Part XIV of the Companies Act 1993

Compromises with Creditors: Theory and Practice

Part 2

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1 Introduction

The compromise regime is set out in Part XIV of the Companies Act 1993 (the Act) in 8 sections. The brevity of the statutory provisions is both a strength and weakness of the regime.

2 History

Rehabilitation regimes have been a feature of company law since the Victorian period.

In Britain a form of the compromise regime can be traced to the Joint Stock Companies Arrangement Act 1870. What was the motive for introducing such rehabilitation processes is not easy to determine. However, from the case law it can be inferred that the failure of insurance companies was of concern. It is likely that the complexity of liability determination in the infancy of actuarial practice was one of the root causes of insurance company failure.

This is in contrast with the position in the United States. The origins of the National Bankruptcy Act within which Chapter 11 is located can be traced back to the Constitution itself. The Constitution made provision for bankruptcy law to be dealt with on a federal basis. It took 100 years before the precursor law, being the National Bankruptcy Act of 1898, was settled. The original draft of the Act was formulated to be very draconian. The draconian elements were significantly moderated to produce the benign regime that now prevails in the US. It would seem that Congress did this to prevent Eastern bankers from extracting their 'pound of flesh' from Western farmers.

The compromise regime was set out in sections 205 and 206 of the Companies Act 1955. The annotative comparisons make reference to predecessor laws, being the Companies Act 1933 and the British Companies Act 1948. The provisions of the 1955 Act are broadly the same except for one important difference – the scheme prevailing until 1993 required the sanction of the Court. This provision was dispensed with in the 1993 Act.

Further historical information is provided in Part III of the Law Commission's paper *Insolvency Law Reform: Promoting Trust and Confidence* [2001] (see especially paragraphs 190 to 201). The Law Commission undertook surveys to ascertain why the scheme was so little utilized. Its conclusions seemed to be that:

- it was little known and
- that it was expensive to implement.

It might have been added that a contributing factor is the reluctance to face up to insolvency generally and, therefore, to engage formal insolvency management at a stage when it is possible for compromise to work effectively.

3 The structure of the compromise regime

3.1 Introduction

The structure of the compromise regime is set out in sections 227 to 229 of the Act.

3.2 Section 227: definitions

There are two important definitions in set out in section 227:

- The term compromise itself.
- The term creditor.

The definition of compromise has a number of important implications. For instance, it specifies that a compromise, amongst other things, entails a either a cancellation of debt or a variation of rights. It is therefore a simple collective re-negotiation of contracts pertaining to debts or rights arising by operation of other laws such as statute (e.g. taxes etc.).

Any variation is therefore permissible. It might be a reduction of debt obligation from 100 cents in the dollar to a lesser amount or the deferral of maturity to a later date. It might also be the issue of shares in lieu of debts owed. This capacity implicitly encompasses an important protection because it sanctions the issue of an instrument that might otherwise fall to be considered the issue of a security to which the Securities Act applies.

As the compromise regime is wholly flexible there is no reason within the regime itself for the variation to be carried out by the issue of an instrument in another company (a 'hive down') – either debt or shares. This might present problems in the operation of the Securities Act. Perhaps more serious might be the recent amendments to the Act in respect to phoenix companies – see sections 386A to 386F. The definition of the term 'phoenix company' is restricted to companies of the same name. If the business transferred is dependent upon the preservation of the name then the issue may arise.

The only reason that a 'hive down' from the distressed company to a new company would be appropriate would be because the first company was, in some way, irretrievably tainted by some past action it undertook (e.g. failure to properly account for PAYE). A fundamental premise upon which this analysis is based is that:

- compromises only work if complete honesty, integrity and transparency prevail and;
- all known creditors must be taken into account.

The purpose of a 'hive down' is not consistent with these principles.

The term creditor is cross-referred to section 303 of the Act. The list of types of creditors set out in section 303 includes the following:

- Present liabilities.
- Future liabilities.
- Contingent liabilities.
- Damages.

