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# Company Law Changes to Create Safe Harbours and Business Debt Hibernation in New Zealand

It is expected that, in the coming months, a number of New Zealand businesses will face serious liquidity issues arising from COVID-19 and the Government's response to it. As foreshadowed by the Government on 3 April 2020[1], Parliament has enacted legislation[2] to give effect to the temporary changes proposed to the New Zealand insolvency regime which seek to mitigate the worst effects of the coming challenges. The legislation was passed in a matter of days, and was included in a wide-ranging omnibus bill[3]: The bill included provisions to give effect to specific policies aimed at addressing the current economic challenges; amendments which seek to give legal effect to the inevitable changes in business and governmental practice which will be a feature of the post-COVID environment; and to address some immediate legislative issues arising from the lockdown.

However, the two key insolvency law reform elements of the bill which are intended to address the coming liquidity challenges (and which are the subject of this note) are:

- the enactment of a temporary "safe harbour" regime, under which directors will be temporarily relieved from a limited number of director's duties; and
- the establishment of the Business Debt Hibernation scheme.

Both regimes will function for a limited six month period, which is expected to be when the most serious liquidity challenges are likely to be faced.

## The 'Safe Harbour'

Under the Companies Act 1993[4] currently, company directors owe duties to the company in respect of how they allow the company to conduct itself in relation to creditors. Under s.135 (entitled "Reckless Trading"):

> *A director of a company must not—*
>
> *(a) agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or*
>
> *(b) cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.*

Under s.136 (entitled "Duty in Relation to Obligations"):

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[1] "Help for Companies Facing Insolvency" (New Zealand Government Website "Unite Against Covid-19", 3 April 2020: https://covid19.govt.nz/latest-updates/help-for-companies-facing-insolvency/).

[2] COVID-19 Response (Further Management Measures) Legislation Act 2020 (http://www.legislation.govt.nz/act/public/2020/0013/latest/LMS339370.html).

[3] The proposed changes were included in the COVID-19 Response (Further Management Measures) Legislation Bill (http://www.legislation.govt.nz/bill/government/2020/0244/latest/whole.html#LMS339369).

[4] Any reference in the footnote to a legislative provision is a reference to the Companies Act 1993 unless otherwise stated.

> *A director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.*

There is, of course, a tension between allowing companies to take commercial risk, and wanting to mitigate the effect of corporate failure on a company's creditors. The intention of ss.135 and 136 is to strike an appropriate balance between those two considerations. However, the proper point of equilibrium is often the subject of contention in the event of a company's failure; it is often the subject of litigation, as liquidators and creditors seek to hold directors personally liable for debts incurred by the company following any breach of duty[5].

Under the "safe harbour" provisions[6], there is to be a temporary relaxation of the duties contained in ss.135 and 136. The effect of the safe harbour legislation is to allow directors to observe the requirements of ss.135 and 136 during the safe harbour period in a manner taking account of any liquidity problems caused by the effects of COVID-19.

The safe harbour provisions apply to all companies who meet the necessary criteria[7], except, essentially, to entities providing financial services[8]. The key requirement is that the company must have been able to pay its debts as they became due in the ordinary course of business as at 31 December 2019[9]. The initial "safe harbour period" is deemed to have commenced on 3 April 2020[10] (after the lockdown began, but when the proposed changes were announced), and will end on 30 September 2020[11]. However, the Government can, by regulation, extend the "initial safe harbour period" to 31 March 2021[12], and can also create a "new safe harbour period" ending no later than 30 September 2021[13].

Under the amendment, during the safe harbour period, the actions of a director will not be reckless trading under s.135[14] if the director believes that the company's liquidity problems arise from the effects of COVID-19[15], provided that certain requirements are met. Specifically, the director must form an opinion, acting in good faith, that any liquidity problems that a company has, or will have in the next six months[16], are a result of the effects of COVID-19 on the company, its creditors or debtors[17]. Furthermore, the director must also be of the opinion that the company will be able to pay its due debts by 30 September 2021[18] or such later date as may be prescribed by regulation[19].

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[5] The New Zealand Supreme Court (New Zealand's final court of appeal) heard an appeal on 1 October 2019 in *Madsen-Ries v Cooper* (SC 29/2019); the decision is expected to be of major significance to the law on directors' s. 135 duties.

[6] A new Schedule 12.

[7] Schedule 12, clause 6.

[8] Schedule 12, clause 5(2).

[9] Schedule 12, clause 5(1)(a).

[10] Schedule 12, clause 5(2).

[11] Schedule 12, clause 5(2)(a).

