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Minister	Hon Kris Faafoi	**Portfolio**	Commerce and Consumer Affairs
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List of documents that have been proactively released		
Date	**Title**	**Author**
23 September 2019	*Insolvency Law Reform*	*Office of the Minister of Commerce and Consumer Affairs*
23 September 2019	*Insolvency Law Reform: Annex One - Minor Changes*	*Office of the Minister of Commerce and Consumer Affairs*
23 September 2019	*CAB-19-MIN-0491*	*Cabinet Office*
23 September 2019	*Regulatory Impact Statement: Insolvency Law Reform – Gift Cards & Vouchers*	*Ministry of Business, Innovation and Employment*
23 September 2019	*Regulatory Impact Statement: Insolvency Law Reform – Reckless Trading Claims*	*Ministry of Business, Innovation and Employment*
23 September 2019	*Regulatory Impact Statement: Insolvency Law Reform - Voidable Transactions*	*Ministry of Business, Innovation and Employment*

Information redacted **YES**

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Impact Summary: Reckless Trading Claims

Section 1: General information

Purpose
The Ministry of Business, Innovation & Employment is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with policy change to be taken by Cabinet.

Key Limitations or Constraints on Analysis
The objective of this document is to provide analysis on options to incentivise liquidators to pursue claims for reckless trading. The Insolvency Working group (**IWG**) was formed in 2015 as part of the Government's review of corporate insolvency law. It comprised an independent chair, two insolvency practitioners, two insolvency law specialists, a credit industry expert and a representative of the Official Assignee. The issue covered in this RIA relates to disincentives for liquidators to make reckless trading claims against directors. It was identified by the IWG in the second of its two reports (**Report No. 2**). Report No. 2 was released for public comment and, of the 29 submissions received, nine commented on this issue. None of those submitters disputed the IWG's conclusion that there was a problem. However, four of the nine recommended a different solution – see the description of option 2 in section 3.1 below. The main limitation of the RIS is that we do not have good information about the scale of the problem. There is no direct information about liquidators not bringing merit-worthy reckless trading claims against company directors. This is because claims for reckless trading (and breaches of other directors' duties) are usually settled out-of-court. In addition, liquidators include information in their reports on individual insolvency administrations about what they did do. There is no reason for them to state what they might have done, had the law been different. Hence, we have largely relied on the expertise of IWG members, along with submissions on Report No. 2 as the basis for concluding that there is a problem.
Responsible Manager (signature and date):
Susan Hall Manager, Corporate Governance and Intellectual Property Policy Commerce, Consumers and Communications Branch Building, Resources and Markets Group Ministry of Business, Innovation & Employment

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Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Background and current situation

The Companies Act 1993 includes a director's duty relating to reckless trading. Under this duty, a director must not 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.

Claims for breaches of this duty typically only arise when a company becomes insolvent. If there has been reckless trading, then the liquidator is best placed to detect it and take a claim against the directors if doing so is likely to benefit creditors as a whole.

When a company enters insolvency, liquidators will distribute dividends based on a defined hierarchy of creditors:

- Secured creditors are at the top – the are generally a bank or other asset-based lender that holds a fixed or floating charge over a business asset or assets. When a business becomes insolvent, sale of the specific asset over which security is held providers repayment for this category of creditor
- Unsecured creditors are generally last to be paid as they rank after secured and preferential creditors such as employees or Inland Revenue. Unsecured creditors are typically suppliers and customers.

There are two drivers for liquidators to take reckless trading claims against directors:

1. To discourage directors from being reckless in the first place
2. To provide opportunities for liquidators to make claims against directors to add to the pool of money available for distributing to creditors harmed by the reckless trading. This can be achieved either by obtaining court orders against the directors, or agreeing to out-of-court settlements.

The primary problem

A problem with the existing law is that liquidators often do not have incentives to make reckless trading claims because there can be a mismatch between who pays the cost of making a claim and who benefits. In many cases:

- the costs will be met from the remaining assets of the company and, therefore, be met indirectly by unsecured creditors because there will be less for the liquidator to distribute to them; and
- any creditors who have security over all of the company's assets will obtain the benefits from a successful claim.