Fines are excluded. All of these types of creditor can and must therefore be taken into account in the configuration of the compromise. In some cases for complex liabilities such as arise in executory contracts the value of the liability may not be clear. Determination of voting rights is dependent upon valuation. It can be inferred that section 307 of the Act applies in such determination.

3.3 Section 228: proposal

The board, a receiver or liquidator has the right to propose a compromise without reference to a Court. Shareholders and creditors only have a right to propose with leave of the Court.

It is notable that the legislature envisaged the possibility of compromise taking place in the context of liquidation. Presumably, if such a compromise was successful the liquidator would then need to apply under section 250 of the Act to terminate the liquidation.

It may be more sensible for a liquidator to employ the procedure set out in section 386D in regard to the establishment of a phoenix company. All liabilities should have crystalised and therefore the problems associated with transferring businesses from a tainted company do not arise.

3.4 Section 229: the formal requirements

3.4.1 Introduction

There are attached a series of Appendices that address the requirements of the formal compromise:

- Appendix 1: Pro forma Notice of Meeting.
- Appendix 2: Pro forma Proposal and explanatory notes.
- Appendix 3: Pro forma Information Memorandum.

The suggested templates for preparing the documentation for the compromise proposal includes a information memorandum that acts as an adjunct to explanatory notes prefacing the text of the proposal itself. Depending on the view taken of the obligation to provide information, the need for a separate information memorandum may not arise.

The first step the proponent must undertake is to compile a list of known creditors by class (see section 229(1) of the Act). It is not likely that this step should be confined to the creditors that the proponent knows about. It would apply to creditors that it is reasonable for the proponent to know about. This list must set out how much is owed to each. The proponent is entitled to estimate the amount owing to each creditor (see below at paragraph 4.2). Clearly, the estimate must be undertaken in accordance with a proper basis for determining value (see below also at paragraph 4.2).

3.4.2 Notice

Appendix 1 provides a pro forma notice of meeting. In accordance with the requirements of section 229(1)(a) of the Act this notice is to be prepared in accordance with the requirements of the 5th Schedule to the Companies Act 1993.

Notice is to be delivered to each known creditor amongst others and to the Registrar for registration. There is no need for public notice. However, it would be wise to issue public notice to ensure that there are no creditors that should have been known about but were not.

It is to be noted that the meeting is to be conducted in accordance with the 5th Schedule. There is a variation from the normal procedure for conducting meetings and that is a super-majority (75%) is needed by number and value.

3.4.3 Proposal

Appendix 2 sets out a pro-forma proposal, being the terms and the required explanatory notes. The explanatory notes are set out so as to address the formal information requirements. These are cross referred to the Information Memorandum where the more detailed information pertaining to the company and its compromise are presented. The formal information requirements are set out in section 229(2)(b) of the Act.

Each compromise is free form. The pro-forma terms of the compromise are configured to vary the rights so that debt is either deferred or abated or both. The alternative is that shares are issued in lieu of debt. There are advantages and disadvantages to both approaches which are set out below.

3.4.5 Information memorandum

Much of the formal information requirements are procedural. The matters which need consideration are:

- The reasons for the compromise.
- Foreseeable consequences for creditors.
- The interest the director has in the proposed compromise.

The format of the pro-forma information memorandum supposes that the best way to explain the reasons for the compromise are to go through the history of the company and explain the reasons for its financial distress. This approach presupposes a high degree of transparency, including presentation of financial statements and forecasts.

The foreseeable consequences for creditors are twofold:

- The rationale underpinning any compromise is that creditors will be better off if they support it than any alternative that may be possible such as liquidation.
- The creditors will, temporarily at least, will be denied rights (and obligations) that may arise in liquidation.

In closely held companies the director's main interests are:

- The business is preserved.
- They escape the potentially punitive consequences of liquidation.

It is important to note that the creditors need to understand:

- There is provision for variation. In the pro-forma terms this is achieved by passing the power to vary to a committee of creditors, subject to some safeguards.
- There is a 'cram down' capacity. That is, the will of the super-majority in each class prevails over the will of the minority.

