Insolvency in the COVID-19 crisis: Voidable transactions and Reckless Trading

The COVID-19 pandemic crisis has already seen, and will continue to see, widespread ramifications on business and the economy in New Zealand and across the world. Increased insolvency is likely to be a consequence of the COVID-related restrictions in New Zealand. Key considerations for businesses in this context are dealings with debtors and any "voidable transactions" that may result in money received being clawed back by a liquidator; as well as Directors' liability in terms of insolvency duties. This Guidance Note considers Voidable Transactions and Directors' Insolvency Duties in the COVID-19 crisis. It has been written by the LexisNexis team with excerpted commentary from Richard Gordon, Nigel Smith, Rodney Craig, Andrew Ryan and Lauren Archer, MinterEllisonRuddWatts.

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Voidable Transactions

A liquidator has a statutory power to undo certain transactions carried out by the company in the period prior to the liquidation. This ensures that the distribution of assets can be carried out in the fairest manner to all creditors, by putting creditors in an equal position, and by maximising the assets available for distribution.

See also:
Business Law: Liquidation
Business Law: Receiverships

Insolvent transactions

A transaction made by a company within two years of the commencement of the company's liquidation may be voidable if it can be shown that the transaction was an "insolvent transaction".

References:
Companies Act 1993, s 292

What constitutes a transaction?

The types of transactions that may be challenged by a liquidator as an insolvent transaction are:

- conveying or transferring the company's property;
- creating a charge over the company's property;
- incurring an obligation;
- undergoing an execution process;
- paying money (including paying money in accordance with a judgment or an order of a Court); or
- anything done or omitted to be done for the purpose of entering into the transaction or giving effect to it.

References:
Companies Act 1993, s 292(3)

In practical terms, the definition of "transaction" is broad and covers most actions that a company is likely to undertake.

A payment is not an insolvent transaction where it is made by another party pursuant to their own obligations owed to the creditor. A key question is whether the funds would otherwise have been available to the company to pay general creditors.

References:
Ebert Construction Ltd v Sanson & Anor [2017] NZCA 239

A transaction can include a transaction entered into by a receiver of the company, unless it is a transaction that discharges, whether in full or in part, a personal liability of the receiver.

References:
Companies Act 1993, s 292(4)

When is a transaction an insolvent transaction?

An insolvent transaction is a transaction made by a company that:

- is entered into at a time when the company is unable to pay its due debts; and
- enables another person to receive more towards satisfaction of a debt owed by the company than that person would receive, or be likely to receive, in the company's liquidation (that is, the transaction must have a preferential effect).

References:
Companies Act 1993, s 292(2)

See other LexisNexis commentary:

Insolvent Transactions
Insolvency Act/Companies Act crossover

When is a company insolvent?

For a transaction to be set aside, it must have been made at a time when the company was insolvent. A company is considered "insolvent" if it is "unable to pay its due debts".

The ability of a company to pay its "due debts" is to be assessed objectively, taking a "practical business perspective". "Debt" includes both present and contingent debts. "Due" means "reasonably temporally proximate".

References:
Companies Act, s 292(2)(a)
David Browne Contractors Ltd v Petterson (as liquidator of Polyethylene Pipe Systems Ltd (in liq)) [2017] NZSC 116

Restricted period

If a transaction is entered into within the "restricted period" it is presumed to have occurred at a time when the company is unable to pay its debts.

The "restricted period" is:

- the period from six months before the date of commencement of the liquidation until the time of the liquidator's appointment; or

- in the case of a company put into liquidation by the Court, the period from six months before the making of the application to put the company into liquidation until the time the Court order was made.

The restricted period presumption is rebuttable, with the burden of rebutting on the person defending the liquidator's challenge to the transaction.

References:
Companies Act 1993, s 292(4A)
Companies Act 1993, s 292(6)

See other LexisNexis commentary:
Introduction to insolvent transactions — overview
What is a "transaction"?

Solvency test

If a transaction is entered into outside the restricted period, or if evidence is raised that rebuts the restricted period presumption, it will be necessary to determine the company's solvency by assessing whether the company was able to pay its due debts at the time the transaction was made.

When will a transaction have a preferential effect?

For a transaction to be set aside, it must have enabled a creditor to receive more towards satisfaction of the debt owed by the company than they would have received in the liquidation. This is commonly known as a "preferential effect".

Preferential effect

To establish that the transaction had a preferential effect, all the liquidator must show is that the creditor received a greater payment than he or she would otherwise have received in the liquidation.

It is no longer necessary to show that the general body of creditors has been disadvantaged as a result of the transaction.

The degree of any preference is to be measured against what the creditor would receive in the actual liquidation.

Preferential effect is to be measured objectively. Whether the company had any intention to give a preferential effect is irrelevant.

