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VOLUNTARY ADMINISTRATION AS AN ALTERNATIVE TO LIQUIDATION

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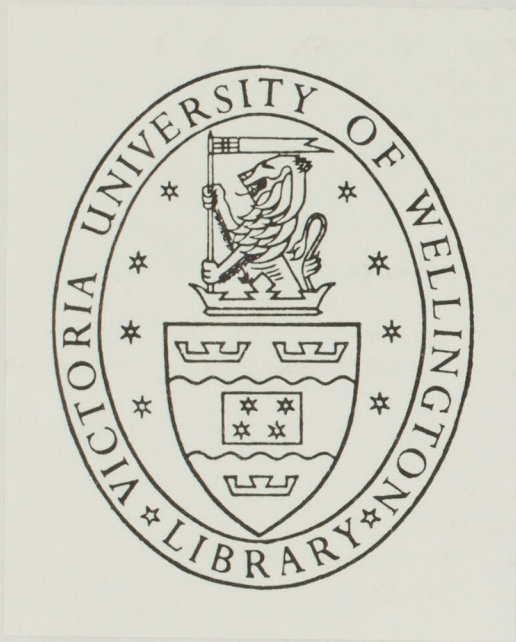
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Abstract

Many countries now have systems for the voluntary administration of insolvent companies. It is difficult if not impossible to assess whether administration is capable of achieving the aims of law reformers. Instead this paper reviews the theoretical bases for administration with a view to proposing a model for New Zealand which is consistent with those aims. This paper analyses some of the key issues such as: how the procedure should be initiated; whether control of the company should pass to an independent outsider; to what extent creditors should participate in, and control the outcome of, an administration and what degree of court involvement is required to prevent abuse of the procedure. In considering these issues this paper compares the system in the United States with that of the United Kingdom and the proposed Australian procedure.

Word Length

The text of this paper (excluding contents page and bibliography) is approximately 15,000 words.

1. Insolvency Law Reform Commission, *Insolvency Law and Practice* (1985) para 1000.

2. Insolvency Law Reform Commission, *General Principles*, Report No. 45 (Insolvency Publishing Service, Canberra, 1985).

3. The Attorney General has stated that it is likely the bill will be reintroduced to Parliament in its current form later this year. *James Graham & Co. v. Australia* (Australia), August, 1988.

4. Throughout this paper the term "reorganization" will refer to the United States system and the terms "administration" and "voluntary administration" will be used to refer to systems in the United Kingdom and Australia.

5. For the history of reorganization see: Cf. Farnham, *Reorganization*, vol. 1, *A Jurisprudence of Bankruptcy*, 31 *Columbia Law Review* (1921) 717; *Waller and Farnham Reports* (1978); *Annual Survey of American Law*.

6. A bill to reorganize insolvent firms. The bill proposes a new chapter simplifying the procedure for reorganization of insolvent businesses. *James Graham & Co. v. Australia* (Australia), August, 1988.

7. See *Can. Inst. of Actuaries, *A Bill to Amend the Insolvency Act* (1985) Report of the 1985 International Financial Law Review (Special Supplement) London, June, 1985.*

8. Part XI, *Insolvency Act 1985*.

THE HISTORY AND ORIGINS OF ADMINISTRATION

Australia and the United Kingdom have both recently reviewed their insolvency legislation. The English Cork¹ and Australian Harmer² Reports proposed a system to encourage intervention in the affairs of a financially distressed company prior to liquidation becoming inevitable. As a result of the Cork Report the administration and company voluntary arrangement procedures were enacted in the Insolvency Act 1986 (UK). A similar procedure is proposed in the Australian Corporate Law Reform Bill 1992.³ By comparison the United States has had various systems of administration, known as reorganization,⁴ since the 1930's⁵ and the existing regime, introduced in 1979, is currently subject to review.⁶

Other jurisdictions have considered, and in some cases implemented, systems of administration for corporations⁷ and, of course, "voluntary administration" for insolvent individuals has long been established as part of New Zealand Law.⁸ While there are now several jurisdictions with systems of administration this paper concentrates principally on the United States and United Kingdoms jurisdictions. Comparisons are also made with the proposed Australian procedure, which is similar to the United Kingdom legislation but has important procedural differences.

The principles cited in the Harmer and Cork reports are seen as being applicable to New

¹ Insolvency Law Review Committee Insolvency Law and Practice (1982 Cmnd 8558).

² Australian Law Reform Commission General Insolvency Inquiry, Report No.45 (Australian Publishing Service, Canberra, 1988).

³ The Attorney General has stated that it is likely the Bill will be re-presented to Parliament in its current form later this year. Jones Sistrum & Co Insolvency Services Newsletter (Australia, August, 1992).

⁴ Throughout this paper the term "reorganization" will refer to the United States system and the terms "administration" and "voluntary administration" will be used to refer to systems in the United Kingdom and Australia.

⁵ For the history of reorganization see: DR Korobkin Rehabilitating values: A Jurisprudence of Bankruptcy 91 Columbia Law Review (1991),717; House and Senate Reports; (1978) Annual Survey of American Law.

⁶ A new bill is currently before the Senate. The Bill proposes a new chapter simplifying the procedure for reorganisation of small businesses. Norton Bankruptcy Law Adviser (Clark Boardman Callaghan, Illinois, August, 1992).

⁷ See J Carr (ed) Solving the Insoluble - A legal guide to Insolvency Regulations around the World International Financial Law Review (Special Supplement) (London, June, 1990).

⁸ Part XV, Insolvency Act 1908.

Zealand.⁹ The Government is currently considering whether a system of voluntary administration should be introduced in New Zealand. It has not been decided whether to implement administration with the Companies Bill or whether separate legislation should be introduced after the Companies Bill has been enacted. While the Law Reform Division of the Department of Justice has sought comments from, amongst others, the Society of Accountants and the New Zealand Law Society there is, as yet, no draft legislation prepared.¹⁰ Even though there is general support for the introduction of administration in New Zealand, there has been insufficient debate as to the form and content of the proposed legislation.

There are many options available as to the structure and form an administration procedure should take. This paper highlights some of the key issues such as: how the procedure should be initiated; whether control of the company should pass to an independent outsider; to what extent creditors should participate in, and control the outcome of, an administration; and what degree of court involvement is required. It is submitted the introduction of the procedure in New Zealand should be deferred until all interested parties, including financial institutions, have had an opportunity to consider and publicly debate these key issues.

Theoretical Bases For Administration

The absence of sufficient statistical and empirical research makes it difficult, if not impossible, to assess whether administration or reorganization is capable of achieving the purposes desired by law reformers. This paper starts with an assumption that such a procedure is desirable in New Zealand and instead looks at several key issues with a view to proposing a model for New Zealand. However an understanding of the aims of insolvency law is useful in determining what structure the administration regime proposed in this paper should take.

⁹ Law Reform Division Department of Justice Insolvency Law Reform - A Discussion Paper (Wellington 1988) pp 7-29; Law Commission Report No. 9 Company Law Reform and Restatement (Wellington, June 1989), para 14.

¹⁰ The comments preceding this footnote were made by a Senior Legal Adviser at the Law Reform Division of the Department of Justice.

Law Reform Reports

The Cork Committee recognised the following as some of the aims upon which modern insolvency law is based:-¹¹

To diagnose and treat an imminent insolvency at an early rather than late stage; to realise the assets of the insolvent which should properly be taken to satisfy his debts, with the minimum of delay and expense.; to ensure the processes of realisation and distribution are administered in an honest and competent manner; ... to recognise the effects of insolvency are not limited to the private interests of the insolvent and his creditors, but that other interests of society or other groups in society are vitally affected by the insolvency and its outcome; and to ensure that these public interests are recognised and safeguarded; to provide means for the preservation of a viable commercial enterprise capable of making a useful contribution to the economic life of the country.

The Harmer Report identified similar principles but also specifically recognised the right of the creditor to participate in the insolvency process:-¹²

Insolvency law should provide mechanisms that enable both the debtor and creditor to participate with the least possible delay and expense. An insolvency administration should be impartial, efficient and expeditious. The law should provide a convenient means of collecting or recovering property that should properly be applied toward the payment of debts and liabilities.

These statements recognise that insolvency impacts upon the wider community. Creditors may be unable to pay their debts and suffer insolvency themselves as a consequence. Insolvency also directly affects directors, members, employees and the public at large. The wider implications of insolvency have long been recognised in the United States although its legislative history has a far stronger emphasis on the rights of the existing owners and managers of the company and upon the "economic efficiency" of reorganization:-¹³

The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for stockholders. The premise of a business reorganisation is that assets that are used for production in the industry for which they are designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop, and require creditors of the business, both

¹¹ Cork Report, para 198.

¹² Harmer Report, para 33.

¹³ House Report (Reform Act 1978) HR 8200 8 September 1977, reprinted in Norton Bankruptcy Code Pamphlet (1990-1991 ed), 728.

trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it can often be returned to a viable state. It is more economically efficient to reorganise than to liquidate, because it preserves jobs and assets.

And at an even more pragmatic level the Senate report stated:-¹⁴

Reorganization, in its fundamental aspects, involves the thankless task of determining who should share the losses incurred by an unsuccessful business and how the values of the estate should be apportioned among creditors and stockholders.... [Reorganization] is designed to counteract the natural tendency of a debtor in distress to pacify large creditors, with whom the debtor would expect to do business, at the expense of small scattered public investors.

Commentators in the United States have considered how the law achieves the aims desired by the policy makers. One "school" attempts to explain the rationale for administration by focusing on economic theory whereas the other "school" focuses on the wider social aims. A summary of these schools of thought is set out below.

