Legal update on insolvency law – August 2019

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Supreme Court confirms asset diminution unnecessary for voidable transactions

In *Robt. Jones Holdings Limited v McCullagh* [2019] NZSC 86, the Supreme Court unanimously held that it is unnecessary for a liquidator to prove that any payment actually diminished the assets of a company to claw back that payment under s 292 of the Companies Act (Act).

The case concerned an appeal from the decision of the Court of Appeal reported in our December 2018 update. Robt. Jones Holdings (RJH) leased a property to Northern Crest Investments Limited (Northern Crest). Following Northern Crest falling into arrears, the parties agreed an amount that Northern Crest was to pay RJH to satisfy its liability under the lease. Some of those payments were made by a subsidiary of Northern Crest to RJH on Northern Crest's behalf. Northern Crest was subsequently placed into liquidation less than two years after those payments were made.

The liquidators applied to the High Court to have those payments set aside as insolvent transactions under s 292 of the Act. It was common ground that the requirements specified in the text of s 292 of the Act were met. Nevertheless, RJH argued that it was also necessary for any payment voided under s 292 to diminish the assets of the company in liquidation. RJH asserted that this had not occurred because the payments were in effect a loan from the subsidiary to Northern Crest.

The Supreme Court unanimously rejected RJH's appeal. In doing so, it affirmed the Court of Appeal's previous decision in *Levin v Market Square Trust*, and emphasised the policy objectives underpinning s 292 as being to ensure the equal treatment of the company's creditors, to prevent a race for payment by creditors, and to simplify the recovery of voidable transactions. The statutory gloss argued for by RJH would, in the Court's view, undermine each of those statutory objectives.

The decision provides an authoritative restatement of the existing law, and ensures that creditors as a whole will not be disadvantaged by any sharp practice of financially distressed companies.

See a copy of the Court's decision here.

Privy council affirms liquidators' common law right to claw back preferential payments

On 29 July 2019 the Privy Council released its judgment in *Skandinaviska Enskilda Banken AB v Conway & Anor* [2019] UKPC 36 that upheld the liquidators' right to claw back preferential payments made to Nordic bank, Skandinaviska Enskilda Banken AB (Publ) (SEB), under Cayman Islands law.

SEB had purchased redeemable shares from Weavering Macro Fixed Income Fund Limited (in liquidation) (Company) as nominee for two Swedish mutual funds between 2006 and 2008. It received US$8,217,761.54 in redemption payments between December 2008 and February 2009. In March 2009 the directors discovered that the Company had been the subject of significant fraud that had inflated its net asset value, and the Company was placed into liquidation.

In August 2014 the liquidators of the Company issued proceedings against SEB seeking a declaration that the redemption payments were invalid preferences under s 145(1) of the Companies Law (2013 Revision) and an order that the USD8,217,761.54 should be repaid plus interest. At the time of the liquidators' action SEB had paid the redemption proceeds out to the mutual funds, and no longer had the ability to seek recovery. It transpired that SEB's indemnity against the mutual funds was unenforceable under Swedish law due to a lack of legal personality.

The first instance court found in favour of the liquidators. The subsequent appeals were dismissed by both the Court of Appeal and the Privy Council.

The Privy Council differed from the Court of Appeal in finding that the basis of the liquidators' right to recover preferential payments was under the common law rather than statute. The Privy Council referred to its judgment in *Lewis v Hyde* [1998] 1

WLR 94 (on appeal from New Zealand), in which the underlying purpose of the clawback of preferential payments was discussed; being 'to ensure compliance with the basic principle of insolvency law viz pari passu distribution of the insolvent estate'.

Notwithstanding the finding that the right to recover was a common law right, the Privy Council rejected the availability of a common law defence of change of position, citing a long standing principle of public policy that the common law will not give effect to arrangements that defeat the statutory scheme of distribution, and an absence of any case law on the existence of such a defence to an action to recover preferential payments.

The Board also rejected SEB's defence that it had not been enriched by the payment, holding that a trustee who is not an agent is enriched at common law by the payments he receives. The Board held at [89]: "A trustee who is not acting as an agent is enriched at common law by the payments which he receives, since the common law ignores the equitable interest of the beneficiaries. He can accordingly be an appropriate defendant in an action for the restitution of money paid to him as trustee." Analogy was drawn with the decision in *Springfield Acres Ltd (in liq) v Abacus (Hong Kong) Ltd* [1994] 3 NZLR 502.

