Dealing with COVID-19 Liquidity Issues: Insolvency Relief for Business Owners

In this note, we look at the Government's proposals to help businesses remain viable, and encourage continued trading between businesses, notwithstanding the prospect of insolvency due to COVID-19.

In an endeavour to cushion the economic impact for New Zealand by supporting businesses and thus protecting jobs and incomes, it is proposed to make some temporary amendments to the Companies Act 1993. These will focus principally on the insolvent trading restrictions and create what the Government has labelled a "business debt hibernation scheme".

According to the Government's media release, the package of temporary changes includes:

- giving directors of companies facing significant liquidity problems because of COVID-19 a 'safe harbour' from insolvency-related duties under the Companies Act;
- enabling businesses affected by COVID-19 to place existing debts into hibernation until they are able to start trading normally again;
- allowing the use of electronic signatures where necessary due to COVID-19 restrictions;
- giving the Registrar of Companies the power to temporarily extend deadlines imposed on companies, incorporated societies, charitable trusts and other entities under legislation; and
- giving temporary relief for entities that are unable to comply with requirements in their constitutions or rules because of COVID-19.

We focus here on the first two key measures, the last three being of more mechanical practical significance.

The insolvent trading "safe harbour" for company directors

If Parliament votes to enact the requisite amendments, directors of companies facing COVID-19 liquidity issues will have a safe harbour from legal liability for breach of sections 135 and 136 of the Companies Act 1993, for a finite period. Presumably the definition of such a company will track or be similar to that used for the purposes of the COVID-19 business wage subsidy.

Section 135 is the provision well-known for prohibiting directors from allowing reckless, or insolvent, trading. A director of a company must not:

1. agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
2. cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

Section 136 backs this up by prohibiting a director from incurring an obligation unless he or she believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.
In other words, the normal rules are that directors must not allow the company to trade in a way that sees creditors facing a high degree of financial risk and must not allow the company to incur obligations it is not reasonably going to be able to meet. Together, these mean keeping a very close eye on revenue and expenditure forecasts and cashflows, obligations and liabilities being incurred and the wider business and economic environment around them.

Directors are personally liable for any breach of these, and other, directors' duties. That breach is actionable by shareholders, including through representative or derivative actions, and in due course by any liquidator.

The Government's proposal (to be backdated to the 3 April announcement date) is that directors' decisions to keep on trading, as well as decisions to take on new obligations, over the next 6 months, will not result in a breach of these duties if:

1. in the good faith 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 COVID-19 on them or their creditors;
2. the company was able to pay its debts as they fell due on 31 December 2019; and
3. the directors consider in good faith that it is more likely than not that the company will be able to pay its debts as they fall due within 18 months (for example, because trading conditions are likely to improve or they are likely to able to reach an accommodation with their creditors).

Whilst the first limb above might be easy enough to satisfy (provided there is good communication with creditors), and the second is basically factual, satisfying the third could be a tall order involving a degree of crystal ball gazing. However, all directors have to do is form a good faith view, which means look around, inform

themselves in industry terms and across the supply chain and talk to creditors. And it only has to be “more likely than not”.

It seems that the temporary safe harbour proposal will only apply to directors of companies, and not those running businesses through some other form of legal entity or as sole traders which may involve direct personal liability to unsatisfied creditors.

COVID-19 business debt hibernation regime

The Companies Act amendments will also add a special, temporary, COVID-19 “business debt hibernation” regime to the Companies Act 1993. It will in fact apply more widely than solely to companies, covering also other forms of legal entity such as trusts and partnerships (but excluding sole traders).

The detail is yet to be seen, though it appears to envisage some sort of majority creditor-sanctioned moratorium on debts, binding on all creditors of the business other than employees. It will encourage early discussion with creditors, allow directors to keep trading and provide new creditors certainty that any payments made to them will not be subject to clawback under the voidable transaction rules – very necessary otherwise the business could be starved of necessary inputs.

The key features of the proposal are that:

- directors will have to meet a threshold before being able to access the business debt hibernation regime and putting a proposal to their creditors - presumably this is referring to a total debts or reduced revenues threshold rather than some turnover threshold, but could also include a requirement that there be a reasonable prospect of the resumption of normal trading;
- creditors will have a month from the date of notification of the proposal to vote on it, with the proposal going ahead if 50% (by number and value) agree and subject to any conditions of their agreement – it seems this does not rule out an earlier approval, which could well need to be engineered given the immediacy of some of the likely COVID-19 liquidity issues; and
- there will be a one month moratorium on the enforcement of debts from the date the proposal is notified and a further 6 month moratorium if the proposal is passed.

The core structure of the proposal seems to encourage agreement amongst creditors for the mutual benefit of all. Although conditions can be imposed, by definition they will need to be reasonable in the circumstances and not risk quashing the whole proposal, potentially forcing the business over the edge.

If creditors reject the proposal, the directors would still have the range of existing options available including trading on, entering voluntary administration and appointing a liquidator.

We will need to see what safeguards are included in order to avoid the business debt hibernation regime simply being used as a means of buying time in a way

much less dramatic than a voluntary administration – admittedly only a month but in some cases that could just be enough to stave off more permanent insolvency action. The 50% creditor approval threshold, and likely consequences of non-approval, may suffice to deal with the scope for misuse.

The business debt hibernation process is meant to be so simple that legal advice is not required before directors invoke it… quite how likely this is will depend on the complexity of the overall situation, the nature of banks' and creditors' contractual rights and the array of alternatives.

In order to encourage businesses to continue to transact with a company that has entered business debt hibernation, it is proposed that any further payments or dispositions of property, made by the company to third party creditors (but not related parties), would be exempt from the voidable transactions regime. That regime puts at risk certain "non-ordinary course" payments received by a creditor of a company that becomes insolvent at any time in the ensuing two years.

But this is no free pass: the transaction with the business in debt hibernation will need to have been entered into in good faith by both parties, on arm's length terms and without the intent to deprive the existing creditors of the company.

Those trading with the company will therefore not have to worry about a liquidator seeking to unwind transactions if the company is later placed into liquidation.

As a separate matter, the voidable transactions regime will be amended as well regardless of a business being in debt hibernation, by reducing the two year clawback window for voidable transactions to a mere 6 months, which is a much more workable period.

The proposed six month time period for these temporary amendments may well be too short but it can be expected there will be provision for that timeframe to be extended by the Minister or by Order in Council.

Other core director duties remain

Whatever a company does with the benefit of these two sets of protection, the directors still have the core duty at the end of the day to act in the best interests of the company, which means the best interests of all shareholders and indirectly other stakeholders. As always, or perhaps more than ever, this remains a difficult juggling act.

For more advice, please contact any Greenwood Roche partner or your usual Greenwood Roche lawyer.