The Economic Account

In situations where there are insufficient assets to satisfy all claims on an insolvent estate the law should provide a procedure whereby the various claims can be partially or wholly satisfied in a rational manner. Without a rational system for the determination of claims on an insolvent estate there results a free for all which is neither beneficial to the company, its creditors or shareholders. This problem of the common pool has been described in the following parable:-¹⁵

Once upon a time, a vulture cruised the desert observing critters plodding in the sand. It ignored several fat ones. When meaty critters die there is enough for everyone and thus no reason to lie and watch over them. Eventually, however, the vulture saw a dying critter which didn't have enough flesh on its bones to feed the entire flock. That discovery led the vulture to begin circling to ensure that when death came, it would be first in line to chomp on the carcass. Other vultures saw the first one circling. Guessing what was afoot and not wishing to miss an impending feast, they too joined the circle. So the entire flock was going round and round. Each vulture noted that as other members joining the circling the prospects of getting a full meal diminished. Skittish vultures became overeager and were tempted to sneak in and snarf up some sinew even while there was life left in the failing critter. As a result, the critter was prematurely dismembered. Many unfed

¹⁴ Senate Report (Reform Act 1978) S2266, 14 July 1978 reprinted in Norton Bankruptcy Code Pamphlet (1991-1992 ed), 760.

¹⁵ JW Bowers Groping and Coping in the shadow of Murphy's Law - Bankruptcy and the elementary economics of failure 88. Michigan Law Review (1990), 2106-2107.

vultures wondered whether, had the critter been able to reach a water hole, it might have put on enough meat to feed an entire flock. Worse, the carcass was not butchered as part of a plan to yield rib-eyes and roasts. Torn up in a free-for-all, valuable cuts became chopped meat.

In other words, creditors being free to take pre-emptive action may lessen the value of the common pool to creditors and claimants of the company. Further it limits the potential of the common pool to expand for the benefit of all claimants.¹⁶ This is the principal reason why insolvency procedures which lack a moratorium on the exercise of creditors remedies are difficult to implement.

In answer to the common pool problem economists have applied the creditors bargain model to explain the theory of insolvency law. That model imposes a system of control on the taking of pre-emptive action by formulating "the agreement one would expect the creditors to form among themselves were they able to negotiate such agreement from an ex ante position."¹⁷ The rationale for the model is that the cost to creditors of pursuing individual action and monitoring the debtor would lead creditors to agree to a rule of equal sharing because receiving a pro-rata distribution is better than the risk of recovering nothing. Also, creditors acting individually lack sufficient information about the bargaining strengths and skills of other creditors to make informed choices.¹⁸ To continue the parable:-¹⁹

The vultures realised the flock would prosper if they all agreed to schedule the banquet at the optimal moment, butcher the carrion into choice cuts and distribute portions equally. Flock members could then engage in productive activity (like cruising for new carrion or sleeping) instead of spying on each other and circling, and yet eat flank instead of scraps. Holdout and free-rider problems prevented them from agreeing. Fortunately Congress realised the vultures needed to be saved from themselves and enacted an optimal collective scavenging law, adopting the terms the vultures would have bargained for had they been able to agree.

Some American commentators, particularly Jackson and Baird,²⁰ have questioned whether reorganization actually achieves an efficient sale of a pool of assets and have

¹⁶ TH Jackson The Logic and Limits of Bankruptcy Law (Harvard University Press, Massachusetts, 1986) 10-19.

¹⁷ TH Jackson Nonbankruptcy entitlements and the creditors bargain 91 Yale Law Journal 857, 860.

¹⁸ Jackson, Logic and Limits of Bankruptcy Law, 30.

¹⁹ JW Bowers, Groping Coping in the shadow of Murphy's Law, 2107.

²⁰ Jackson, Logic & Limits of Bankruptcy Law; DG Baird The Uneasy case for Corporate Reorganisations 15 Journal of Legal Studies 127 (1986).

concluded that reorganization is no more "economically efficient" than liquidation. Further a recent study has shown that reorganization does not, at least in publicly listed companies, provide much economic benefit for creditors let alone shareholders.²¹ However the basic theory that creditors will, unless restrained, generally race to exercise their rights rather than risk losing out to other creditors remains valid. Equally if those creditors could have been restrained for a short period the potential for a greater return for all creditors may be enhanced. This is particularly the case with secured creditors. For example, if the lessor of a crane to a building company is restrained from repossessing the crane until current work is completed there will be a greater prospect of other creditors receiving payment than if the work was abandoned immediately. If the secured creditor can somehow be assured that the value of its security will not diminish during that period and that it will share in payment from the completed work then, it is submitted, the secured creditor should be restrained from exercising its contractual rights.

It would be naive to expect that administration will always produce a better result for all creditors than the alternative liquidation but that is not an argument against the introduction of the procedure. Instead the legislation should provide mechanisms to encourage companies to use administration in appropriate circumstances but provide a quick exit to liquidation when it becomes apparent that there is little benefit to anyone in prolonging the existence of the company.

The Value Based Account

Proponents of the value based account argue that insolvency law is not simply a response to the problem of collecting debt.²² The wider social, political and economic "values" which a voluntary administration should encourage are the same principles previously identified in proposals for law reform. There are also "hidden" economic costs which extend beyond the cost suffered by the individual creditors such as: the company's original establishment costs (for example hiring staff, product development and marketing); the cost of another party establishing a successor business; the impact upon creditors of the loss of potential future business from the insolvent company; the domino effect upon creditors who are unable to meet their own obligations as a result

²¹ M Bradley, M Rosenzweig *The untenable case for Chapter 11* 101 Yale Law Journal (1992) 1043.

²² D R Korobkin *Rehabilitating Values: A Jurisprudence of Bankruptcy* 91 Columbia Law Review (1991); 717 and *Value and Rationality in Bankruptcy Decision Making* 33 William and Mary Law Review (1992), 333; E Warren *Bankruptcy Policy* 54 University of Chicago Law Review (1987) 775; and *A Theory of Absolute Priority* (1992) Annual Survey of America Law, 9.

of the company's insolvency; and additional costs borne by the state in the form of social welfare benefits and lost revenue.

A good example of how reorganization can work to satisfy economic as well as non-economic values is the Johns-Manville reorganization.²³ This publicly listed company was for many years involved in the production of asbestos products. While highly profitable the company was, by 1982, facing multi-million dollars claims from former employees for an asbestos related disease contracted while working for the company. At the time of going into reorganization the company was solvent but it was acknowledged that the company could not meet anticipated future claims. For this reason the company was actively resisting individual and class actions brought by former employees.

Originally the shareholders wished to transfer the assets and business of the company to another entity using the purchase price to partially satisfy existing creditors, including asbestos related claimants. The proposal would leave potential future claimants in an uncertain position. There was public outcry that the company should try to use the reorganisation procedure in this manner, particularly as the company had knowledge of the dangers of asbestos some twenty years before the first claims arose but had chosen to do nothing to remedy the known defects in the production process. However to liquidate would have resulted in the loss of a profitable business and employment, produced a negative result for shareholders and difficulties for potential future claimants who, because of the long latency period, did not know they had contracted the disease.

The court was persuaded to reject the shareholders' proposal and a lawyer was appointed to represent potential and unknown future claimants. That lawyer was able, by a process of negotiation, to persuade the various classes of creditors to agree to a plan under which the company would set up a trust to meet the current and future asbestos related claims over a number of years. In addition to receiving a shareholding in the reorganised company, the trust was funded by proceeds from settlements with insurers, annual contributions and a right to draw on up to 20 percent of Johns-Manville profit for as long as necessary to settle the health victims' claims. In order for the proposal to succeed property damage claimants (worth 80 billion dollars) agreed to subordinate their claims to that of the health victims and receive only 1% of the value of their claims.

²³ The facts of the case are set out in *Kane v Johns-Manville* 843 F.2d (2nd Cir. 1988) and referred to in Korobkin *Rehabilitating Values*.

The company's business reputation was salvaged, it was able to pursue its business free from the constraints of expensive and prolonged litigation, jobs were saved, shareholders retained an interest in the company and the divergent interests of various classes of creditors were satisfied.²⁴

Proponents of the value based account argue that the law of reorganization achieves these wider purposes by creating a forum where informed discussion and negotiation can take place and where different values and interests can be explored and resolved. Part of that process includes structuring the rules in a way that no party can assert an overly dominant position to the extent that it, whether the company or a particular creditor, can determine the terms of the administration.

Critics of reorganization in the United States believe that the procedure is geared too highly in favour of the company and that the rules allow companies to continue to survive when they should properly be liquidated. Conversely in the United Kingdom the rules make it difficult for many companies to contemplate administration even though there could be benefits to all parties in making the procedure more freely available. The difficulty lies in developing a system which recognises and achieves those aims.

The remaining sections of this paper concentrates on developing rules which seek to achieve the aims for administration set out by the law reformers.

INITIATION

Who Should Initiate the Procedure?

Directors

It is generally accepted that directors charged with the management of the company should have the power to initiate administration and that they should be encouraged to do so in appropriate circumstances. It was originally thought that the voluntary nature of the procedure coupled with protection from disqualification and liability for wrongful trading would encourage directors to make use of the administration procedure²⁵ but this has

²⁴ The lawyer who masterminded and managed to persuade the parties to agree was amply rewarded when the court, in answer to his request for payment (out of the company's assets) of a fee of \$2.3 million, agreed and granted him a bonus of a further \$2.3 million. Korobkin *Rehabilitating Values* p759, note 199.