4 Issues

4.1 Classes

Whilst there is little by way of governing statute this does not mean compromise is free of legal complication. Central to the proposal is the need to have its terms accepted by a super-majority within each class of creditors. There is no statutory guidance on what may or may not constitute a class.

This matter arose early in the history of the compromise regime. In the matter of *Sovereign Life Assurance Company v Dodd* [1892] 2 QB 573, CA a strand of law began which has caused the notion of 'class' to be read narrowly rather than broadly.

Dodd had taken out 10 year endowment policies for a value of £2,000. He borrowed £1,100 in 1887. Sovereign became insolvent and was wound up after Dodd's policies matured. Its liquidator proposed a compromise. The compromise proposal included the term that the policies would be transferred to another life company, suitably abated in their value. The compromise was put to the policy holders and agreed. Dodd did not agree.

The Court of Appeal was asked to consider two issues. First, did Dodd have a right of set-off as against the liquidators? Second, was he bound by the compromise agreement? The Court found he did have a right of set-off. This judgment contrasted with a similar case where the holder of a policy which had not vested was denied a right of set-off. The Court considered that Dodd did not have a sufficient commonality of interest with those claimants whose policies had not matured for them to form a single class.

About 110 years later a similar issue arose in *Re Hawk Insurance Co Ltd* [2001] 2 BCLC 480. In this matter the liquidators proposed a scheme of arrangement. It first needs to be appreciated that in the United Kingdom a compromise needs the sanction of the Court both before the meeting of creditors and afterwards. Hawk was involved in reinsurance. The scheme entailed paying the reinsured creditors 100% for claims they had paid, 75% for claims received but not paid and 50% for incurred but not reported claims (an estimate of likely claims). The creditors were treated as one class and returned to Court where the judge was concerned that the meeting was improperly constituted and declined to ratify it. The Court of Appeal considered the matter against the backdrop of Dodd.

The Appeal judges considered Dodd had been misinterpreted. They stated that Dodd's circumstances differed not because his claim was vested where the other policy holders' claims had not. Rather they considered his interest differed because of the element of the right of set-off. They did not accept that a liquidated sum differed in relevant respects from a claim that was not certain in value. The result of the meeting was up-held.

The ultimate principle, drawn from Dodd was that a class 'must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest'. Mere dissent from a minority does not fatally undermine the will of the majority.

It is clear therefore that complexity of valuation does not bear on class status. Class status depends on the 'counter-factual' – what would have happened in the event of liquidation fully executed. Differing rights in liquidation are the determining factor of class status. There are generally three layers of rights arising:

- Securities of one sort or another.
- Statutory preferences.
- Everybody else.

The vulnerability for the compromise manager is that there is a peculiar feature of a claim such as was true of Dodd. An example might be an interest in implied trust as well as in contract. There is no need to fear such possibilities. It is clear that if there was a material peculiar interest its owner would make evident the nature of its rights. If it is not material then it is unlikely that the composition of the classes will be evident.

Those with statutory preference have a significant source of competition with other unsecured creditors. It is quite possible that those in the preferred class might well benefit on liquidation at direct expense of all or some of the general unsecured class.

It does then beg the question as to what would happen in the event the compromise took place inside the liquidation. Presumably the preferred creditors would fall back into the general class for either there were no voidable preferences or the rights had been exercised and redistribution had taken place.

Each class of secured party will need to be dealt with separately. This will usually be a bank. There are some parties with possessory liens such as shipping companies. It is hardly worth including such people as they will have to be paid come what may.

One problem which can easily arise is what happens when one party falls into more than one class. For instance, a secured party with inadequate security may fall into more than one class. This is essentially academic as each secured party, with material security, will constitute a class of one and therefore have a power of veto. The more likely possibility is that those with statutory preference may have no preference for part of their claim. Inland Revenue (but rarely Customs) together with employees will almost always be in the preferred and general creditors classes.

A recent case, *Re Jones Publishing Limited: CIR v Grant* CIV-2009-404-7388, has considered the conduct of creditors meetings in the context of voluntary administration (VA). The point at issue was the ability of the chair to cast a deciding vote when there is a conflict between a majority of numbers and majority by value. In one sense the judgment is unfortunate.