[12] Schedule 12, clause 5(2)(b) and clause 10(1)(a).

[13] Schedule 12, clause 10(1)(b).

[14] Schedule 12, clause 6(1).

[15] Schedule 12, clause 6(2).

[16] Schedule 12, clause 6(2)(a).

[17] Schedule 12, clause 6(2)(b).

[18] Schedule 12, clause 6(2)(c) and clause 6(3)(a).

[19] Schedule 12, clause 6(2)(c) and clause 6(3)(b).

Similar amendments have been made in relation to the s.136 duty[20]. A director who, during the safe harbour period only[21], agrees to the company incurring an obligation in circumstances in which the company has or will have liquidity problems during the next six months arising from COVID-19[22], is deemed to have reasonable grounds for believing the company could perform that obligation[23] provided that it could perform the obligation by 30 September 2021[24] (or such later date as prescribed by regulations[25].

Directors wishing to avail themselves of this protection will bear the burden of proof in defending any claim brought against them for breach of director's duty [26].

Among the regulations which can be made are regulations extending the safe harbour period[27], either by extending the safe harbour period[28] or establishing new safe harbour periods[29]; however, the safe harbour period may not extend beyond 30 September 2021[30], with corresponding extensions of the "benchmark" date by which a company can perform its obligations[31]. All of the provisions relating to the "safe harbour" will be automatically repealed on 31 May 2022[32].

Whatever view one might have of the extent of directors' duties under the current legislation, the enactment of "safe harbour" provisions makes clear to directors (and to anyone assessing directors' performance, including liquidators and the Courts) that, provided the criteria are satisfied, it would not be a breach of a director's duties by continuing to trade in the current COVID-19 environment. It also potentially gives directors comfort that, they can continue to carry on business, while seeking to reach accommodations with creditors, which might include the availability of Business Debt Hibernation (discussed below).

## Business debt hibernation

The new Schedule 13 introduces the Business Debt Hibernation (BDH) scheme, as a new form of insolvency process. The stated intention of BDH is that it should be straightforward, and that an entity should be able to enter into the regime without the need for professional advice. It also allows the business to be carried on by the current directors, without any external appointment.

Schedule 13 is extensive and the following is only a summary of how BDH operates. This note does not address the detailed procedures which a debtor needs to follow to avail itself of the protections provided by BDH.

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[20] Schedule 12, clause 7.

[21] Schedule 12, clause 7(1)(a) and clause 7(3).

[22] Schedule 12, clause 7(1) and 7(2).

[23] Schedule 12, clause 7(2).

[24] Schedule 12, clause 7(2)(b) and clause 7(4)(a).

[25] Schedule 12, clause 7(2)(b) and clause 7(4)(b).

[26] Schedule 12, clause 8.

[27] Schedule 12, clause 10.

[28] Schedule 12, clause 10(1)(a).

[29] Schedule 12, clause 10(1)(b).

[30] Schedule 12, clause 10(1)(b)(ii).

[31] Schedule 12, clause 10(6)(b).

[32] S. 138B, as enacted by the COVID-19 Response (Further Management Measures) Legislation Act 2020 (Schedule 2, Part 2, clause 6).

The legislative purpose of BDH is stated to be to maximise the chances of a business entity facing liquidity problems arising from the outbreak of COVID-19 to continue in business, or, failing that, to ensure a better outcome for creditors than would occur under an immediate liquidation[33]. If an entity goes into BDH, an entity is given temporary protection from the enforcement of creditor rights[34]. However, it is not the purpose of BDH to allow an entity to allow for the deferral of a decision about liquidating an entity that has no realistic prospect of continuing to trade in the medium or longer term, or to allow for any substantive amendment to creditor rights (including cancellation of debt) after the end of any temporary protection period[35].

BDH is available to a range of eligible entities in addition to companies, including partnerships and any other body corporates[36]; although BDH is not available to entities providing financial services[37]. The last date for entry into BDH is 24 December 2020 (unless that date is extended by Regulations)[38].

An entity is eligible to go into BDH if the entity was able to pay its debts as they fell due in the normal course as at 31 December 2019[39]. To enter BDH, 80% of the entity's directors must vote in favour of the resolution to go into BDH[40]. The directors must believe that the entity was able to pay its debts on 31 December 2019[41], that the entity, its debtors or creditors will be affected by liquidity problems over the next six months arising from COVID-19[42], and that it is more likely than not that the entity will be able to pay its debts by 30 September 2021[43] (or any later date prescribed regulation[44]). .