References:
Companies Act 1993, s 292(2)(b)
Levin v Market Square Trust [2007] 3 NZLR 591
Tyree Power Construction Ltd v D S Edmonds Electrical Ltd (in liquidation) [1994] 2 NZLR 268

Creditor-debtor relationship

The Courts have held that the preference gained must have been by a person in a creditor-debtor relationship with the company and must have been received in their capacity as a creditor.

References:
Gray v Chilton St James School CA107/96, 12 December 1996, BC9661731

This is because the preferential effect, as discussed above, is measured against what the person would have otherwise received in the liquidation. Only creditors of the company would receive any payment during the liquidation. As such, the provisions do not apply to other creditors.

Continuing business relationship exception

There is an exception under the insolvent transaction regime for transactions which took place as part of a "continuing business relationship".

This is commonly referred to as the "running account" exception, and provides for all transactions between a creditor and the insolvent company to be treated as a single transaction in circumstances where:

- a transaction is, for commercial purposes, an integral part of a continuing business relationship between the company and the creditor; and
- in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions.

In that case, the single transaction (being all of the "running account" transactions grouped together) can only be set aside as an insolvent transaction if it was voidable.

The effect of this exception is that a transaction which might on its face be considered voidable may be allowable because of its role in the continuing business relationship between the company and the creditor.

The "continuing business relationship" test was adopted from the equivalent Australian legislation and replaced the former exception for transactions made "in the ordinary course of business."

(Transactions completed prior to 1 November 2007 will still be subject to the ordinary course of business exception.)

References:
Companies Act 1993, s 292(4B)

See other LexisNexis commentary:
Voidable transactions: Ordinary Course of Business

Voidable charges

A charge over the company's property, or an undertaking given by the company, is voidable if:

- it was given within two years of the commencement of the company's liquidation; and
- immediately after it was given, the company was unable to pay its due debts.

References:
Companies Act 1993, s 293

Note that the solvency requirement is slightly different to that for voidable transactions. For a transaction to be voidable under *s 292*, the company must have been unable to pay its due debts at the time the transaction took place. For a charge to be voidable under *s 293*, it is enough that the company's inability to pay debts arose immediately after the charge was given.

Exceptions

The following types of charge are exempted from this rule:

- Charges given in substitution for an existing charge, where the existing charge was given before the specified period.

- Charges that secure:
  - money actually advanced or paid at that time or any time after the giving of the charge;
  - the actual price or value of property sold or supplied to the company; or
  - any other valuable consideration given in good faith by the grantee of the charge at the time of, or at any time after, the giving of the charge.
- Charges that secure the unpaid purchase price of property, whether or not the charge is given over that property, if the instrument creating the charge is executed not later than 30 days after the sale of the property (or, in the case of the sale of an estate or interest in land, not later than 30 days after the final settlement of the sale).

References:

Companies Act 1993, s 293(1A)(a)
Companies Act 1993, s 293(1A)(b)
Companies Act 1993, s 293(4)

Restricted period

If a charge is given by the company within the "restricted period" it is presumed to have been unable to pay its due debts immediately after giving the charge. The "restricted period" is:

- the period of six months before the date of commencement of the liquidation until the time of the liquidator's appointment; or
- in the case of a company put into liquidation by the Court, the period of six months before the making of the application to put the company into liquidation until the time the Court order was made.

As with voidable transactions, the restricted period presumption is rebuttable, with the onus of rebutting the presumption on the person defending the liquidator's challenge to the validity of the charge.

Solvency test

Also, as with voidable transactions, if a charge is given outside the restricted period, or if evidence is raised that rebuts the restricted period presumption, it will be necessary to determine the company's solvency by assessing whether the company was able to pay its due debts immediately after the charge was given.

References:
Companies Act 1993, s 293(2)

See other LexisNexis commentary:
Voidable charges
Definition of "charge", "property" and "undertaking" by the company
Effect of insolvent transactions
Who receives the benefit of recoveries by the liquidator?

See also:
Procedure for setting aside an insolvent transaction or voidable charge

Directors' liability for "reckless trading"

General duties

Generally, under s 135 of the Companies Act 1993, directors have a duty not to agree to, 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. A breach of this duty is commonly referred to as "reckless trading".

This is a positive duty on directors designed to protect creditors and to encourage directors not to act recklessly so as to exacerbate the indebtedness of the company if it encounters financial difficulty. Whether or not there has been reckless trading is an objective test and a director need not have acted knowingly to be in contravention of this duty.

There is also a duty within s 136 of the Companies Act 1993 not to agree to the company incurring an obligation unless the director believes, at that time, on reasonable grounds that the company will be able to perform the obligation when it is required to do so. The rationale for this duty is the same as above, but with a focus on commitment to individual transactions rather than director's the overall conduct.