A vote cast pitted Inland Revenue against other creditors, most of whom voted to approve the continuation of the VA. It was clear that the continuation of the VA worked against the interest of Inland Revenue in respect to its preferences arising if the 7th Schedule was applicable. In other words, there was no community of interest between the prospectively preferred creditor and those that were not. What is perplexing is that section 239AK of the Companies Act 1993 makes reference to the conduct of meetings within classes, albeit, perhaps, somewhat obliquely. Had it been recognized that if Inland Revenue had been in a class of preferred creditors the matter being contested would not have arisen. Apparently this matter was raised in submission but not dealt with in the judgment. In consequence, the judgment may have clarified some issues but left others in a state of confusion.

4.2 Determining the value of liabilities

The right to vote at meetings of creditors presupposes that the nature of any liability is known and that it can be quantified. Several problems may arise, including:

- The liability is disputed.
- The liability is of uncertain amount or timing (a provision in the language of accounting).
- The liability is subject to a set-off.
- Liabilities due to related parties.

It is likely to be the case that most liabilities are undisputed and liquidated. No problem arises.

There is no simple answer for disputed debts. Before a compromise can begin all such disputes must be resolved. Clearly this is important not merely for the purposes of voting, but also a sum due must be determined before it can be deferred and paid at a later date or otherwise substituted for another instrument.

It is proposed that because a creditor is defined by reference to Part 16 of the Companies Act (section 303), the valuation of the liability will be similarly defined. That is, in accordance with the principles set out in section 307. This is not quite as contentious as it may sound. The case law pertaining to compromises – being substantially in regard to insurers – is replete with exercises of this nature. For example, one of the points at issue in Hawk was the treatment of IBNR. In the scheme of arrangement IBNR liabilities would only qualify for 50% of the quantified sum. That must mean a complex actuarial calculation was accepted as a precursor to settling the sum to be honoured. Such liabilities include executory contracts and claims in tort or under statute (e.g. taxation). They will include financial arrangements such as FX contracts (or, less likely, interest rate swaps), contracts of guarantee, leases, warranties and other contracts of extended duration (e.g. construction contracts).

Section 307 is not sufficiently detailed so as to provide a guide to how to carry out the process of estimation. There is, however, legally binding prescription in financial reporting law which provides a compelling basis for liability determination. In both 'old' generally accepted accounting practice (GAAP) and 'new' GAAP there are binding standards that address the matter. These are FRS-15 *Provisions, Contingent Liabilities and Contingent Assets* and NZIAS 37 with the same title and, so far as it is applicable, NZIAS 39 *Financial Instruments: Recognition and Measurement* (soon to be superseded by NZIFRS 9) For most purposes these standards are virtually identical. Both prescribe detailed measures for determining provisions. These methods, it is suggested, have application in determining quantum. Unfortunately, both depend upon complex actuarial calculations. Clearly, the creditor will have to be persuaded to accept the valuation process for otherwise litigation may ensue.

In respect to set-off common sense would suggest that the valuation of a liability would be the net of sums owed and sums due. This cannot depend upon application of section 310 of the Companies Act 1993 because it specifically does not apply. The various stands of contractual, common law or equity will have to govern the determination of a net position if any. This might seem simple at first sight, but it needs to be recalled that the Dodd matter was really about rights of set-off. This case is a landmark as it changed the law in the 19th century because up until Dodd it had been thought that no right of set-off existed. Earlier case law had allowed no right of set-off where both sides of the set off were not liquidated. In Dodd's case they were so the set off was allowed.

A question perennially arises in regard to the status of sums due to related parties. The classic example of such sums due would be sums to the credit of a shareholder current account or to companies controlled by the shareholder. The first question to be considered is whether such sums are, in fact, liabilities. There is an argument that such sums in 'thinly capitalised' companies are not liabilities but equity. If that argument was valid, the shareholder would not be a creditor and would, therefore, have no vote. Ultimately, as insolvency management presupposes that the interests of creditors are paramount consideration should be given to refraining from voting even if the current account is validly regarded as a liability.

