven, Myles O'Brien, Bridie McKinnon, Matthew Triggs, Oliver Gascoigne, Luke Sizer, Annie Cao

13 May 2020

The Government has published the COVID-19 Response (Further Management Measures) Legislation Bill (the Bill), an omnibus bill containing amendments (both temporary and permanent) to several acts. These amendments aim to both assist organisations in effectively managing the “immediate impacts of the response to COVID-19”, as well as mitigating some of the pandemic’s “unnecessary and potentially longer-term impacts on society”. The Bill is being considered by the Epidemic Response Committee and was reported back to the House on Tuesday 12 May 2020, and is likely to pass into law shortly thereafter.

A significant feature of the Bill is its proposed changes to the Companies Act 1993 (the Act), directed primarily at enabling companies (as well as other entities) to continue functioning through the period of extreme economic uncertainty wrought by the pandemic.

The Bill also makes several adjustments to other insolvency legislation, to ensure that the provisions adjusted are better suited to accommodate the solvency issues faced by many New Zealand businesses as a consequence of COVID-19.

This article addresses the Bill’s proposed changes to insolvency legislation, and the practical implications that these changes will have for boards navigating their businesses through these uncertain times. In brief, the changes are:

- The introduction of a "business debt hibernation scheme" (BDH) that allows debtor companies and other entities to temporarily suspend their debts
- The introduction of safe harbour measures for directors of companies otherwise at risk of breaching their duties in relation to insolvent trading
- Reducing the suspect period for voidable transactions (other than with related parties) from two years to six months
- Increased time allowances for mortgagees and lessees in default under the Property Law Act
- Allowing security agreements containing powers of attorney to be executed electronically
- Delay to the introduction of anticipated law reforms providing for the regulation of insolvency practitioners.

Business Debt Hibernation Scheme

The Bill introduces a new process for businesses and other entities to postpone some or all of their debts for a limited time. BDH will allow struggling entities to propose an arrangement with creditors that is intended to provide a breathing space to recover from the economic effects of COVID-19 by protecting entities from creditor actions for an agreed period of up to six months. Importantly, the BDH process does not permit a compromise with creditors, although agreed subordination does not appear to be excluded.

Key features of the new process are:

- It applies to a wide range of entities, including unincorporated associations of persons. This broad definition will allow companies, partnerships, trusts, sports clubs and churches, among others, to take advantage of the new process (certain entities, such as banks, licensed insurers, non-bank deposit takers, and operators of designated settlement systems or licensed derivatives issuers are excluded, as are entities already in a formal insolvency procedure)
- It provides for a two stage moratorium preventing creditor action against the entity or its property, except by General Security Agreement (GSA) holders.
  - there is an initial one month period that commences when the entity delivers a notice to the Registrar of intention to propose a debt hibernation arrangement
  - if the arrangement is agreed to by the requisite majority of creditors, then a further moratorium will apply to all creditors, for a further period of up to six months during which the arrangement is in force
- The majorities required to approve an arrangement are 50% in number and in value of creditors (*excluded debts* must be disregarded). All creditors, including secured creditors, are grouped in a single class. Creditors' meetings are voluntary