The process for entering into BDH is for the entity to deliver to the Registrar of Companies[45] and to send to each known creditor a notice in a prescribed form[46] that the entity is to enter BDH. Upon the entity giving notice to the Registrar, an initial protection period of no more than one month commences[47]. During that period, the entity is expected to propose an arrangement to its creditors, and for the creditors to consider the arrangement[48]. If the proposed arrangement is approved by a majority of the entity's creditors, both by number and by value[49] (but excluding creditors who are related parties[50]), the protections continue for a further six months[51].

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[33] Schedule 13, clause 1(1).

[34] Schedule 13, clause 1(2).

[35] Schedule 13, clause 1(3).

[36] Schedule 13, clause 3(1) and clause 4(1).

[37] Schedule 13, clause 3(2).

[38] Schedule 13, clause 3(b).

[39] Schedule 13, clause 5(1)(a).

[40] Schedule 13, clause 5(1)(b).

[41] Schedule 13, clause 5(1)(c)(i).

[42] Schedule 13, clause 5(2)(a) and (b).

[43] Schedule 13, clause 5(2)(c) and (3)(a).

[44] Schedule 13, clause 5(3)(b).

[45] Schedule 13, clause 6.

[46] Schedule 13, clause 7.

[47] Schedule 13, clause 14 and clause 15(1).

[48] Schedule 13, clause 9 and clause 10.

[49] Schedule 13, clause 24.

[50] Schedule 13, clause 32.

[51] Schedule 13, clause 15(2).

Any arrangement which has been approved is binding on all creditors who received notice of it[52]. The arrangement is, as suggested, a period of "debt hibernation" only. While payment of debts may be postponed under BDH[53], debts may not be cancelled or otherwise varied, nor may other creditor rights at the conclusion of the protection period be affected[54].

During the period of protection, a creditor may not commence proceedings (in court or by way of arbitration)[55], nor enforce any judgment[56] or any security interest[57]; nor may property owners seek to recover property used by the entity[58]. (Among the changes elsewhere in the bill were changes to the Property Law Act 2007 extending the period of notice which mortgagees and lessors of real property have to give before taking action following default[59]). Also creditors are unable to bring proceedings under a guarantee of the entity's indebtedness by certain related individuals[60]. Notwithstanding that, a creditor can seek permission from the court to enforce the creditor's rights notwithstanding hibernation[61]. An entity can terminate BDH before the expiry of the protection period[62].

"Excluded debts" are not subject to the general creditor moratorium: "excluded debts" are debts owed to creditors whose debts have arisen during the protection period; and all employee wages and salaries (along with amounts due for employee tax and other statutory salary deductions[63]). Also not subject to the moratorium are secured creditors who hold a charge over all (or substantially all) of the assets of the entity, who continue to have all of their rights of enforcement without limitation, notwithstanding any temporary protections[64], including the right to appoint a receiver. In most cases, the holders of such charges (normally General Security Agreements) will be the entity's principal financier, normally a bank; in most cases, any entity seeking to enter BDH is going to have to have its bank's agreement to it doing so: given that, the proper role of an entity's principal financier was a matter of some consideration during the legislative process[65].

There will also be exemptions from the law of voidable transactions for companies in BDH. (Significant changes have also been made to the substantive law of voidable transactions, whereby the pre-liquidation period in which transactions can be challenged has been shortened to six months for all but "related creditors"[66], but those changes fall outside the discussion in this note[67].)

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[52] Schedule 13, clause 29.

[53] Schedule 13, clause 30(2).

[54] Schedule 13, clause 30(1).

[55] Schedule 13, clause 40(1).

[56] Schedule 13, clause 42.

[57] Schedule 13, clause 38.

[58] Schedule 13, clause 39.

[59] Property Law Act 2007, ss.120A-120E, ss. 129A-129E and ss. 245A-E.

[60] Schedule 13, clause 44.

[61] Schedule 13, clause 38(1)(a), clause 39(b), clause 40(1)(b), clause 42 and clause 44(1).

[62] Schedule 13, clause 18 and clause 19.

[63] Schedule 13, clause 4 definition of "excluded debt", clause 4(a)(ii) and clause 40(2)(b).

[64] Schedule 13, clause 2(2), clause 21, clause 40(1)(a) and clause 47(1)(b).

[65] COVID-19 Response (Further Management Measures) Legislation Bill: Report of the Epidemic Response Committee May 2020 (the Select Committee), p. 6) (https://www.parliament.nz/resource/en-NZ/SCR_97736/51f82470d716998886801f80a714bf61131f5cb0).