4.3 Advantages and disadvantages of compromise

To a substantial degree the advantages of compromise have already been addressed. The principal advantage is that the process is relatively simple, though this may be more apparent than real. It is certainly an advantage that ratification by the Court is not necessary. However, if there is anything contentious it may be advisable to seek approval in accordance with sections 232 or 236 of the Companies Act 1993 as appropriate.

There are two potential disadvantages of compromise:

- There is no ability to stay proceedings.
- There is no obligation to undertake investigation.

In contrast to sub-part 9 of Part 15A of the Companies Act 1993 (Voluntary Administration), there is no ability for actions of creditors, secured or otherwise, to be stayed. This difficulty is more apparent than real. Compromise only works at a practical level if all parties, particularly the Crown and a company's banker, see the scheme to be in their interest (see below paragraph 5.3 below).

A more fundamental disadvantage is that the compromise regime does not impose an obligation to investigate breaches of various business law statutes. This contrasts with sections 239AI and 258A of the Act which impose an obligation on administrators and liquidators to report misconduct.

Some may see this last point as an advantage. It is instructive, perhaps, that a number of high profile property developers have sought refuge in the Insolvency Act equivalent of a compromise. The comments made by the Court of Appeal in *Property Ventures Investments Limited and others v CIR* CA234/2010 [2010] NZCA 217 are illuminating in this regard. PVIL is a subsidiary of a company controlled by David Henderson (Christchurch) which sought a compromise over the objection of the Commissioner. The Court said:

> We consider that there is a strong public interest in having an independent inquiry into the affairs of the applicant companies, sooner rather than later.

The final dimension that may be an advantage or disadvantage depending upon your point of view is that a company's problems become known the moment the compromise proposal is initiated. Inevitably the company will be forced onto a 'cash on delivery' basis for all or most of its supply at the very moment it is least able to gain access to liquidity.

4.4 Professional responsibility

The position of the professional facilitating a compromise needs to be considered with great care. There are two issues:

- The nature of professional obligation.
- The role of the professional and the possibility of litigation.

It is clear that SES-1 *Insolvency Engagements* issued by the New Zealand Institute of Chartered Accountants applies. A number of issues arise in that context. Many of these are the same as for any other insolvency. SES-1 distinguishes between formal and informal insolvency. Whilst it does not specifically say so a professional facilitating a compromise is almost certainly engaging in informal insolvency practice. In that event a letter of engagement is necessary.

Appendices 4 and 5 are suggested texts to establish the terms of the relationship between the board and the professional.

Another concern which might arise is in the event the compromise fails and the company is liquidated. Directors, when engaging a professional, are likely to rely on the advice given even to the point of potentially being seen to act in accordance with the directions given. With the advent of *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* [2010] NSWSC 233 the risk of being held accountable as some form of informal director would appear to be much diminished. Provided the professional facilitator confines themselves to insisting on proper corporate governance and transparency (see in particular the format of the Information Memorandum at Appendix 3).

One of the primary suggestions made in the configuration of a compromise made in this paper is that there is established a committee of creditors. The risk posed to such people of being held subsequently accountable as directors in the event of failure must be present. The professional facilitator would be remiss in his or her duty if this possibility was not drawn to their attention.

5 Practical steps for implementation of a compromise

5.1 Step 1: acceptance of the problem

The board of a company must identify as early as is possible that a company is insolvent or in danger of becoming so.

It is still possible for a compromise to work even if a company is already insolvent. All creditors are generally better off getting one cent in the dollar rather than nil. However, it is self-evident that the more the prospective loss the less inclined creditors will be to support the compromise.

5.2 Step 2: preliminary steps

At the point the board resolves to attempt compromise it will be necessary to begin to accumulate some cash to bridge the gap between when the company notifies its creditors that there is a problem and when the compromise is in place.

> To do this may be legally dubious and the professional advisor needs to be very careful in advising on such matters. At the very least the advisor should tell the director / shareholders of closely held companies that they will need to curb their lifestyles and accumulate cash so far as they are able. In some cases

the individuals are in financial difficulties themselves and there may need to be consideration to a proposal under the Insolvency Act to run contemporaneously. This adds significant complication.