This can be an issue where one of more directors of the debtor company holds a general security agreement (GSA) over all of the assets of the company. There is little point in the liquidator taking a reckless trading claim against the directors if some or all of the amounts recovered will then be re-distributed to the same directors, because they are also secured creditors. The risks are particularly high where the directors (or related parties) hold a substantial portion of the secured debt of a company.

Consequently, liquidators often do not have incentives to make reckless trading claims.

Why it needs to be addressed now

This problem needs to be addressed now for two reasons. First, creditors will continue to be adversely affected the longer the problem remains unresolved. Second, it can only be

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addressed by amending the Companies Act 1993. This change is suitable for inclusion in the forthcoming Insolvency Law Reform Bill. It is likely to be several years before another legislative opportunity would arise to make this change.

Evidence and assumptions for the problem definition

The Insolvency Working Group (IWG), which included four insolvency industry experts, identified the problem in IWG Report No. 2. The insolvency experts on the group have had experience of circumstances where this had been an issue in practice. The IWG's suggestion that recoveries from reckless trading claims should be made available to unsecured creditors only is consistent with the case in Australia and the United Kingdom.

2.2 Who is affected and how?

Whose behaviour do we seek to change

We seek to change the behaviour of:

- Liquidators, by removing a barrier to pursuing reckless trading claims. This will rebalance the unfair outcomes between unsecured and secured creditors; and
- Directors, by reducing the incidence of reckless trading, if there is an increased threat of personal liability (including, for example, the possibility of having to sell the family home or another major asset). This can help focus individuals' minds.

Who does and does not want this to happen?

It will be in the collective interests of all creditors for the number of merit-worthy reckless trading claims to increase. However, there are competing interests between different classes of creditors, with change likely to benefit unsecured creditors but potentially to the detriment of other secured creditors (e.g. banks), not just secured creditors who were directors of the debtor company. The reasons for this are explained in the options analysis section later in this RIA.

2.3 Are there any constraints on the scope for decision making?

Scope

Nothing is out of scope.

Connections

The recently enacted Insolvency Practitioners Regulation Act 2019, which will come into force in June 2020, should also lead to an increase in the number of reckless trading claims. One of the goals of the licensing regime is to reduce the number of 'debtor-friendly' liquidators. These are practitioners who obtain appointments as liquidators by fostering a reputation for never taking actions against the directors who appoint them, including making it clear that they never investigate possible breaches of directors' duties.

Such conduct will be at risk of contravening the code of ethics and professional standards that will form part of the licensing regime.

While this change will likely lead to an increase of reckless trading claim, it will not address the mismatch between who pays the cost of making a claim and who benefits, especially when the "reckless trading" directors are also secured creditors of the failed company.

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Section 3: Options identification

3.1 What options have been considered?

The two options considered were:

Option 1 – provide that recoveries from reckless trading claims are not available to secured creditors but instead are distributed only to unsecured creditors, including preferential creditors.

Option 2 – provide that recoveries from reckless trading claims are not available to related party secured creditors. In practice, this means that recoveries would be distributed to unrelated secured creditors, with any leftover distributed to unsecured creditors.

We have assessed these options against the following criteria:

1. Will it reduce barriers to liquidators taking reckless trading claims against directors?
2. Will creditors who have suffered loss as a result of reckless trading receive the benefit from successful claims?
3. Will the impacts on other creditors be proportional?

We also considered but discarded the option of retaining the status quo on the basis that it would not satisfy any of the criteria set out above.

3.2 Which of these options is the proposed approach?

We consider that option 1 is the best option. We have reached this view on the following basis.

	Option 1	Option 2
1. Will it reduce barriers to liquidators taking reckless trading claims against directors?	✓✓	✓
2. Will the creditors who have suffered loss as a result of reckless trading receive the benefit from successful claims?	✓✓	✓
3. Are the impacts on other creditors proportional?	No material change	No material change

Will it reduce barriers to liquidators taking reckless trading claims against directors?
Both options will increase the incentives on liquidators to bring claims against directors for breaching the duty to not trade recklessly, because they will both reduce the likelihood that one group of creditors will obtain the benefits while another group of creditors will pay the costs. We consider that option 1 is likely to do this to a greater extent because, unlike option 2, it will fully remove the risk of misaligned incentives.