- The position with regard to GSA holders has been clarified following the report back from Select Committee. The protections in Part 5 do not apply at any stage in relation to a GSA holder (or to the debts owing to the GSA holder). A GSA holder can therefore still enforce its charge (and take other actions to enforce payment of the debts owed to it). Clauses 18 and 71 are amended to clarify that an entity in BDH can enter into receivership or be put into liquidation (at which point, the protections in Part 5 cease to apply). Clause 54 has been narrowed so that it no longer applies to section 293 of the Companies Act 1993 (which relates to voidable charges)
- Employee debts and debts incurred during the period when the arrangement is in force are excluded from the effect of the arrangement, meaning that if an entity defaults on a post-arrangement debt, then the creditor is entitled to take enforcement action, which could include a liquidation application, but not, for example, the appointment of a receiver. The moratorium on enforcement of charges or recovery of property during the protection period will prevent new secured lenders/owners from enforcing their security/ownership rights in relation to what are excluded debts. This will be a strong disincentive to the provision of new money by secured parties
- The definition of "*excluded debt*" in clause 4(1) has been clarified. In summary, the term now includes salary, wages, and other employment debts. Previously, these amounts were referred to separately. The term has been amended to ensure that it does not include interest or penalties on pre-existing debts or other amounts that fall due for payment on or after the entity enters into BDH if the obligation to pay the amount was entered into before the entity enters into BDH. This may include, for example, rent payable under an existing lease
- Related party votes are not to be counted unless a court permits them to be, which is a welcome reversal of the process applicable in liquidations, under Part 16 of the Companies Act
- The voidable transactions provisions in Part 16 of the Companies Act and the Property Law Act will not apply to transactions entered into with entities the subject of arrangements, if those transactions are entered into good faith and at arm's length. There seems to us to be some risk of abuse of this carve-out. The postponement of the implementation of insolvency practitioner regulation is unfortunate in this context, among others
- Reliance on ipso facto provisions in contracts (eg to terminate on the ground of insolvency) is prohibited during the protection period under an arrangement.

Overall, we consider BDH in form proposed in the Bill to be an overly complex process given that it is intended to be used by entities without the need for professional assistance. It is also of limited use to debtor entities, because they can only postpone their debts and then only for up to six months. The primary benefits of the process are the statutory and contractual moratoria. It seems likely therefore that entity boards may use it as 'springboard' to a full creditors' compromise. Part 14 of the Companies Act is of an elegant simplicity and suffers mainly from a lack of pre-compromise moratorium. This could easily be remedied by Parliament and would provide a longer term benefit to struggling companies than BDH.

Safe harbour measures for directors

The Bill introduces a safe harbour for directors at risk of breaching the insolvent trading provisions under sections 135 and 136 of the Act. Those sections provide that a director cannot allow for a company to recklessly trade (section 135), or incur obligations it is unable to meet (section 136). In the current environment, those provisions can inhibit the ability of directors to make necessary decisions on whether to continue to trade, given the difficulty in predicting how economic circumstances might develop going forward.

Accordingly, with limited exceptions the Bill grants a "safe harbour" to directors of companies from the insolvent trading provisions when their business has been affected by COVID-19. Where, between 3 April 2020 and 30 September 2020 (known as 'the initial safe harbour period') a director has:

- Taken an action that would breach the duty not to trade recklessly under section 135
- Agreed to the company incurring an obligation that would be a breach of section 136 (because the company cannot meet that obligation)

that director will have safe harbour from the insolvent trading provisions, if at the time of making the relevant decision they believed in good faith that:

- The company has, or in the next six months is likely to have, significant liquidity problems
- The liquidity problems are, or will be, a result of the effects of COVID-19 on the company (or its debtors or creditors)
- It is more likely than not that the company will be able to pay its due debts on and after 30 September 2021.

When assessing the company's future ability to pay its due debts, a director may have regard to any matters they consider relevant. These might include the likelihood of trading conditions improving, or the likelihood of the company reaching a compromise (or other arrangement) with its creditors.

Safe harbour is not available to directors of all companies. Only directors of companies that were able to pay their debts as they fell due in the normal course of business as at 31 December 2019, or of companies that were incorporated between 1 January and 24 March 2020 (dates inclusive) qualify for protection. It is also unavailable to directors of registered banks, licensed insurers,

non-bank deposit takers, and qualifying counterparties under the Reserve Bank of New Zealand Act 1989.

These changes will give comfort to directors seeking to continue trading without a heightened risk of personal liability. The following considerations will be relevant to directors who may later rely on the safe harbour:

