

Corporate insolvency – when a company fails

It is not uncommon for a company to encounter financial problems at some stage during the development of its business. It may not have the resources to sustain the growth of the business, or its directors may not have enough experience to deal with the problems the company is facing. The company may be able to trade out of its financial difficulties – or it may not. When a company fails, what happens?

Alternatives

When a company fails one of three things usually happens. The company:

- Is placed into receivership;
- Enters into a compromise with its creditors; or
- Is put into liquidation.

Receivership

Debenture holders (usually banks) or other secured creditors have the power to appoint a receiver to a company. The receiver takes control of and preserves the assets over which the secured creditors have security.

Receivers may be appointed by the court or privately by the exercise of a contractual power contained in the documentation creating the creditor's security.

A receiver's powers and duties are set out in the Receiverships Act and in the relevant security documentation.

Receivership can offer an opportunity to reconsider and restructure a company's affairs and does not necessarily always mean the end of a business.

When the receivership option is followed, the only objective is to look after the secured creditor. The receiver looks after the secured creditor and has a duty to realise the assets of the company to repay the secured creditor. However, it should be noted that receivers have a legal duty not to take any action that would affect the rights of unsecured creditors.

Compromises with creditors

A compromise is an agreement between a company and its creditors. Most compromises have two basic features. They provide that:

- Creditors will be paid their debt in part or in full over a period; and
- During the term of the compromise, debts are frozen and no creditor may take any action against the company.

Often a compromise can be an alternative to receivership or liquidation – giving the company the opportunity to survive.

Under the Companies Act, for a compromise to succeed it must be approved by 75% in number and 75% in value of each class of creditor affected by the proposal. Creditors have the right to vote for or against the proposal and to vote for or against amendments to the proposal. Each class of creditors affected by a compromise must vote as a class. There will usually be a meeting of creditors to discuss the proposal, which gives creditors the opportunity to ask questions and ask for modifications to the compromise (if appropriate).

In order to satisfy creditors, it is recommended that an independent compromise manager be appointed to manage the proposal. Also, the documentation should be professionally prepared, comply with the Companies Act, and be comprehensive and informative.

If a compromise does not work out then the company may be put into liquidation by creditors.

Liquidation

A company is placed in liquidation by the appointment of a named person as liquidator. In practice, a company will usually be put in liquidation through one of the following three methods:

- Special resolution of the shareholders;
- Decision of the board of directors following an event specified in the constitution to cause liquidation; or
- Court order following an application by either the company, a director, a shareholder, or a creditor of the company.

Ordinarily, when a company is placed in liquidation through either of the first two methods a private sector liquidator will be appointed. Where a company is put into liquidation by court order, either the shareholders or creditors will choose their own liquidator or the Official Assignee will be appointed.

The duties and powers of the liquidator are clearly set out in the Companies Act. The liquidator has a duty to take possession of, protect, realise, and distribute the proceeds of realisation of the company's assets to its creditors and (if any surplus remains), to its shareholders. The liquidator looks after the interests of all creditors. Once the liquidation is complete the company is struck off the companies register.

The liquidation of companies is governed by a complex set of statutory rules. Once liquidation commences, the same procedure is followed in all cases. There is no distinction between solvent and insolvent liquidation.

The effect of liquidation on the company, its directors, and its creditors is immediate and serious. Principally:

- From the date of liquidation, the liquidator will take custody and control of the company's assets.
- If the company is still trading it will usually be closed down.
- Although directors will remain in office, their powers will be limited.
- Directors have a duty to co-operate with the liquidator to enable the affairs of the company to be fairly and equitably resolved. It is an offence to conceal or remove property or records of the company. The liquidator has wide powers to seek information from directors.
- Directors will be required to complete a statement of affairs covering matters including the history of the company, trading, the company's assets and liabilities, and legal claims against the company.
- From the date of liquidation, an unsecured creditor cannot, without the permission of either the court or the liquidator, start or continue any legal proceeding against the company or its property, or start to enforce rights against the property of the company.
- Creditors will receive reports from, and have meetings with, the liquidator throughout the liquidation process and the liquidator must have regard to the views of creditors.
- In certain circumstances, the liquidator or creditors may have the right to take action against directors, eg where the company has traded recklessly or while insolvent.

Finally

Talk to us if you think that your company may be facing financial difficulties. We will be able to provide you with comprehensive advice on your options.

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See us first

- Before making any financial decisions.
- To assist you in meeting the necessary legal or financial requirements.
- If you consider that any of the issues contained in this fact sheet may affect you.

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