[66] SS. 292-296, as amended by the COVID-19 Response (Further Management Measures) Legislation Act 2020 (Schedule 2, Part 2, clause 7).

[67] There was some questioning as to whether it was necessary or appropriate to make permanent changes to the law on this subject in the context of temporary emergency-response legislation (Submission of RITANZ to the

Under the unamended legislation, reasonably commonplace transactions entered into with a company unable to pay its debts could be "voidable" in any subsequent liquidation as having "preferential" effect (even if there was no element of preferential intention). Accordingly, creditors of a company in BDH might well be reluctant to continue trading with it, as, almost inevitably, a company in BDH is a company "unable to pay its debts", and any transactions with such an entity other than on the basis of "cash payment" could be technically voidable.

To ensure that companies in BDH can continue to obtain supplier credit, the law provides that transactions undertaken during the protection period or which have been authorised as part of the creditor arrangement, are excluded from challenge under the voidable transactions regime, provided the transactions are in good faith and on arm's length terms[68]. However, that exemption does not extend to the granting of security by the company, which are still voidable in the normal way[69].

There are a number of further procedural and miscellaneous provisions[70]; however, of significance is a provision whereby the entry into BDH is not to be treated as an event of default for the purposes of contracts, nor is it evidence of insolvency, nor can it be grounds for the exercise of any right otherwise not exercisable[71]. Furthermore, the ability to make regulations under the Companies Act 1993 is extended to include regulations in respect of BDH (including the potential to change applicable dates)[72]. All of the provisions relating to BDH will be deemed to be repealed on 31 May 2022[73].

## Conclusion

New Zealand's economy is substantially made up of small and medium-sized businesses; many of these have limited working capital: liquidity challenges could quickly cause many such businesses to cease trading, which would have significant economic and social impacts. The changes aim to work in tandem: they provide a mechanism whereby viable businesses can look to continue to trade, with a mechanism to address liquidity constraints arising from "pre-COVID" conditions (with the agreement of their creditors); and directors can also know that they would not necessarily be in breach of their duties by seeking to do so.

It is difficult to gauge how many entities will seek to adopt BDH. However, as was noted in some of the submissions to the Parliamentary Select Committee, the most important consequence of the BDH procedures could be to allow a debtor, operating a viable business and enjoying a high degree of creditor support, to have a framework for negotiations with creditors; BDH can limit the extent to which any individual creditor can bring about the

Select Committee, 8 May 2020, paras. 11-13 (https://www.parliament.nz/resource/en-NZ/52SCEP_EVI_97676_EP239/5ae83fab8fc029cdf4199dbc484d262ad993ea6f) (RITANZ is the New Zealand member body of INSOL)).

[68] Schedule 13, clause 53.

[69] The continued potential voidability of a granting of security by an entity in BDH was recommended by the Select Committee (and by many of those making submissions to the Select Committee), and was reflected by not including s. 293 (voidable charges) in the provisions suspended while an entity is in BDH)).

[70] Schedule 13, clauses 54-74.

[71] Schedule 13, clause 66.

[72] S. 395B, as enacted by the COVID-19 Response (Further Management Measures) Legislation Act 2020 (Schedule 2, Part 2, clause 12).

[73] S. 395A(3), as enacted by the COVID-19 Response (Further Management Measures) Legislation Act 2020 (Schedule 2, Part 2, clause 12).

demise of the debtor's business in the immediate term[74]. We will have to see whether a system which allows debts to remain (metaphorically) hibernating while the economy moves into Spring, will let businesses survive to enjoy a return of Summer's prosperity.


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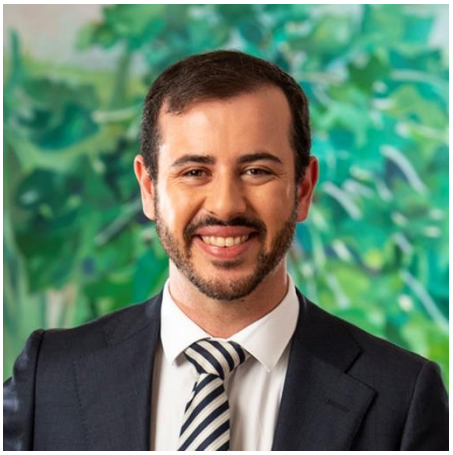

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[74] For example, Statement of Paul Heath Q.C. to the Select Committee (p. 8): (https://www.parliament.nz/resource/en-NZ/52SCEP_EVI_97676_EP264/1ce01d62051039d412d32e452741bf1a538bde37).