²⁵ Cork Report para 501; Harmer Report para 53.

not been the experience in the United Kingdom.²⁶ Similarly there are very few wrongful trading actions brought in New Zealand simply because insolvent companies do not have the financial resources to bring such an action and creditors are reluctant to throw "good money after bad." So the threat of disqualification or liability for trading whilst insolvent is, realistically, unlikely to be a major incentive for directors to invoke the procedure.

A far more significant incentive for management is the prospect of retaining employment with the company, at least in the short term. Although directors are automatically displaced in favour of an administrator in the United Kingdom they frequently go on to retain employment in the reorganised business.²⁷ In the United States it is rare for management to be replaced by an outsider although in public companies existing management is frequently displaced either immediately before or shortly after the commencement of reorganization.²⁸ The prospect of retaining employment for themselves and their workforce is likely to be a significant incentive, particularly for the management of a closely held company.

If initiation of the procedure is promoted as a responsible alternative to receivership and liquidation then it is likely that directors will be encouraged to initiate the procedure without fear of being "tainted with the brush of failure."²⁹ For reasons elaborated below it is important that the procedure be perceived by the public as a truly voluntary solution taken, on the company's own initiative, and not as just another alternative for creditors to liquidation.

Creditors and Members

In jurisdictions which allow creditors to initiate the procedure it is seldom used because creditors rarely have sufficient information about the company's financial affairs to initiate

²⁶ The statistics indicate that the risk of these penalties being imposed is slight. S Hill Company Voluntary Arrangements (1990) 6 *Insolvency Law and Practice*, 47, 52-53.

²⁷ One study found that 62 percent of directors retained their position where the business returned to solvency or a voluntary arrangement was put in place. A further 18 percent were re-employed where the business was sold as a going concern. A survey of Administrators under the Insolvency Act 1986 The Result of Administration Orders made in 1987. A report by M Homan of Price Waterhouse for the Research Board of the Institute of Chartered Accountants in England and Wales 1989 p 10 ("Homer Study") *Corporate Recovery The Immediate Impact of the Administrator Scheme*.

²⁸ One United States study revealed that, on average, only 46 percent of incumbent directors remain in office during the course of a reorganisation. SC Gilson Bankruptcy, Boards, Banks and Blockholders (1990) *Journal of Finance and Economics* 335.

²⁹ T Scoular "Insolvency Law Reform - Voluntary Administration. A report to the Department of Justice Law Reform Division" (August 1991) para 74 ("Scoular").

the procedure³⁰ or, as in the United States, the rules are designed to discourage initiation by creditors.³¹ In the United States an individual creditor can only initiate liquidation or reorganization proceedings where the company has less than 12 creditors and the petitioning creditor holds a debt of at least \$5,000. If the company has more than 12 creditors then at least three creditors holding an aggregate debt of \$5,000 are required to jointly commence an application.³² Less than 10% of all liquidations and reorganization proceedings are filed by creditors.³³

Members have other remedies available to them if they are dissatisfied with the company or its management; allowing members to initiate the procedure would be an unnecessary divergence from normal company law principles that management powers are reposed in directors not shareholders. Creditors have the remedy of winding up proceedings if they are concerned that the company is insolvent or engaging in voidable transactions. The issuing of a statutory demand is widely used in New Zealand by individual creditors to enforce payment of a debt. Further creditors with unsecured debt are unlikely to initiate a procedure which may result in a pro rata payment when there is some prospect of inexpensively obtaining full payment.

It has been argued that an individual creditor, provided they have an in-depth knowledge of the company's financial affairs, should have the power to initiate administration as a "collective response" to the problems faced by the company and its creditors.³⁴ However it is submitted that allowing creditors or members to initiate the procedure will detract from the voluntary nature of the procedure and may possibly result in abuse.³⁵

Exception for holders of floating charge?

Several reports have proposed that secured creditors be given the power to initiate administration provided they hold a charge over substantially all the company's property

³⁰ Only 5 percent of the administration orders made in the United Kingdom in 1987 were presented by banks or other creditors. Homer study, 17.

³¹ JF Williams Counting Creditors under Code s303(b): The Tale of the Ubiquitous Such. Norton Bankruptcy Law Adviser (June, 1992) 7-9.

³² 11 USC s303(b)(1),(2).

³³ DG Baird The Initiation Problem in Bankruptcy. International Review of Law and Economics (1991), 223, footnote 4.

³⁴ DG Baird The Initiation problem in Bankruptcy 224.

³⁵ eg a competitor could become a member or creditor for the purpose of using administration to weaken the company's business reputation. Scoular para 75.

and are entitled to appoint a receiver by virtue of a default in the payment of money due under the charge.³⁶ In Australia the original draft legislation³⁷ proposed that holders of floating charges be entitled to appoint an administrator if default had been made in the payment of money secured by the charge.³⁷ However a much wider provision has been drafted into section 436C(1) of the Corporate Law Reform Bill (1992) (Australia) to allow a chargee over all, or nearly all, of the company's property to appoint an administrator in any circumstance where the charge has become enforceable. It is submitted that this clause is too wide and may allow debenture holders to appoint administrators for minor technical breaches of the charge even though the company is not otherwise in breach of its obligations.

It is estimated that ninety per cent of first debentures granted by companies in New Zealand are in favour of trading banks.³⁸ Unlike other creditors, banks have access to financial information about the company, and generally have knowledge of a company's deteriorating financial condition long before other creditors. Scoular argues that the banks are in a good "... position to focus their customer's attention on its problems and encourage it to initiate the procedure rather than the bank itself."³⁹ Thus the threat to invoke administration could be a useful tool to persuade management to initiate the procedure themselves. However debenture holders can achieve the same purpose by threatening receivership if an administrator is not appointed by the company.

Allowing secured creditors the right to initiate administration will detract from the voluntary nature of the procedure. Secured creditors already have adequate remedies and administration should not become a "quasi receivership" run for the benefit of debenture holders but not necessarily for the benefit of the company or unsecured creditors. In summary it is submitted that the management of the company should have the sole right to appoint an administrator.

Grounds For Initiating the Procedure

If the aim of administration is to encourage financially distressed companies to use the procedure prior to liquidation becoming inevitable then consideration should be given as to whether the law should impose pre-requisites to be met before the procedure can be

³⁶ Scoular para 76; Harmer Report para 66; Cork Report para 504.

³⁷ Harmer Report, para 66; draft section VA 5(3).

³⁸ Scoular para 29.

³⁹ Scoular para 77.

invoked. It should also be recognised that these pre-requisites increase the cost to the company and its creditors of in invoking the procedure.

Requirement for Insolvency

Most jurisdictions, with the United States being an exception, require the company to be either insolvent or likely to become insolvent.⁴⁰ The rationale for requiring insolvency is the traditional view taken as to the sanctity of contract and the position taken by secured creditors that the cost of obtaining credit will increase and/or the availability of credit will decrease in response to a perceived threat to their security position. The Harmer and Cork Reports did not consider whether administration should be available to solvent companies even though formal and informal schemes of arrangement do not require insolvency as a criteria.

The public admission of insolvency may be a disincentive to encouraging management to initiate the procedure. Further the public recognition that a company is, or is likely to become, insolvent will affect the attitudes of suppliers, customers, lenders and employees. This "trauma of insolvency" may, in itself, reduce the prospects of a company surviving administration:⁴¹

Suppliers may cease supplying altogether, or press for more stringent terms. Customers will be hesitant to purchase (particularly if the product requires after-sales service), be slow to pay if they do not believe that any further business relationship will be damaged, and be unwilling to enter long term contracts. The effect on lenders is that they will inevitably seek repayment while employees will at best be demotivated and at worst, simply leave.

These problems are largely unavoidable. However if financial problems can be identified early and management encouraged to take action without the necessity of being satisfied that one of the "tests" of insolvency has been met then it is possible that the public stigma associated with other insolvency procedures (such as receivership and liquidation) will be reduced.

If the administration procedure is likely to have an effect on the supply of credit then consideration should be given to whether that concern can be addressed in areas other than the initiation of the procedure. For example if the moratorium period is relatively short, and the creditors are given wide powers to determine the company's future, then there will

⁴⁰ There is, however, a requirement for insolvency when reorganization is initiated by creditors in the United States 11 USC 303(h).

⁴¹ Homer Study, page 13.

be little advantage in solvent companies invoking the procedure. This problem may simply be one of the negative effects which must be accepted in order to attain the objectives which administration tries to achieve.

Requirement for court approval

In the United Kingdom the court must be satisfied that an administration order will be likely to achieve one or more of the following purposes:⁴²

- a) the survival of the company or its business as a going concern
- b) the approval of a voluntary arrangement under Part I of the Insolvency Act 1986
- c) the sanctioning of a scheme of arrangement under section 425 of the Companies Act
- d) a more advantageous realisation of the company's assets than would be achieved in a liquidation.

Further, the court has an overriding discretion to refuse making an order.⁴³ Commentators in the United Kingdom, including members of the original Cork Committee, are critical of the initiation procedure:⁴⁴

[Administration is] used with considerable hesitation because of the very heavy front-end loading in costs: a five-figure sum must typically be committed in professional fees, even for a very small company, before there is any certainty that the court will actually make the order. If it declines to do so, the money is wasted.

The requirement for court involvement is to protect creditors against companies abusing the procedure. The equivalent voluntary arrangement procedure for individuals requires the court, on application, to make an interim order suspending creditor's rights for a short period until the creditors have had an opportunity to meet and vote on the debtors proposals. The individual voluntary arrangement procedure is seen as being successful⁴⁵ and it has been recommended that the role of the court be reduced in a similar manner for companies.⁴⁶

Our proposed solution means that the Court need do no more than impose a short standstill, which in most cases will be routinely granted (as it is for individuals), in order to let the creditors decide whether the

⁴² Section 8(3) of the Insolvency Act 1986 (UK)

⁴³ Section 9(4) Insolvency Act 1986 (UK).