Under the Act, a Court can hold a director personally liable to any creditors of the company who have suffered a loss as a result of a director breaching its duties under the Act.

References:
Companies Act 1993, s 135
Companies Act 1993, s 136
Companies Act, s 301
Mason v Lewis [2006] 3 NZLR 225

See also:
Directors' duties and obligations

COVID-19 exemptions

Following a similar temporary legislative change in Australia, the New Zealand Government has passed the COVID-19 Response (Further Management Measures) Legislation Act, which makes changes to the Companies Act 1993, temporarily exempting directors from insolvency duties, to minimise business disruption during the pandemic crisis.

The temporary changes include:

- giving directors of companies facing significant liquidity problems because of COVID-19 a 'safe harbour' from insolvency duties under the Companies Act;
- enabling businesses affected by COVID-19 to place existing debts into hibernation until they can 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.

Other protections in the Companies Act 1993, such as those addressing serious breaches of Directors' duties to act in good faith and punishing those who dishonestly incur debts, will remain in place.

The Ministry of Business, Innovation and Employment advises the following with regards to these proposed changes:

Safe harbour

Under the temporary changes, directors' will be given a "safe harbour" from their duties under ss 135 and 136 of the Companies Act 1993 as follows:

Directors' decisions to keep on trading, as well as decisions to take on new obligations, over the coming six months will not result in a breach of 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 six months as a result of the impact of the COVID-19 pandemic 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).

Business Debt Hibernation

The Business Debt Hibernation (BDH) regime is intended to:

- encourage directors to confer with their creditors with a view to putting together a simple proposal for putting the business into hibernation;
- allow for the directors to retain control of the company, rather than passing control to an insolvency practitioner;
- provide certainty to new creditors that they won't have to repay any money they receive, to encourage continued transactions with businesses in BDH;
- be simple and flexible so that it can be enacted quickly without businesses necessarily needing to obtain legal advice.

The Companies Office lists the key features of the regime as follows:

- A business may enter into Business Debt Hibernation if, as at 31 December 2019, it was able to pay its debts and, if at least 80 per cent of the directors (or equivalent) agree that it may do so.
- To enter Business Debt Hibernation an entity must submit an entry notice to the Registrar. The board (or equivalent) of the entity must then send to each known creditor a copy of the notice and proposed arrangement between the entity and its creditors, along with any other information.
- Business Debt Hibernation will cease after one month unless the creditors vote to approve the arrangement, and the entity submits the decision notice to the Registrar. Approval requires a majority in number and value of creditors voting in favour of the proposed arrangement.
- The entity is required to submit the decision notice regardless of the result of the vote.
- If the arrangement is approved, the Business Debt Hibernation continues to apply until the expiry of the six-month period, which starts on the date of the approval.
- An entity can enter into Business Debt Hibernation only once.
- During the period of Business Debt Hibernation, a business cannot be placed into liquidation.

Business Debt Hibernation will be binding on all creditors other than the entity's employees and will be subject to any conditions agreed with creditors. If the creditors reject the proposal, the directors will still have the range of existing options available including trading on, entering voluntary administration and appointing a liquidator.

While a business is in BDH it will be able to continue to trade, subject to any restrictions agreed with creditors as a condition of entering into it.

In order to encourage businesses to continue to transact with a company that has entered BDH, any further payments, or dispositions of property, made by the company to third party creditors will be exempt from the voidable transactions regime. This exemption would not extend to related parties.

Application of these changes

The COVID-19 Business Debt Hibernation regime enables companies and other business entities affected by the pandemic to place existing debts into hibernation for up to seven months.

Business Debt Hibernation is available to all forms of entity with legal personality as well as entities that do not have legal personality (i.e. trusts and partnerships).

It will not, however, extend to licensed insurers, registered banks and non-bank deposit takers, and sole traders. Sole traders who become insolvent are instead subject to the Insolvency Act 2006 (which covers personal insolvency) because there is no separation between the trader's business finances and their personal finances.

For more information on these and further COVID-19 legislative changes, see:
Companies Office: Law changes to help businesses through COVID-19
Companies Office: Business Debt Hibernation
Companies Office: 'Safe harbour' for company directors
Business.govt.nz: Business Debt Hibernation

Other COVID-19 Business Support Measures

To support businesses facing the threat of insolvency, the Government has announced a range of support packages, including:

- The Wage Subsidy and Leave Schemes;
- The Business Finance Guarantee Scheme;
- Business cash flow and tax measures;
- The Small Business Cashflow Loan Scheme; and
- Support for Māori communities and businesses

For further information on this scheme, see also:
Business.govt.nz: Business finance guarantee scheme
Unite against COVID-19: COVID-19 financial support tool
Unite against COVID-19: Financial support for businesses