Will the creditors who have suffered loss as a result of reckless trading receive the benefit from successful claims?
We consider that both options will increase the likelihood that the creditors who have suffered loss as a result of reckless trading will receive the benefit from any successful claim.

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However, option 1 is likely to do this to a greater extent.

Although reckless trading has the potential to disadvantage all creditors (both secured and unsecured) the disadvantage to **unsecured creditors** is almost always more pronounced. With the exception of the Inland Revenue Department (which has preferential status in relation to unpaid income tax, PAYE, and GST and other withholding taxes), it is unusual for unsecured creditors, particularly trade creditors, to have incentives to apply to the High Court for a liquidator to be appointed. Other than being costly and potentially time-consuming, applying to the Court is also risky because:

- ordinary unsecured creditors will rarely know how much the debtor company owes to higher ranking creditors (i.e. secured creditors and preferential creditors) at the time they might be contemplating seeking the appointment of a liquidator; and
- the outcome of most liquidations is that ordinary unsecured creditors receive nothing or only a fraction of what they are owed.

In summary, the common *ex-ante* perspective for ordinary unsecured creditors is to not apply to the Court to have a liquidator appointed because they will, in all likelihood, be throwing good money after bad.

By contrast, **secured creditors** who are not directors of the debtor company (e.g. banks) have recourse to specific assets of a company. Any general reduction in the value of the company caused by reckless trading will not adversely impact on secured creditors so long as the value of those assets is sufficient to satisfy the company's obligations to them. All of the losses are borne by unsecured creditors.

Secured creditors also have the ability to enforce their security against a company by appointing a receiver. This gives them the ability to protect their position without needing to bring an action against directors for reckless trading.

An argument in favour of option 2 (i.e. to also allow unrelated party secured creditors to obtain the benefits) is that reckless trading claims tend to affect the value of the whole of the business and, in particular, its value as a going concern. Therefore, a secured creditor which has based its lending decisions on the value of a company as a going concern would potentially be exposed to some losses. They would have the option of surrendering the balance, making them unsecured creditors. However, they would only receive the same dividend as other ordinary unsecured creditors, which, as noted above, is usually only a fraction of the amount owed.

We also note that secured creditors sometimes hold personal guarantees from directors for the debts of a company. Because of this, directors may be more willing to settle claims for reckless trading where they know that the money they pay would go towards satisfying debts they might otherwise be personally liable for. Option 1 may therefore reduce the extent that directors are prepared to settle claims for reckless trading.

Are the impacts on other creditors proportional?

We consider that the distributional impact arguments are finely balanced. For the reasons outlined below, unsecured creditors are proportionately better off under option 1, while unrelated party secured creditors are proportionately better off under option 2. Our overall conclusion is that the distributional arguments are relatively immaterial.

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Analysis

Under both options secured and unsecured creditors will be neither better nor worse off in relation to reckless trading claims that would have been taken under the status quo.

Where liquidators are incentivised by the law change to take reckless trading claims they would not otherwise have taken, the distributional impacts are as follows:

- Under both options, there are no proportionality issues in cases where there are sufficient funds to pay secured creditors everything they are owed, with or without the reckless trading claim.

- Under option 1, unsecured creditors receive all of the benefits, which, in turn means that unsecured creditors are proportionately better off where there are insufficient funds from other sources to pay secured creditors everything they are owed.

- Under option 2, secured creditors would be proportionately better off than unsecured creditors, because they get paid first. This, in turn, means that:
    - in some cases secured creditors will obtain all of the additional amount obtained through the reckless trading claim, with nothing remaining to be distributed to unsecured creditors
    - in all other cases secured creditors will receive whatever is needed to ensure that they receive everything they are owed, with whatever is left over to be distributed to preferential creditors in the order specified in Schedule 7 of the Companies Act. It would be very unusual for ordinary unsecured creditors to receive anything.