⁴⁴ Cork Gully Discussion Paper Number 1 (London, June 1991), page 3.

⁴⁵ Cork Gully paper p 3-4. In 1990 individual voluntary arrangements accounted for 14 percent of individual and unincorporated business failures. In contrast administration and voluntary arrangements combined accounted for only 1.5 percent of company failures.

⁴⁶ Cork Gully Paper p 9.

rescue scheme is viable: it is after all their money, and we suspect most creditors would prefer to make up their own minds, at a creditors meeting, rather than being presented with a fait accompli because the court has already done so for them.

The proposed Australian model does not require court involvement as the procedure is initiated by a directors' declaration that the company is, or will become insolvent⁴⁷. If potential abuse of the procedure can be dealt with in other ways it is submitted that there is no need for court involvement in the initial stages of administration invoked by the company.

Opportunity For Creditors to Veto Initiation of Administration

In the United Kingdom the holder of a charge over all (or nearly all) of the company's property has an effective right to veto the administration by appointing a receiver within 5 days of service of the application.⁴⁸ The Cork committee was obviously influenced by the view that a receiver could take control of the company and where possible preserve the profitable parts of the business.⁴⁹ Likewise the Harmer Report considered that a charge holder could "provide an ordered administration of the company's affairs albeit one conducted for the benefit of a secured creditor rather than all creditors."⁵⁰ Unlike the United Kingdom model, the proposed Australian legislation⁵¹ contemplates that the administrator will stay in office but that his or her powers would be subject to that of the receiver or the charge holder. It is difficult to assess what role an administrator could usefully play in such circumstances other than to act as a general representative of the company and other creditors.

The object of the legislation is to encourage creditor forbearance for a short period to allow the company to consider its options, which may include refinancing its debt or looking for further equity investment. That object is undermined by giving one creditor the power to veto the procedure by appointing a receiver. Further it will delay the commencement of administration as the administrator will not accept an appointment until

⁴⁷ Clause 436A Corporation Law Reform Bill 1992 (Aust).

⁴⁸ Section 9(2),(3)(a) Insolvency Act 1986 (UK). This followed the recommendation of the Cork Report (para 504). The Cork Committee perceived administration would be primarily used "in cases where the company has not granted a debenture secured by a floating charge, although it is not intended to be limited to such cases."

⁴⁹ Cork Report para 495-497

⁵⁰ Harmer Report Para 67

⁵¹ Corporate Law Reform Bill 1992 (Aust) s441A.

the position of the chargeholder is obtained. It is submitted that if the debenture holder has not taken steps to exercise its security prior to the appointment of an administrator then it should not be entitled to do so after the advent of administration.

Summary

The procedure should be promoted in the commercial and wider community as a constructive response by a company to its financial distress and not simply as another creditors' remedy. To encourage that aim management should be the only party entitled to initiate the procedure. Further management must be encouraged to use the procedure as soon as problems become apparent and without fear that administration will cause a panic among its creditors, employees and customers. For these reasons there should be no requirement for the directors to admit to insolvency or meet other tests before the procedure is available. There being no threshold tests there is no requirement for court involvement at the initial stage and entry costs are consequently lowered.

CONTROL AND MANAGEMENT OF THE COMPANY

It is suggested that management should not be displaced upon the advent of administration otherwise there will be little motivation for the directors to invoke the procedure as soon as soon as problems become apparent. At the same time creditors may be sceptical of management's ability to effect a rescue plan, particularly if there is a perception that "bad management" was the cause of the company's current problems. Creditors who have already tolerated a period of broken promises and bounced cheques are unlikely to repose much confidence in rescue plans proposed by the company.

In the United States the directors are not automatically displaced upon the commencement of a reorganization. The checks on abuses of the procedure are a statutorily appointed creditors committee with wide powers to investigate the conduct of the management of the company⁵² and upon the court to provide protection to creditors who are disadvantaged by the procedure. There is provision for interested parties to apply to the court for the appointment of a trustee⁵³ to manage the affairs of the company but such appointments are rare and will not normally be made in the absence of fraud or serious mismanagement. Even rarer are appointments by the court of

⁵² 11 USC s1102.

⁵³ 11 USC s1104(a)

examiners to formally investigate the management of the company and report to the court.⁵⁴ There is a strong presumption in the United States that management retain control over the company.⁵⁵

In the United Kingdom an independent administrator is appointed to assume control of the company; management's powers are only exercisable with the specific consent of the administrator; and he or she has the power to dismiss directors. In addition the administrator must submit a report on any misconduct by the directors in the management of the company prior to his or her appointment to the Department of Trade and Industry.⁵⁶ There are similar provisions in the proposed Australian legislation. Hill suggests that these factors are a disincentive to the use by directors of the administration procedure in the United Kingdom.⁵⁷

It is said that the United States has a more tolerant attitude to business failure than the United Kingdom. This "rescue culture" where poor managers are more likely to be given a second chance is considered to be absent in the United Kingdom.⁵⁸ While it is difficult to change public attitudes the legislation should encourage rather than inhibit directors using the procedure. At the same time creditors need to be assured that their interests are protected, particularly during the initial moratorium period. Consideration must also be given to the cost of outside control bearing in mind that with an insolvent company it is the creditors who ultimately bear the cost of administration. If management are not displaced than some control over the exercise of their powers is necessary. The following sections look at how other jurisdictions have dealt with this problem.

Exercising Control Over Management

Bankruptcy courts in the United States exercise considerable control over the management of a company in reorganization and lawyers and other professionals are extensively involved in assisting the company. Such an approach, it is submitted, would

⁵⁴ 11 USC s1104(b)

⁵⁵ J L Westbrook A comparison of bankruptcy reorganisation in the US with the administration procedure in the UK (1990) 6 *Insolvency Law and Practice*, 86.

⁵⁶ Company Directors Disqualification Act 1986) (UK) s6,7. This report can form the basis of a prosecution against the directors and the imposition of penalties and future disqualification from holding management positions.

⁵⁷ S Hill *Company Voluntary Arrangements* 52-53;

⁵⁸ J L Westbrook "A comparison of bankruptcy reorganisation in the US with the administration procedure in the UK (1990) 6 *Insolvency Law and Practice*, 86.

not be favoured in New Zealand, firstly, because the courts in New Zealand do not have the same expertise and degree of specialisation as the United States bankruptcy courts and, secondly, the involvement of lawyers and other professionals greatly increases costs.

A conceptually novel approach is taken in Ireland where the Court may appoint an examiner to work alongside the company's existing management. The examiner performs a role similar to an executive director and his or her powers include the ability to: obtain information from the company and investigate its affairs; preside at board or general meetings as well as to propose motions and resolutions; veto any course of action which, in the examiners opinion, is likely to be detrimental to the company or any interested party. However, the examiner's chief role is formulate to rescue proposals to put before the company, its members and creditors. The examiner has been described "...as a sort of company doctor who analyses the patient, prescribes remedies and gets the parties concerned to try to agree."⁵⁹ This is in contrast to the view taken by one commentator that the United Kingdom administration procedure "...is still regarded as calling in a priest for the last rites rather than summoning the doctor for curative surgery."⁶⁰

An important feature of the Irish procedure is the ability to apply to the court for an order that all or any of the functions or powers which are vested in the directors shall be exercisable only by the examiner. The court must consider the following factors in determining the application:-⁶¹

- (a) that the affairs of the company are being conducted, or are likely to be conducted, in a manner which is calculated to prejudice the interests of the company or of its creditors as a whole, or,
- (b) that it is expedient, for the purpose of preserving the assets or safeguarding the interests of the company or its creditors as a whole, that the carrying on of business of the company by ... its directors or management should be curtailed ..., or,
- (c) that the company, or its directors have resolved that such an order should be sought, or,
- (d) such other factors as the court see fit.

There does not seem to be a specific reason for requiring court approval where the company or its directors agree to place the management of the company under the

⁵⁹ G McCormack "Rescue of ailing companies in Ireland: new rules" (1990) 6 *Insolvency Law and Practice* 98.

⁶⁰ *The Times*, (London, England), 15

⁶¹ Section 9 Companies (Amendment) Act 1990 (Ireland).

control of the examiner. The court should only be resorted to where there are conflicting interests, and it should not be necessary to involve the cost and delay of an application to court where the company and examiner agree. If there is a conflict between the wishes of the company (ie its members) and its directors, or, where there is not unanimity between the directors, then an application can be made under subsection 9(d).

There is also provision for the examiner to apply to the court to obtain the powers of a liquidator.⁶² It may be useful in situations where the company is hopelessly insolvent to provide the examiner with power to apply to the court to have the company placed in liquidation. Once again the requirement of court approval should only be necessary where the examiner is unable to persuade the company or management that there is no realistic prospect of the company or its business being salvaged.

It is submitted that the Irish procedure strikes an effective balance between the interests of the company and its creditors. Directors do not lose control of the company but obtain the benefit of expert independent advice. At the same time creditors are reassured that existing management are not taking advantage of the procedure to pursue their own interests to the detriment of the company's creditors. The company knows that the examiner can apply to court for further powers and this places the examiner in a position to "persuade" management to accept his or her advice. Thus, hopefully, resort to the court will only be exercised where the negotiation process fails.