5.3 Step 3: approaching creditors

5.3.1 Introduction

This is the crucial step. It is necessary for the key creditors to be approached on an informal but coordinated basis before any formality attaches to the compromise. That means creditors need to be classified into types for this process to begin. Typically, and in order of importance, creditors fall into the following groups:

- The bank.
- The Crown.
- The landlord.
- The major continuing suppliers.
- The staff.
- Utility companies.
- Everybody else.

5.3.2 The bank

There are three characteristics of the relationship a bank invariably has with its closely held client:

- It will be as aware of financial difficulties as its client.
- It will have various forms of security over virtually all of the assets of the company.
- It will have a personal guarantee from the director / shareholder.

Not least because it will be in a voting class of its own, at least to the extent the assets subject security are material and have value, the bank will hold a power of veto over the compromise. There will be some reluctance to participate if the bank is seen to write down the indebtedness if this is necessary. Such transparency is necessary if the level of transparency suggested in Appendix 3 is to apply.

The bank will need considerable persuasion before it will support a compromise. For what it is worth the Law Commission in its 2001 study cited a paper delivered by Derek Williams of the Bank of New Zealand[1]. He said:

> A secured creditor would be influenced by:
>
> - The nature of the relationship with the debtor and the professional advisors;
> - Whether the "problem" which created the insolvency would continue to exist if the compromise was implemented;
> - Whether the secured position would be weakened or disadvantaged by consent; and
> - Whether reckless trading or fraud was involved, this being a factor which would weigh against acceptance.
>
> Mr Williams emphasised that each proposal was considered on its own merits but that if there was to be agreement by a secured creditor there would normally be:
>
> - A full reservation of rights should there be default;
> - A requirement of full financial disclosure, including budgetary information, for the compromise; and
> - Confirmation of what was required from the bank in terms of the compromise.
>
> The bank would also want to know what fiscal position was being taken by the shareholders or directors of the company in relation to the compromise; for example, was any money being injected to pay creditors?

There is no reason to believe that these principles would not still apply. In fact, given the present economic circumstances, and the exposure the banks have to the economy, the bankers may be more inclined to support a compromise than they were when Derek Williams was writing 10 years ago. The banks know (as perhaps they didn't in 1990) that the failure of one company can have a knock on effect on other companies some of which will be their customers.

The real problem is that, practically, the compromise might need to be fully designed before the bank is approached. That could put the professional advisor in an awkward position as he or she will have to undertake the bulk of their work before

[1] These were Derek Williams own views and NOT those of the Bank of New Zealand.

the outcome of the compromise is known (see last bullet point above). To avoid this and the need to apply Step 2, discussions with the bank will need to be iterative.

Ultimately, compromises only work if the directors are wholly transparent. There is little point the director throwing him or herself on the mercy of the bank if the approach is not made on a full and frank basis. Even if there has been dubious behavior, as is the case in a substantial proportion of New Zealand closely held companies, being straightforward will work in the customer's favour.

5.3.3 The Crown

The Crown, technically, only encompasses ministries and departments but it is convenient to discuss other agencies associated with the Crown. Each agency will have its own imperatives and these need to be taken into account. By far the most important agency to consider is Inland Revenue followed by New Zealand Customs Service. Other agencies with regulatory powers will also need to be considered. Then there are entities such as ACC which behaves in some respects in much the same way as a utility.

Inland Revenue

Inland Revenue has a clearly defined rehabilitation regime set out in Part 11 of the Tax Administration Act 1994 (TAA). The regime is quite complicated in that it enables a natural person to apply for hardship relief (section 177 of the TAA). A notion of a natural person is extended to encompass closely held companies as defined (see section YA1 of the Income Tax Act 2007). Essentially the natural person hardship relief provisions are an extension of the 'care and management' provisions set out in section 6A of the TAA. These provisions oblige the Commissioner to maximize recovery across time and to maintain the integrity of the tax base. As these two notions can be in tension with one another, section 6A can mean what anybody wants it to mean. However, it does establish a foundation for Inland Revenue to operate within a rehabilitation regime such as compromise.