In the postscript the Board acknowledged this might lead to harsh results for creditors and that greater protection could be achieved through legislation. In New Zealand section 296 of the Companies Act 1993 provides statutory defences to the liquidators' right to claw back voidable preferences.

The Privy Council decision can be found here.

Licensing system for insolvency practitioners introduced

Nine years after first being introduced, the Insolvency Practitioners Bill is finally law. The Bill aimed to strengthen the regulation of insolvency practitioners by introducing a licensing system. What was initially proposed was that the Registrar of Companies would have powers to restrict or prohibit individuals from providing corporate insolvency services. In 2011, the Commerce Committee considered that a negative licensing system would not work and recommended introducing a register of insolvency practitioners and to establish offences and penalties for practitioners who failed to comply. These recommendations were adopted.

The Bill has been divided into two acts that were passed in June 2019: The Insolvency Practitioners Regulation Act 2019 (IPRA) and the Insolvency Practitioners Regulation (Amendments) Act 2019. Provisions of both Acts will come into force in stages but within the next year.

The IPRA provides for the licensing scheme. Insolvency practitioners will need to be fit and proper and demonstrate that they meet minimum standards of competence and experience to obtain a licence. Anyone who acts as an insolvency practitioner without a licence will commit an offence punishable by a fine of up to $75,000. Insolvency practitioners now also have a duty to report 'serious problems' to the Registrar and other authorities including the Police.

The Insolvency Practitioners Regulation (Amendments) Act 2019 amends the Companies Act 1993 and Receiverships Act 1993. Some important changes include requiring a liquidator to:

- Keep company money in a bank account to the credit of the company or in a general or separate trust account and the failure to do so is now a serious criminal offence
- Keep company records from a minimum of one year after completion of the liquidation to at least six years following completion of the liquidation. Again, the failure to comply is an offence.

The farm debt mediation bill (No 2)

The Government's Farm Debt Mediation Bill (No2) has progressed to the Select Committee stage and is due for report back on 4 November 2019. The scheme will be administered by the Ministry of Primary Industries and is intended to provide for fair, equitable and timely resolution of farm debt issues by requiring lenders to participate in a compulsory mediation process before enforcing security over certain farm property.

The Bill is a marked improvement on the first bill and appears to have widespread parliamentary support. However there are a number of aspects of the Bill that we consider could be improved upon, including clarity as to the extent of the types of farming operations covered by the scheme. Further insights from Buddle Findlay in relation to the Bill can be found here.

A copy of the Bill is attached here.

Mainzeal (No 2) - calculation of compensation for reckless trading an inexact art

Cooke J has delivered his second judgment in the Mainzeal litigation. The first judgement, our summary of which can be found here, found four of the five directors of Mainzeal liable for damage caused by their reckless trading. The second judgment related to applications by both the liquidators and the directors to alter the quantum of compensation awarded.

The defendant's argued that the amount the company owed to creditors did not represent the creditors' likely losses because the company had assets which could be realised to partially offset the loss. Cooke J found that although valuing the assets of the company at the point of liquidation is a difficult forensic exercise, the only available evidence indicated that the starting point for calculating the compensation should have been $23m lower than it was found to be in the initial judgment. In so doing, he rejected the liquidators' argument that the level of recovery made by the liquidators was in fact far lower than the $23m contended for by the defendants.

The plaintiffs argued that the compensation sum should have included interest between the date of liquidation in 2013 until the date of payment. Cooke J found that interest should have been factored into the initial calculation of losses suffered in order to grant compensation for the loss suffered by being deprived of the funds for a six year period.

Cooke J found that while both applications should be granted, they roughly cancelled each other out so he did not in fact make any alteration to the compensation awarded. To have made an alteration would have indicated that the calculations of compensation were far more precise than the more 'broad-brush' equitable judgment that the Court actually reached.

As defendant Richard Yan has not responded to the liquidators' invitation to settle the judgment against him, pending his appeal, they are reported to be commencing bankruptcy proceedings against him.