Responsibility for Appointment of Administrator

It is submitted that the directors should have the power to appoint of an "examiner" to oversee the initial stages of administration until such time as proposals for the company's future can be prepared. If a compromise with creditors is contemplated then creditors should have the option of replacing the administrator and/or management with someone of their choice. The rationale for this proposal is that, upon insolvency, creditors effectively supplant the shareholders as owners of the company's assets and will ultimately decide the company's future.⁶³ Secondly creditors must have confidence in the person overseeing the company's recovery before they will support the proposal. Surveys in the United Kingdom show that Banks are less likely to veto an administration where the proposed administrator is someone who they know to be both independent and

⁶² Subsection 9(4).

⁶³ Cork Gully Paper 7.

competent.⁶⁴ Anecdotal evidence suggests that creditors in New Zealand would prefer the appointment of an independent administrator to work in conjunction with the company.⁶⁵

Assuring Independence and Competency of Outside Control

Both Australia and the United Kingdom have systems for the licensing and registration of insolvency practitioners. The Harmer report summarised the case for a licensing system in the following terms:-⁶⁶

An insolvency practitioner is, above all else, a trustee, of whom the highest standard of honesty, competence, skill and diligence is required. A regulatory system for insolvency practitioners is needed to maintain appropriate standards and protect persons who may be affected by a departure from those standards. The commission did not receive any submissions suggesting that there was no need for regulation. The issue is what is the most efficient and effective method for the regulation of insolvency practitioners.

The New Zealand Law Commission does not see the need for statutory licensing of insolvency practitioners, apparently on the basis that such a system would be a restrictive. That view is unfortunate given that the system of administration proposed in this paper depends for its integrity on an honest, competent and efficient administrator. A system for the licensing of insolvency practitioners is supported by the New Zealand Society of Accountants which has, itself, established guidelines for insolvency practitioners.⁶⁷ In the absence of legislative support for a formal system of licensing, administrators will only be required to comply with the minimum requirements set out in the Companies Bill for receivers and liquidators.⁶⁸

Clause 217(1)(a) of the Companies Bill requires a receiver or liquidator to be:-

A person who has substantial experience in administering or advising on the insolvency of individuals or the liquidation or companies, or receiverships is an experienced insolvency practitioner ...

⁶⁴ Homer Study, p 16-17; A Report by the City of London University Department of Law, 1988, p 18-19.

⁶⁵ This conclusion is supported by the author's discussions with insolvency practitioners, and comments from interested parties appended to TA Scouler's Report the Department of Justice Law Reform Division on Insolvency Law Reform - Voluntary Administration, Wellington, August 1991.

⁶⁶ Harmer Report para 930.

⁶⁷ New Zealand Society of Accountants "Guidelines for Insolvency Practitioners" (Guideline 9, revised 1991).

⁶⁸ Companies Bill (NZ) clause 217.

The phrase "substantial experience" is a subjective term and there is no attempt in the legislation to further define its meaning. Scoular recommended that an administrator file a declaration with the Companies Office stating his or her qualifications and insolvency experience "so as to focus his [or her] thoughts on the experience which is looked upon as being necessary to carry out an administration."⁶⁹ It is submitted that the administrator should also provide creditors with a copy of the declaration to assist them in determining whether the administrator has sufficient experience to deal with the administration. The declaration should include details of the administrator's professional qualifications, assignments the administrator has previously accepted in businesses and industries related to the company now under administration, membership of professional bodies and attendance at continuing education courses. The declaration should also state that the administrator has no previous association with the company such as would disqualify him or her from acting pursuant to clause 217(1)(d) of the Companies Bill.

Such a declaration will not, in itself, protect creditors during the initial moratorium period. The proposed Australian legislation requires the administrator to call a creditors meeting within 7 days of his or her appointment to determine whether the creditors accept the company's choice of administrator. It is submitted that the cost of this a meeting is not justified at such an early stage of the administration, particularly because creditors will meet within a matter of weeks to consider the administrator's proposals. Also the administrator is unlikely to have much information to give to creditors and the meeting will only be necessary if the creditors wish to remove the administrator.

Instead the administrator should be obliged to form a creditors committee consisting of between 2 and 5 of the company's largest creditors (depending upon the size of the company). The largest creditors should be invited to serve on a creditors committee to liaise between the administrator and the company's other creditors. When the committee has been formed an initial letter should be sent to all creditors advising them that the company is in administration, the likely date of the first meeting, the names of all known creditors and the amounts of their debt.

The creditors committee should have the power to call a creditors meeting to remove the administrator if he or she does not comply with the minimum qualification standards set out in the Bill and/or the administrator does not appear to have the general support of the majority of the company's creditors.

⁶⁹ Scoular para 51.

Ideally, it is submitted, there should be both a formal licensing system for insolvency practitioners and control over the individual appointment of administrators by the creditors committee. In the absence of a formal licensing system, the creditors committee will provide some measure of control over the conduct of the administration until a full creditors meeting is called to consider proposals for the company's future. It is envisaged that the creditors will also vote at that meeting whether to retain the administrator to oversee implementation of the proposals.

THE MORATORIUM

The initial period

The temporary moratorium on action by creditors against a company is an essential feature of any system of administration. Without it creditors would naturally seek to reduce their exposure to loss by, for example, taking possession of assets subject to security, retention of title provisions, distraint, or by obtaining and enforcing judgment. The moratorium enables the company to obtain a breathing space to formulate and consider a rescue plan, free from the threat of creditors taking action which could, by the removal of assets, threaten the company's ability to continue as a going concern.

Bradley and Rosenzweig argued there was a trend in the United States for managers to overcommit the company and then use reorganization as a 'financial management tool' to renegotiate the company's debt obligations. Notably the removal of the requirement for insolvency under the Code was one factor for the huge increase in the use of reorganization in the United States⁷⁰ The solution to this problem is not to impose a requirement for insolvency but to make the procedure less attractive to solvent companies. Reorganizations in the United States, particularly of large companies, may take several years. During that period interest on claims stops accruing although secured creditors can continue to accrue interest up to the value of their security.⁷¹ In the words of one commentator "[t]he proponent of the plan must somehow satisfy claims, but the free ride on interest is money out of the pockets of creditors and into the debtors".⁷² In general

⁷⁰ Bradley and Rosenzweig *The Untenable Case for Chapter 11* (1992) Yale Law Journal 1045, 1044, 1057, 1058. The current code came into force in October 1979: in the 1960's there were approximately 1,000 reorganization petitions filed per year; in the 1970's approximately 2,500 and in the 1980's approximately 17,000 per year.

⁷¹ 11 U.S.C 502(b)(2).

⁷² Norton (ed) *Norton Bankruptcy Law & Practice* (Callaghan, Illinois, 1990) para 49.01.

the United States code provides many mechanisms to enable the company to renegotiate the terms of its contractual obligations with its creditor. While some commentators argue that these mechanisms are necessary to balance the company's lack of negotiating power it is submitted that, as a general principle, companies should not be encouraged to avoid its contractual obligations.

To prevent abuse of creditor rights the initial non-consensual moratorium period should be as short as possible and the powers of the administrator should be limited to the extent necessary to achieve the purposes of the legislation. The next two sections consider the time period of the initial moratorium and specific exemptions to the moratorium.

Time period for calling meeting to consider proposals.

In Australia the administrator is required to call an initial meeting within 28 days to consider the administrators proposals.⁷³ One submission on the bill suggested it was doubtful an administrator could, except in the simplest situations, prepare a recommendation within that time.⁷⁴ That view is confirmed by the experience of administrators in the United Kingdom where the administrator is required to call a meeting within 3 months of his or her appointment. The Homer study of administrations in the first year after the legislation was passed indicated that the majority of administrators were calling the meeting either toward the end of the 3 month period, or not at all. The administrators surveyed were asked why it would not have been possible to hold the meeting within one month of appointment. The responses were: more time was required to formulate proposals; incomplete accounting records and statement of affairs not received from directors; requirement to give 14 days notice of meetings; and a desire not to disclose confidential sale negotiations.⁷⁵ It has been suggested the time period for calling the meeting could be reduced to two months if the initial proposal required only a broad outline of the strategy and approach intended to be adopted by the administrator.⁷⁶

It is submitted the administrator set out in the initial notice to creditors the time within which he or she proposes to call the first meeting of creditors which should be, say, a

⁷³ Proposed s 439A

⁷⁴ see P Noonan Voluntary Administration - issues that have emerged during the public consultation process" (Business Law Division, Attorney Generals Department, Canberra, June 1992), para 5.4(b).

⁷⁵ Homer study, para5.07.

⁷⁶ Homer study, para 11.

period of 4 weeks. If the administrator feels more time is required then that information should be conveyed to the creditors together with an explanation of the reasons for delay. In any event the legislation should prescribe a maximum period, say 2 months, beyond which the administrator must require the consent of the court or creditors committee. If no meeting is called then the administration will automatically come to an end.

Specific exemptions to moratorium

The company should be prevented from using administration as a last resort effort to avoid its creditors. An exemption to the moratorium should be allowed to creditors who have already begun to realise upon their security, for example by taking steps to appoint receivers or to sell property. Similarly creditors who have filed an application to wind up the company should be allowed to continue with that action. The administrator, if necessary, can apply to the court for relief (for example a stay of the winding up order, or an injunction from sale) if appropriate circumstances exist. Creditors who have issued default or repossession notices should be prevented from further enforcing their contractual rights during the initial period but be entitled to rely the original notice if a subsequent meeting of creditors decides to end the administration. If the company attempts administration at a stage where creditors have already begun enforcement action it will need to convince the administrator that the company can remedy the defaults or get the approval of creditors to a rescue plan. If those circumstances do not exist then the administrator should be wary of accepting an appointment as there are unlikely to be sufficient assets to pay his or her fees.⁷⁷

These suggested exceptions to the moratorium should alert the company and the administrator that administration should not be used to delay an inevitable receivership or liquidation. Likewise if the meeting of creditors resolve to end the administration creditors with security or proprietary interests will not be prejudiced by the delay in the enforcement of their rights.