Ironically Inland Revenue is often approached on the basis of section 6A and its derivatives to undertake a bilateral arrangement. Frequently, this means that the Inland Revenue is expected to be the only creditor to write-off debt. The compromise regime is more benign from the perspective of the Commissioner as it causes all creditors to share the burden of loss.

Inland Revenue will apply similar reasoning as that set out by Derek Williams. Inland Revenue will consider that a company who has failed to account for substantial amounts of PAYE, for instance, may not be a person worthy of support as this may undermine the integrity of the tax system. On the other hand, Inland Revenue can be persuaded to support a reasonably honest company that has fallen on hard times even though to do so may be to surrender inchoate rights which arise on liquidation. Inland Revenue can be persuaded to recognize that the voidable preference provisions might give a short term gain but may endanger persons from whom moneys are to be clawed back. That might be seen to offend against the principle of maximizing the tax take across time.

Ultimately, it needs to be understood that Inland Revenue is in an awkward position. It cannot sanction flagrant illegality, but equally it cannot be seen to willfully destroy business that might otherwise have survived. As with banks an approach earlier rather than later is more likely to succeed.

Customs

By way of contrast Customs is not subject to a similar rule as set out in section 6A of the TAA. It is responsible for collection of import duty (including GST and, incidentally, additional duty). Duty arising under the tariff has become much less important than it once was. Further, Customs has powers of recovery beyond those available to Inland Revenue. Goods upon which duty has not been paid belong to Customs before anybody else.

Customs exposure as an involuntary creditor arises primarily in regard to excise. Tariff duty has become less significant over the years.

The Customs and Excise Act 1996 does not provide for extending payment terms to domestic manufacturers beyond the usual time limits. The settlement obligations are set out in Regulation 57 of the Customs and Excise Regulations 1996. Licensees are required to settle their debts 15 days after the last day of the month in which the goods were removed for home consumption. The settlement regime for duty arising on importation is similar. Neither the Regulations nor the Act make provision for any accommodation outside of this.

Customs is not legally prevented from agreeing instalment arrangements or agreeing some other concession to those who are in default. However, market equity has tended to influence Customs not to offer terms. This is because excise by its nature is an intervention in a narrow market segment (eg alcohol) and if Customs allows an "unsuccessful" entity terms that its competitor does not get, it has arguably gained an unfair advantage.

Customs has now taken the view that it should have regard to the compromise regime in the Companies Act. That is in the right circumstances, Customs is obliged to assist companies to which the compromise regime is applicable, in the same way as it would be in the application of voluntary administration for large companies.

Customs also recognizes that it is important that a wider view is taken of the notion of market equity. It may be more detrimental to a given market segment if Customs were to enforce liquidation without thought. This is because disposing of product at fire sale prices into a saturated market might be more damaging than taking a more lenient view of collection. The difficulty is that Customs does not have a legal framework to implement installment arrangements. Because of this Customs is keen for a formal but benign form of insolvency administration to be applied. The theory being that compromise is the will of the legislature and is, therefore, supplemental to the Customs and Excise Act 1996. To this end Customs has promoted compromise as its desired approach and has sought and obtained government support to this effect.

As with banks and Inland Revenue, Customs will expect companies seeking rehabilitation to have been reasonably honest in its dealings with the Crown and others.

Other agencies

Other Crown agencies need to be accommodated. For instance, there is little point subjecting an organization such as Ministry of Agriculture and Forestry to a compromise in respect to relatively small sums without any discussion with them. Frequently, the compromise candidate may be subject to a licensing regime without which it has no business.

5.3.4 Major suppliers

It is likely that at the point the 'music stops' the most substantial trade creditors will be those persons who have a continuing relationship with the company in difficulties. Those people have an incentive to support a compromise as not only do they have the usual incentives to maximize their return, they also have the lure of continuing business.