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Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties	**Secured creditors**: Option 1 may, on occasions, encourage secured creditors to take enforcement action against companies earlier as they will not be able to have recourse to any claims against directors in order to satisfy a company's obligations. It may also increase the extent to which secured creditors pursue personal guarantees provided to them by debtor company directors. **Liquidators** will have increased incentives to incur the costs of taking additional reckless trading claims. However, liquidators will only do so where they have *ex-ante* expectations that the benefits to creditors will exceed the costs, taking the probability of success into consideration. **Directors** will incur costs defending reckless trading cases taken against them by liquidators. The scale of the costs will depend on whether or not there is an out-of-court settlement. The costs will be higher where it does go to court.	Low
Regulators	Nil	-
Wider government	To the extent the Crown is a secured creditor of a company, option 1 will reduce the pool of assets it can have recourse to in order to satisfy that company's secured obligations.	Low
Other parties		
Total Monetised Cost	-	-
Non-monetised costs		*Low*

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Expected benefits of proposed approach, compared to taking no action		
Regulated parties	**Unsecured creditors** will obtain the net benefits (i.e. the difference between the amounts successfully claimed and the additional costs incurred by liquidators pursuing the additional claims) from additional claims against directors for reckless trading. This may make directors more conscious of their duty to creditors, which could in turn reduce the number of breaches of this duty, to the wider benefit of creditors.	Low
Regulators	Nil	-
Wider government	The Inland Revenue Department is the largest unsecured creditor of businesses in New Zealand. Additional reckless trading claims could, at times, result in increased recoveries by the Crown. However, the amounts involved would be a very small fraction of total government revenue.	Very low
Other parties	-	-
Total Monetised Benefit	-	-
Non-monetised benefits		Low

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4.2 What other impacts is this approach likely to have?
The direct costs and benefits outlined in table 4.1 are immaterial. The indirect benefits to society are more important: there is a wider public interest in providing liquidators with stronger incentives to take reckless trading claims.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?
Option 1 was recommended by the IWG in Report No. 2, which was released for public consultation. 29 submissions were received. Nine submitters commented on this proposal. Five were in favour of it or a variant of it for the reasons given by the IWG: there is a mismatch because secured creditors recover the proceeds first, regardless of whether they suffered the relevant loss. Four were opposed, with some of them suggesting option 2 as an alternative. Submitters who opposed this proposal largely did so on the basis that reckless trading claims tend to affect the value of a whole business, and in particular its value as a going concern. A creditor with a general security interest, who has based its lending decisions on the value of the company as a going concern, will therefore be exposed to losses in going concern value (as well as physical asset value) arising from reckless trading activities. It was also noted that changes to entitlements to the proceeds of reckless trading claims may have adverse consequences for the willingness of secured creditors to fund such claims by liquidators.

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Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
Option 1 can only be implemented by amending the Companies Act. The change will be included in an Insolvency Law Reform Bill, to be introduced in 2020, with a view to it being enacted in 2021. We will finalise the approach to be taken to the transition after consulting with insolvency practitioners and insolvency law experts. Liquidators will be responsible for enforcing the new arrangements.

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Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
It will be very challenging to assess the impacts for the following reasons: • There are no reliable means for determining whether the changes will have reduced in the incidence of reckless trading • It will be difficult to determine whether individual reckless trading claims are a consequence of the legislative change or would have proceeded without the change • Claims by liquidators (or receivers) are often settled out-of-court, so any consideration of court cases will not give a complete picture of the extent of recoveries by liquidators from directors for reckless trading.

7.2 When and how will the new arrangements be reviewed?
In our view this is a minor issue. The change will be just one part of a wider set of insolvency law reforms that will be enacted via an Insolvency Law Reform Bill. There are other more important changes in the package. We intend to carry out an assessment of the package of reforms about five years after they come into force. This would be a one-off assessment because we would expect the insolvency community, and possibly other stakeholders, to identify any material issues within that period. It is possible that further issues would be identified at a later date, perhaps as a consequence of the courts clarifying the law in ways that we did not anticipate. We already monitor key court decisions, so nothing needs to change in that regard.

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