At the meeting called to consider the administrators proposals the creditors should be given wide powers, subject to review by the court, to determine the outcome of the administration. That meeting should determine whether:

⁷⁷ The administrators fees are generally a first charge on the company's unsecured assets. While the administrator is entitled to an indemnity out of the company's assets, this may prove worthless if the assets are fully secured. The funding of administrations and the liability of administrators are issues which require investigation but which are not considered further in this paper.

- a) The creditors agree to vote on a plan.
- b) The administration should end.
- c) The company is insolvent and should be placed into liquidation.

The next section considers what level of creditor support should be required before a plan can be approved. A related question is whether creditors, should for voting purposes, be classified into separate groups. The inter-relationship of these two issues is considered with an example of the way in which various jurisdictions deal with majority voting and classification issues.

MAJORITY VOTING AND CLASSIFICATION ISSUES

Majority in value or majority in number.

The Harmer and Cork reports both considered the issue of voting rights at meetings to obtain creditor's approval to a scheme of arrangement. Interestingly the two committees reached divergent conclusions and subsequent legislation in both countries did not adopt the recommendations made by either committee. The Harmer Report identified the following options:⁷⁸

- Option A. Simple majority by number.
- Option B. Majority in value only.
- Option C. A double criterion: majority (or greater) in number and value.
- Option D. Simple majority in number with provision for two or more creditors to request that voting be by a majority in number and value.

In assessing these options the Harmer Report considered that any voting system should be simple; facilitate voting by creditors with contingent or unascertained claims; avoid stalemates and recognise interests of major creditors. All of these options attracted at least some degree of support from parties making submissions on the proposals.⁷⁹

Option A would simplify the voting process (requiring a mere counting of votes) and is perceived as being democratic. It would facilitate voting by contingent or unascertained creditors as there is no requirement for votes to be allocated according to the amount of the creditors claim. However option A, unlike option B, fails to weigh creditor's votes according to their financial interest in the company and there is merit in the argument that those who have most at stake should have a greater say in whether a proposal should be

⁷⁸ Harmer Report para 572 - 575

⁷⁹ Harmer Report para 577

adopted. Option C provides a better balance between the interests of major and minor creditors but the Harmer Commission considered that this option caused unnecessary difficulties with the valuation of contingent or unascertained claims. It can also lead to a deadlock where only one of the criteria is met.

The Harmer report in recommending option D (ie simple majority in *number*) rejected a submission that a single major creditor should be entitled to insist upon a majority vote by *value* as it would allow the creditor "to obstruct proceedings for capricious reasons."⁸⁰ The Cork report recommended a simple majority in *value* also providing that at least two creditors vote in favour of the scheme.

Option D removes the requirement for the administrator having to value claims in the first instance but it is likely that he or she will be required to do so upon the request of major creditors. A prudent administrator would take the precaution of valuing claims (contingent or otherwise) prior to the meeting to avoid delay. Thus option D may not result in simplifying the voting system or in any significant saving of time or expense. It is submitted that in most cases it will be a relatively simple exercise for administrators to value creditors claims against the company.

It should be noted that options C and D do not deal with the situation of a stalemate which may arise when, for example, a majority in number approve the scheme but not a majority in value. In the event of a stalemate between a majority in value and a majority in number the Harmer report recommended the court resolve the dispute upon the application of the administrator. The report is silent as to what criteria the court should consider and it is submitted that some criteria be outlined to avoid the uncertainty of a case by case approach. In jurisdictions which require a majority in value only there is provision for a particular creditor to apply to court for relief if the proposal supported by the major creditor is unfairly prejudicial to minor creditors. However the cost and delay associated with an application to the court may be a disincentive for a minor creditor.

It is interesting that both reports recommended approval by a simple majority rather than a special majority as was the requirement under previous companies legislation. Simple majority voting will make it easier to obtain creditor approval of the plan. Under the United

⁸⁰ Harmer Report para 579. The Report also recommended that there be provision for a dissatisfied creditor to apply to the court where it had substantial grounds for alleging prejudice to itself." The Cork report also made a similar proposal (para 925).

States Code a majority in number and two thirds in value is required whereas in New Zealand a majority in number and 75 percent in value is required.

There is, as far as the author is aware, no research on how a company's debt is typically split among its creditors. The mere fact that this will vary enormously from company to company makes it difficult to determine whether a simple majority will be sufficient to indicate general acceptance of a plan by the company's creditors. On the other hand a requirement of a special majority of 75 percent may in some circumstances be a too onerous requirement. As a general principle creditors with the largest unsecured debt should have a greater influence on the outcome of plan and accordingly it is submitted that a majority (or greater) in value rather than a majority in number is the more appropriate test.

Classification of Creditors

Creditor's interests and legal entitlements vary and the classification of classes can have a significant effect on the outcome of a plan. Prior to reform of the companies legislation in Australia and the United Kingdom the legislation relating to formal schemes of arrangement was identical with that of sections 205 and 206 of the New Zealand Companies Act 1955. The case law in these jurisdictions has traditionally focused on classifying claims by both legal entitlement and by "interests"⁸¹. Examples of "interests" include creditors who are in competition with the company and insiders who are claimants of the company and stand to benefit from the avoidance of liquidation. Classification by legal entitlement is relatively straightforward falling broadly into three separate groups, secured, preferential, and unsecured. Even with that task accomplished the proposers must then look at whether there are competing interests within a class as the Courts have refused to sanction schemes where parties with particular interests have used their majority to impose their interests on a dissenting minority.

Secured Creditors

Secured creditors would individually form their own classes unless they have identical rights and priorities over the same security when it would be appropriate that they form the same class. "Secured creditors cannot usually be lumped together in one class because each will have different security which differently affects his judgment. Some secured

⁸¹ See S. L. Wheeler *Company Reconstructions and arrangements under section 205 of the Companies Act 1955* (1990) 20 VUWLR page 69 - 82; J. R. Lingard *Corporate Rescues and Insolvencies* (Butterworths London 1989 second edition) pages 56 - 62.

creditors may be acutely conscious that their security is of little value; others may know that they are fully secured. Some secured creditors may have security which is readily saleable; others may know that it will be some time before they can realise their security."⁸²

Preferential Creditors

Preferential creditors generally form another group of classes depending on their respective priorities. In a recent case, *Commissioner of Inland Revenue v Kane Builders Ltd*⁸³, Master Towle held that the Commissioner's preferential claim for unpaid tax put him in a separate class from other unsecured creditors. Further the Crown could not be bound without its specific consent as "there is no specific provision in Pt V of the Companies Act within which section 205 falls which would indicate that the Crown may be bound."⁸⁴ In effect the Crown is given the right to veto the plan.

In comparison the United States Code provides for payment of preferential tax claims to be deferred for a period of up to six years. Other preferential creditors either receive payment in full or must agree to the scheme before they can be bound. Under the voluntary arrangement regime in the United Kingdom preferential creditors are accorded the same priority as they would receive in a liquidation unless they individually consent to a different arrangement.⁸⁵ In Australia there appears to be no special treatment of preferential creditors in either formal schemes of arrangement or administration.

There has been much debate on the justification for statutory preferences in a liquidation. However while they exist it is submitted that provision be made for such claims in administration particularly where the company may subsequently go into liquidation. It is submitted that there is no compelling policy reason for the Crown to be accorded an effective right to veto a plan where a majority of other creditors have voted in favour of the scheme. If the state is going to legislate to restrict the contractual rights of creditors it is fair to impose similar restrictions on itself.

⁸² J. R. Lingard *Corporate Rescues and Insolvencies* (Butterwoths London 1989 second edition)page 57.

⁸³ (1992) 14 NZTC 9,085. The Commissioners' claim is stated to be for unpaid GST, income tax and ACC levies; it is uncertain whether that amount also included penalties which do not receive preferential treatment under the section 308 of the Companies Act.

⁸⁴ (1992) 14 NZTC 9,087

⁸⁵ Insolvency Act 1986 (UK) s 4(4). This is in contrast with the treatment of preferential creditors under the Companies Act 1985 s 425 where preferential creditors form a separate class and if the requisite majority is achieved, the statutory rights of all preferential creditors may be restricted.

Unsecured Creditors

Similar issues arise with the classification of claims by unsecured creditors whose priority is the same in a liquidation but may differ in a pre-liquidation context by virtue of their contractual terms (eg entitlement to interest for late payment). Then there is the class or classes of creditors with proprietary rights; eg lien holders, lessors, claimants under restraint of trade clauses. In many cases it will be necessary for these parties to receive separate classification.

If approval of all classes to the plan is required then the classification of creditors into classes increases the possibility that an individual creditor can veto the plan. Likewise preferential creditors must, in most jurisdictions, agree to the plan before they can be bound by it. However it is important that creditors are classified separately otherwise there is potential for the plan to ignore a particular classes interests or treat some creditors unfairly. For example, the plan may propose to pay some creditors claims immediately while other creditors must wait for payment; retention of title claimants could lose their right to trace proceeds for the sale of their goods; secured creditors could lose their right to security or payment of contractually agreed rates of interest. It would be unfair for these creditors to be put in the same class. One solution is to separate creditors into classes for voting purposes, but then aggregate all votes to determine if the requisite majorities are achieved. This option, which has been adopted in Australia, is considered in the next section.