- **Accurate record keeping is essential:** To meet the criteria for safe harbour, directors must have accurate records of the company's financial state, both to demonstrate that the company was cashflow solvent prior to COVID-19, and that there is a basis to believe that the business will be able to pay its debts at a later date
- **Consultation may assist**: The case for safe harbour might be strengthened where a director can demonstrate that they have consulted with others (either internal or external to the company) on the company's present and future solvency. As with financial records, any consultation that forms the basis of a director's view should be well documented
- **Protections backdated**: A director's behaviour can qualify for safe harbour if it occurred at any point from 3 April 2020. The retroactive effect of the amendments extends protection to directors who were affected by COVID-19 prior to the Bill's passing
- **No relief for directors struggling prior to COVID-19**: Directors of companies that were cashflow insolvent at the end of 2019 are ineligible for safe harbour. The heightened risk of liability for insolvent trading, coupled with existing solvency issues, demand a director of such a company to make a frank assessment as to whether it should continue trading
- **Other directors' duties remain unchanged**: The Bill does not alter the application of any other duties in the Act, including the duty to act in the best interests of the company, to exercise reasonable care, skill and diligence, and the duty to disclose interests on the interests register. Directors cannot use the conditions created by COVID-19 as an excuse to let the standards of their behaviour slip.

Insolvent transactions and voidable charges – changes to suspect periods

The Bill has also introduced, in a modified form, changes to the suspect periods for insolvent transactions and voidable charges which were previously signalled in a Cabinet Paper from November last year (see our legal update on this).

Currently, insolvent transactions and voidable charges which are entered into in the two year period prior to liquidation, at a time when the company was insolvent, may be set aside by a liquidator. The amendments provide that insolvent transactions (under section 292 of the Act) and voidable charges (under section 293 of the Act) may only be challenged by a liquidator where the transaction occurred, or the charge was granted:

- In the case of a transaction or charge with a related party, within two years prior to liquidation
- In in all other situations, within six months prior to liquidation.

'Related party' is a new term in the Act and is defined exhaustively by the Bill. It includes a broad range of possible connections to the company for the counterparty, both familial and commercial (such as a director, a shareholder, or a 'close business associate').

These amendments will apply in respect of liquidations which commence after the date that the amendments come into effect.

Additional insolvency law changes

Changes to remedy periods under Property Law Act 2007 (PLA).

The Bill extends various timeframes under the PLA to accommodate the likely increase in mortgage and rental defaults that will be caused by COVID-19, and to therefore provide mortgagors and tenants with more time to remedy those defaults. Specifically:

- Notices under sections 119 and 120 of the PLA relating to the exercise of mortgagee's power over land must give the current mortgagor 40 working days to remedy any default, instead of the usual 20 working days
- Notices under sections 128 and 129 of the PLA relating to the exercise of mortgagee's power over goods must give the current mortgagor 30 working days to remedy any default, instead of the usual 10 working days
- A lessor's intention to cancel a lease for failure to pay rent cannot be served until rent has been in arrears for at least 30 working days, and the lease cannot be cancelled until the lessee has been given 30 working days to remedy the breach. Usually, these periods would both be 10 working days.

These extensions are drafted to reach back to 1 April 2020 and apply to enforcement action and legal proceedings that have been attempted since that date.

Electronic execution of deed that creates power of attorney

The Bill provides for the temporary application of the provisions (under the Contracts and Commercial Law Act 2017) which allow for the electronic execution of documents, to any deed that creates a power of attorney in connection with a security interest. This will allow secured lenders and borrowers to execute by electronic means security agreements which contain (as is typically the case) a power of attorney clause in their terms. This change will apply for six months from the date that the change comes into force, unless extended by Order in Council.

Delay of the implementation of the insolvency practitioner reform legislation

To avoid the creation of additional uncertainty during COVID-19, the Bill has delayed the implementation of reforms to the Insolvency Practitioners Regulations Act 2019 and the Insolvency Practitioners Regulation (Amendments) Act 2019 (as referred to in our August 2019 legal update). While the reforms were previously going to come into force on 17 June 2020, this will now not occur until 1 June 2021.

Auckland

188 Quay Street
Auckland 1010

PO Box 1433
Auckland 1140
New Zealand

P: +64 9 358 2555
F: +64 9 358 2055

Wellington

Aon Centre
1 Willis Street
Wellington 6011

PO Box 2694
Wellington 6140
New Zealand

P: +64 4 499 4242
F: +64 4 499 4141

Christchurch

83 Victoria Street
Christchurch 8013

PO Box 322
Christchurch 8140
New Zealand

P: +64 3 379 1747
F: +64 3 379 5659