At the risk of appearing cynical it is the major suppliers who must be persuaded to support the compromise. As they will constitute the vast proportion of the general unsecured class of creditors, they will have the voting power to impose the compromise on a potentially dissentient minority. Those suppliers who have do not have a recurring relationship do not have the same set of incentives.

However, it is to borne in mind that compromise only works, realistically, by persuasion. For most small companies the burden of facing a Court challenge will almost certainly crush the compromise under the weight of dispute.

5.3.5 The staff

The staff will generally have the same set of incentives as applies to recurring suppliers and should vote the same way. The advantage in persuading staff is that, in some measure, they will be represented in the preferred class. Consequently, they will off-set a disgruntled Crown, not only because they will vote in the same class. The Crown is not likely to vote in such a way as to cause loss of jobs.

5.3.6 Utilities

It is never going to be practical to elicit support from companies with large customer bases such as electricity or telephone companies. The compromise regime makes no provision for forcing continuity of supply. If support cannot be gained then the compromise proponent has two choices – change suppliers or, if that is not possible, seek approval from the compromise meetings to pay the utility.

5.3.7 All other unsecured creditors

General creditors need to be persuaded to the extent that a majority is needed by value and numbers.

6 Step 4: design the compromise

This step probably needs to be sketched very early in the process (see Derek Williams' comments above). The design of the compromise can be done in one of three ways:

- Either, by a rescheduling of the debt to a future date at a reduced amount;
- Or, by an issue of equity of some sort.
- Or, a combination of the above.

If debt is to be rescheduled then it is essential that a properly prepared forecast is prepared that shows when the debt is to be repaid. This can be very burdensome as in the current economic climate it can be difficult to foresee the future. Most creditors will not accept that the debt they are due will be stated to be payable at some amount and time which cannot be determined – after all debt generally encompasses certainty of amount and settlement date.

A further problem is that in making forecasts creditors may expect there to be variance reporting. This may also prove burdensome if required to be done too frequently.

The solution to the problem is that the compromise proposal must have built into it a mechanism for variation without incurring the cost of a full meeting procedure. This is the primary purpose of the committee of creditors. The power to vary must be put into its hands, subject to certain safeguards.

It may also be advisable that a signed but undated resolution to put a company into liquidation is held by the committee of creditors so that the company in distress can be easily liquidated if the compromise terms cannot be met.

The alternative to rescheduling debt is to convert the debt to equity. This approach has a number of significant advantages. For example, it is not quite as critical to carry out forecasting to determine when creditors are to be repaid. The disadvantage is that there is no tradition in New Zealand of outside parties holding equity interests in small companies. Many creditors will balk at the suggestion, most particularly the Crown and the bank.

The Crown will claim that it has no statutory power to accept shares in lieu of debt. The primary impediment will be the Public Finance Act 1989. However, the Minister of Finance will generally have the residual power to over-ride any prohibitions.

Banks also will have great difficulty with accepting shares. Their financial reporting obligations will cause significant difficulty, particularly if the shares issued constitute a controlling stake.

There will be a significant burden placed on the company to carry out proper secretarial practice not only in the maintenance of share registers but also other important registers such as the interests register.

Until such time as the issue of shares in lieu of debt becomes routine this approach to compromise will be difficult to sell. It might, therefore, be expedient to have a mix of debt and shares. But that approach suffers from both of the sets of disadvantages set out above.

Some consideration will need to be given to what happens in regard to taxation when a company is subject to compromise. For example, there may be a tax implication in terms of debt forgiveness. This should not be a problem if the company has brought forward losses. However, if those losses have been ceded elsewhere (e.g. by group relief or to the shareholders) then there may be a windfall gain giving rise to an income tax liability. Clearly, if that happens most compromises will be impractical. Inland Revenue, it is understood, is currently working on policy in this regard.

Tax advice may need to be taken particularly if the scheme proposes to swap debt for equity.

7 Implement

As the compromise only practically works if it is pre-arranged the formal implementation should only be a formality in colloquial sense. Speed is of the essence and, therefore, planning is critical.

Short bibliography

Source material includes:

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