Inter-relationship between Classification and Majority Voting Issues

The requirement to classify creditors into classes combined with a requirement that each class must approve the plan, can make it unduly difficult to obtain approval of a plan. To illustrate how the various jurisdictions deal with this issue an example follows of a typical closely held company. The company is facing financial pressures from its creditors but there is some prospect that the company will survive if creditors can be persuaded from taking action to have the company wound up.

Assume the company's only business is a restaurant which formerly specialised in catering for business functions. With the recession and the introduction of fringe benefit tax for business lunches profitability began to decline. The company director was gradually changing the focus of the business to cater for patrons who attended the theatre next door. In fact the company had entered an agreement with the theatre to jointly promote "dinner and show" evenings over the Christmas period. Already in September there were

solid bookings and the administrator believed that the company would survive if it could remain in business until November when the promotion started.

The Bank had considered and rejected the possibility of appointing a receiver to sell the business as a going concern because: the lessor of the premises out of which the business operated was company X which was owned and controlled by the director of the company under administration and company X would not agree to an assignment of lease unless arrears due under the lease were paid; the company's director, also the chef, was not prepared to work for new owners; and Inland Revenue's preferential claim would significantly reduce the return to the Bank. However the Bank was confident that the administrator could preserve its position during the administration and agreed to a proposal to trade on through the Christmas period with a view to selling the business as a going concern if the company's position did not improve in the new year.

Company X also supported the proposal. However Inland Revenue and some of the unsecured creditors believed that if they rejected the proposal either the Bank or the company director would come to the rescue and pay out their claims now. The unsecured creditors felt they had nothing to lose by taking this approach as it was unlikely that there would be any return to them if the company was liquidated. However the Bank was not prepared to increase its exposure as it was already under-secured; it estimated the current value of its security at only \$40,000.

The company's total debt was \$100,000 split between the following three classes:

- One secured creditor with \$60,000 debt
- Inland Revenue with a preferential claim of \$10,000
- Eleven unsecured creditors with \$30,000 debt (Company X with \$10,000 debt and the others with debts of \$2,000 each)

The administrator will try to classify the claims in order to obtain the requisite majorities to accept the plan under the various regimes. Assume that Inland Revenue and five of the unsecured creditors (holding total claims of \$10,000) will reject the proposal. Assume also that the plan is "fair" to all creditors and "feasible". It will be seen that the same plan gets different results depending on the regime adopted.

Section 205 of the Companies Act 1955

Classification

Class A	The Bank (value of its security \$40,000)
Class B	Inland Revenue (\$10,000)
Class C	The Bank (unsecured claim of \$20,000); company X(\$10,000); unsecured creditors (\$20,000)

Voting

Class A	Accepts
Class B	Rejects
Class C	7 creditors accept (\$40,000) and 5 creditors reject (\$10,000)

The plan fails because Inland Revenue must be classified separately and the Crown cannot be bound without its specific consent. The plan also fails to obtain approval of a majority in number and 75 percent in value of each class of creditors.

The Companies Bill (NZ)

Classification

Class A	The Bank (\$40,000)
Class B	Bank (\$20,000); Inland Revenue (\$10,000); Company X (\$10,000); Unsecured Creditors (\$20,000)

Voting

Class A	Accepts
Class B	7 creditors accept (\$40,000) 6 creditors reject (\$20,000)

The plan will fail as the requisite majority of seventy-five percent in value has not been achieved. Even though Inland Revenue rejects the scheme the Companies Bill provides that the Crown can be bound a scheme of arrangement. However if the court is entitled to review the classification issue then it may find that Inland Revenue's preferential status requires its claim to be in a separate class. On that basis the plan will fail as all classes must approve the plan.

Section 425 of the Companies Act 1985 (UK)

Classification and voting will be the same as for section 205 of the Companies Act 1955. The plan will fail because of the requirement for the separate classification of preferential creditors.

Company Voluntary Arrangements - Insolvency Act 1986(UK) Part I

Classification	
Class A	all creditors
Voting	
Class A	7 creditors accept (\$40,000) and 6 creditors object (20,000)

Secured creditors vote only on the unsecured portion of their debt. The plan fails as approval has not been obtained from seventy-five percent in value of the companies creditors. There is no requirement to classify creditors into separate classes. The plan also fails because the Act provides that secured and preferential creditors cannot have their claims restricted without their specific consent.

Schemes of Arrangement - Chapter 5.1 Corporations Law (Australia)

Classification	
Class A	The Bank (value of its security \$40,000)
Class B	Inland Revenue (\$10,000)
Class C	The Bank (unsecured claim of \$20,000); company X (\$10,000); unsecured creditors (\$20,000)
Voting	
All classes	7 creditors accept (\$80,000) and 6 creditors object (\$20,000)

The legislation retains class meetings, but then votes are aggregated and approval by a majority in number and seventy-five percent in value of all creditors has been obtained. There appears to be no special treatment of the preferential creditors and the Act specifically binds the Crown. The plan succeeds. However if the company were to subsequently go into liquidation then the priority rights of the preferential creditor would have to be considered in the context of the liquidation.

Deed of Arrangement - Corporate Law Reform Bill 1992 (Aust)

Classification - none	
Voting - simple or special majority in number	

The treatment of the classification and majority issues in the proposed administration procedure is uncertain. There is no requirement for the Administrator to classify the creditors into classes, nor is there any provision for the Court to do so. The Administrator is required to call a meeting of creditors who may "resolve" that the company execute a deed of arrangement. The Bill does not define whether it is a majority in number or a majority in value which is required. Nor does the Bill specify whether a bare majority (in

number or value) is sufficient or whether a special majority of 75 percent is required.⁸⁶ As it happens, the plan succeeds anyway. There is no special treatment of preferential creditors.

United States

Classification

Class A	The Bank (value of its security \$40,000)	
Class B	Inland Revenue (\$10,000)	
Class C	The Bank (unsecured claim of \$20,000); Company (\$10,000); Unsecured creditors (\$20,000)	X

Voting

Class A	Accepts
Class B	Forced to accept
Class C	7 creditors accept (\$40,000) 6 creditors reject (\$20,000)

A majority in number and two-thirds in value in each class are required to accept the plan. Inland Revenue may have full payment of its claim deferred for a period of up to six years after assessment. Other preferential creditors must accept payment in full unless they individually agree to a separate arrangement. The plan succeeds. The United States code provides for the plan to be approved over the objection of a dissenting class in certain circumstances.

The above example is a simplified version of what might occur in reality. If the unsecured creditors rights and legal entitlements differ then, arguably, they should receive separate classification. So the creditor who leases the espresso machine to the company and the dry cleaner who has a lien over the company's linen would receive separate classification and could, potentially, veto the plan.

Also some creditors may seek to challenge the composition of the unsecured class of creditors on the basis that Company X is in reality representing the company directors interests and has a clear motive for accepting the plan. If the objection by creditors was upheld then Company X's vote would be either disallowed or placed in a separate class. Approval to the plan could not be obtained under any voting formula which required the support of majority in number of creditors. (6 creditors supporting the plan and 6 creditors opposing).

⁸⁶ "Resolution" is defined in the Federal Corporations Law section 9 as "a resolution other than a special resolution." A special resolution requires a 75% majority (section 253.)

Summary

Even though it was assumed that the plan was fair to all creditors, in most cases it was not approved. If voting was by two-thirds majority in value then there was a greater likelihood of success. Also the requirement for separate classification of claims enhances the ability of an individual creditor to veto the scheme. Classification and majority voting issues are sufficiently intertwined that they cannot be resolved separately. Relaxing the voting requirements may make it easier for plans to be approved, but the risk of prejudice to minority creditors increases. Insisting upon classification of creditors increases the risk that a dissenting majority in a particular class can veto the scheme. It is impossible to devise a system which will fulfil both aims. Rather than requiring a majority in each class it is submitted that voting should take place in separate classes and then all votes aggregated to determine whether a simple (or greater) majority of all the company creditors approve the plan. Provision can then be made for the court, on the application of the administrator or any creditor, to review the plan.

ROLE OF COURT- SUBSTANTIVE REVIEW OR PROCEDURAL FAIRNESS

Schemes of Arrangement Under the Companies Act 1955 and the Companies Bill

If, at the meetings, a majority in number representing 75 percent in value of each class of creditors agree to the scheme then an application is made to the Court to sanction the scheme. In *The New Zealand Municipalities Co-operative Insurance Co Ltd v The Dunedin City Council* (1989) 4 NZCLC 65,044. the court set out the following requirements to met before the court would sanction a scheme of arrangement:

- a) compliance with the statutory provisions;
- b) the scheme was fairly put to the classes concerned, including whether sufficient information was contained in the circular;
- c) the classes were fairly represented by those who attended and the majority acted bona fide without coercing the minority;
- d) the scheme was such that an intelligent and honest business person, acting as a member of the class, might reasonably approve it;
- e) the scheme was fair and reasonable to all classes concerned.

The courts despite determining classes prior to the meeting have, in at least one case, refused to sanction the scheme on the basis that the classes had been incorrectly

classified. This lead to uncertainty for the proposers of the plan in that, even after the court had classified the claimants into categories, the court could at the application to sanction the scheme decide that the classification was incorrect and refuse to sanction the scheme. Under the Companies Bill the role of the court is limited to one of review where a creditor can apply to the court on the ground that it has been unfairly prejudiced. Interestingly, the provision under the Act whereby the Court could determine how creditors should be classified has not been carried over into the Bill. However the Bill still clearly envisages that creditors will continue to be separately classified (clauses 215, 216).⁸⁷ Will the absence of any specific provision entitling the court to determine classes of creditors mean that the court will be precluded from any investigation into the classification of creditors?⁸⁸

For reasons of cost and delay it is submitted that court sanction of a scheme should not be an obligatory requirement. Further if the creditors generally approve the plan then there is no reason why the court, unless some objection is raised, should review their collective decision. However there may be circumstances where it is appropriate for the court to review the acceptance or rejection of the proposal by the creditors as a whole. It is submitted that provision for review by the court is an important safeguard for individual creditors that are unfairly prejudiced by the plan. There should be a finite period, say 10 days, in which the application for review will be made.

To assist the court in reviewing the objection the requirement for classification of claims is desirable as it enables the court to consider how the various classes of creditors is treated. As a further safeguard creditors should also be allowed to apply to the court on the grounds that the administrator has failed to comply procedural provisions such as the requirement for a notice of meetings, proper disclosure of the company's affairs etc. The United States approach to the approval of plans, which is considered shortly, provides a number of guidelines. It is submitted that the legislation should enact specific guidelines

⁸⁷ Whilst "class" is defined in respect of shareholders (clause 94) "It is not clear whether this definition will be adjusted for [ie to include] creditors, or whether the courts will continue to follow the common law approach of erring on the liberal side so as to avoid the confiscation[of rights] and injustice." A. Beck & A. Borrowdale Guidebook to New Zealand Companies and Securities Law (Commerce Clearing House Auckland 1990) page 261.

⁸⁸ It is possible that the court will consider the classification as a procedural issue upon which proponents of the plan may apply for directions under clause 217(1). However clause 217 states that the court may give directions "in relation to a procedural requirement imposed by this part of the Act" The Bill while envisaging that creditors may be classified into classes, imposes no procedural requirement that they in fact be separated into classes. Nor is there any definition as to what constitutes a class of creditors.

to assist the court in reviewing a plan. Enacting specific guidelines will make the procedure more certain as the parties will know what standards must be met at the outset.

In addition there should also be provision for the administrator to apply to the court for review of the outcome of the creditors meeting. This will enable the court to consider and approve plans which, because of the vagaries of the classification and majority voting systems, have not been approved despite general creditor support. It will also be an important protection for the company in circumstances where the creditors have, unreasonably, decided that the company is insolvent and should be placed in liquidation.

Approval of a plan - the United States Approach

Even if requisite majorities are achieved the court is still required to consider whether the plan meets the "confirmation standards" set out in the Code. In addition the court may force dissenting classes to accept the plan provided certain conditions are met. This provision known as "cram down" is an important feature of reorganization. Because the model proposed in this paper does not require all classes to accept the plan there is consequently no requirement for an analogous cram down procedure. Section 1129(a) of the United States Code sets out the various requirements which must be met before the plan will be approved. The main requirements are discussed in turn.

Compliance with all applicable provisions of title 11 - (Section 1129(a)(1) and Proposed in Good Faith - Section 1129(a)(3)

The Code and the associated rules have extensive procedural requirements designed to ensure that creditors receive adequate information about the plan and are fairly treated. Classification and voting must be dealt with strictly in accordance the Code and the plan must be proposed with honesty, good intention and with a basis for expecting that a reorganization can be effected.⁸⁹

In the best interests of creditors - section 1129(a)(7)

The plan must provide that a dissenting creditor receive at least what that creditor would receive in a liquidation but a creditor is not prohibited from choosing to accept less than the liquidation value of its claim.⁹⁰ This may be an important consideration when parties related to the company (eg company directors, or their relatives in closely held

⁸⁹ In re Johns-Manville Corp., 843 F.2d 636,649 (2d Cir. 1988)

⁹⁰ as occurred in the Johns Manville reorganization.

companies) have substantial unsecured claims and wish to forgo their claims, thereby giving other creditors a larger dividend, in the hope of gaining creditor acceptance to the plan. The benefit for the insider is that they or their relatives may continue to control the company or retain employment by it.

Mandatory treatment of certain preferential claims - section 1129(a)(9)

Section 507 sets out the order and priority of claims in a reorganization. Expenses incurred in operating the company⁹¹, including creditors costs and professional fees⁹² incurred in connection with the commencement of reorganization and some taxation claims⁹³ have first priority for payment with "involuntary gap" creditors⁹⁴ forming a second priority. Each of these claimants must receive payment in full unless they individually agree to different treatment. Payment of other priority tax claims may be deferred for a period of up to six years after the date of assessment.⁹⁵

In the authors experience it is exceedingly common for insolvent companies to defer making provision for taxation in favour of making payments to other creditors. This is probably because other creditors can more easily threaten the continuing operation of a trading business by refusing to supply goods and services or calling up securities. As a consequence it is likely that a company considering administration will frequently have a large outstanding obligation to Inland Revenue. If that debt must be paid in full as soon as the plan is approved then it is likely companies will simply not have the financial resources to contemplate invoking the administration procedure. For these reasons, and for reasons previously referred to,⁹⁶ it is submitted that the legislature should consider allowing for the payment of taxation liabilities to be deferred without penalty. Of course current tax liabilities, like any future obligations, must be capable of being met by the company.

⁹¹ As defined and set out in detail in section 503(b).

⁹² section 503(b)(4) and section 330

⁹³ section 503(b)(1)(B)(C)

⁹⁴ Section 502(f). Where a group of creditors have filed a petition against the company then creditors dealing with the company subsequent to filing the petition are accorded priority. The purpose of the rule is to prevent creditors refusing to deal with the company (and potentially freezing its business) prior to the hearing of an involuntary petition.

⁹⁵ Section 1129(a)(9)(C)

⁹⁶ see discussion of preferential creditors in the Classification section of this paper.

The plan must be feasible - section 1129(a)(11)

Section 1129(a)(11) requires that "confirmation of the plan is not likely to be followed by liquidation, or the need for further financial reorganization...unless such liquidation or reorganization is proposed in the plan." Thus reorganization does not need to result in the resuscitation of the company or any part of its business in order to be confirmed. The feasibility test is designed to prevent hopeless plans being proposed as a means to defer recovery action by creditors. Factors the court should consider will include: adequacy of capital structure; earning power of business; economic conditions; ability of management; availability of credit and provision for adequate working capital.⁹⁷

It is anticipated that this will be an important ground for secured creditors to challenge a plan. If a company has a high proportion (in value) of unsecured creditors then it may be tempting for the administrator to make unrealistic promises to those creditors in order to gain their acceptance of the plan. If the plan is not realistically capable of fulfilment in the terms originally proposed then secured creditors should not be forced to accept a plan that will ultimately fail. Further the integrity of the administration procedure as a whole will be undermined if creditors generally perceive that plans will frequently require amendment after acceptance.

It is submitted that these tests could usefully be incorporated into legislation as guidance for the courts in determining whether to approve a plan in New Zealand. However unlike the United States procedure where court approval is required in all cases, the function of the court should be limited to one of review.

SUMMARY

The object of this paper has been to propose a system of voluntary administration for financially distressed companies in New Zealand. In exploring some of the key issues the author has endeavoured to conform with the principles of modern insolvency law as set out in the reports supporting law reform. In accordance with those principles the following conclusions are offered.

To encourage early and timely use of the procedure it is proposed that there be no threshold tests to be satisfied before the procedure can be initiated. The procedure should

⁹⁷ In re U.S. Truck Co., 800 F.2d 581 (6th Cir. 1986)

be seen as a constructive response by the company to its financial problems and not as just another creditors' remedy. Accordingly the only party entitled to invoke the procedure is the company.

Management will not automatically lose control of the company but an independent adviser will be appointed to control the company's finances and prepare advice and proposals for the company's future. The administrator will initially be appointed by the company but the creditors will have power to replace the administrator with someone of their own choice.

There will be a short moratoria on the enforcement of action against the company to enable the administrator to formulate a rescue plan free from the threat of creditors taking action which could jeopardise the company's ability to continue as a going concern. However a company should not be encouraged to use administration as a last resort effort to evade its creditors when liquidation or receivership is inevitable. Accordingly creditors who have taken steps prior to the initiation of administration should, in some circumstances, be permitted to continue with that action.

It is acknowledged that the administration has the potential to seriously affect the value of a creditor's security. The option of allowing secured creditors, particularly those with a floating charge, to exercise a power of veto has been rejected in favour of making the procedure more widely available. It is difficult to devise legislation which will ensure that creditors security interests are adequately protected and this is an area where further research is required.

Consistent with the theory that creditors of an insolvent company become the 'owners' of the company they should be given wide powers to collectively determine the company's future. It is practically impossible to devise a voting system that will truly reflect the collective views of creditors while at the same time protecting their individual interests. It is therefore appropriate for provision to be made for the court to review the administrators plan and creditors objections to it. There should also be provision for the administrator to obtain the approval of the court to a plan that is objectively fair and reasonable in circumstances where the proposed voting system has failed to represent the collective interests of the creditors and the company.

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For reasons of cost and delay, and also in recognition of the creditors superior right to determine the outcome of the administration, there is no requirement for the court to sanction the administration whether at the initiation stage or after approval of the plan.

If the proposed system can encourage companies to consider administration as soon as financial or management problems appear then the wider social and economic benefits of protecting jobs and saving viable businesses will follow. In some circumstances all an administration will achieve is an orderly winding up of the company's affairs. If that results in a saving of costs and a greater dividend to creditors then it can equally be said that the procedure has been successful.

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