The judgement can be found here.

Mortgagee unable to rely on mortgage registered through fraud

FM Custodians Ltd v R & Smith [2019] NZHC 1128

FM Custodians Ltd advanced loans secured by mortgages over properties owned by Ballarat Terrace Ltd and the Prospect Family Trust (of which Mr Smith was a director and trustee respectively). Smith forged the signature of a co-director of Ballarat Terrace Ltd, thereby causing it and the Prospect Trust to enter into various loans with FM Custodians with supporting guarantees of the other party's loans. Smith's lawyer, Murdoch James & Roper, was acting as agent on behalf of FM Custodians in execution of all loan and authority documents for the mortgage. The lawyer never met with the co-director of Ballarat Terrace Ltd and certified to FM Custodians that the documents had been executed correctly.

Smith was convicted for using forged documents. FM Custodians claimed relief against forfeiture to the Crown of the land as property used in the commission of the offence of using the forged documents by virtue of its mortgage. The court held that Smith, acting as sub-agent for his lawyer and therefore FM Custodians in execution of the documents, had committed the forgery in the course of an agency relationship. The court held that FM Custodians could therefore not rely on the indefeasibility of mortgages because the mortgages in question were created by fraud. FM Custodians was therefore not entitled to relief against forfeiture.

A copy of the decision can be found here.

High Court of Australia reviews treatment of trading trusts in receivership

The High Court of Australia in *Carter Holt Harvey Woodproducts Australia Pty Ltd v The Commonwealth* [2019] HCA 20 has reviewed the rules governing the distribution of assets of a trustee company in receivership.

Receivers had been appointed to Amerind Pty Limited (Amerind), a company operating solely as trustee of a trading trust. After provision for remuneration of the receivers, the Commonwealth of Australia claimed priority over the remaining surplus, as a preferential creditor under s 433(3)(c) of the Corporations Act 2001. The surplus comprised the proceeds of sale of trust assets, to which Amerind was entitled in accordance with its trustee's right of indemnity.

This claim was opposed by Carter Holt Harvey Wood Products Australia Pty Ltd (CHH), a secured creditor of Amerind. CHH argued that because s 433 could only apply when a receiver 'is appointed on behalf of the holders of any debentures of a company or registered body that are secured by a circulating security interest' (under s 433(2)(a)), the priority provisions of s 433(3) only gave priority over circulating assets that are the property of the company. As the 'asset' in question was the trustee's right of indemnity, the priority regime of s 433 did not apply.

A majority of the Court agreed that a trustee's right of indemnity was a non-circulating asset. However, the Court unanimously found that this did not exclude the amount available under the right of indemnity from being captured by s 433 (provided the receivers had been appointed in accordance with s 433(2)(a)). The adoption of CHH's argument would entail an arbitrary distinction between priority creditors of a trustee company and a regular company; an outcome that the Corporations Act clearly did not intend.

On the right of indemnity in insolvency generally, the Court endorsed a distinction between trust assets realised by exoneration and those by reimbursement. When a trust asset is realised by exoneration (to repay the trustee for debts incurred in that capacity), that asset can only be distributed to trust creditors. When a trust asset is realised by reimbursement (to repay the trustee for money lent to the trust), that asset can be distributed among all creditors of the trustee without limitation.

Read the full decision here.

Directors held not liable for company breaching the balance sheet solvency test

Burnden Holdings (UK) Ltd v Fielding [2019] EWHC 1566 (Ch)

The English High Court's judgment in *Burnden Holdings* covers many topics of interest to commercial and insolvency practitioners. The proceeding has a long history, with certain interlocutory issues on limitation reaching the Supreme Court last year. The liquidators of *Burden Holdings* brought proceedings against two directors arising from two transactions: (1) a distribution in specie by Burnden of its shareholding in subsidiary company, Vital Energy Utilities, and (2) the granting of security in favour of the directors for loans made by them to the Burnden group of companies. Burnden was later placed into liquidation. Claims arising from the transactions included a claim that the distribution was unlawful, that it was made with the intention of defrauding creditors, and that it gave rise to a breach of fiduciary duty. The granting of security to the defendants was also challenged as being a breach of the directors' duty and as a transaction at an undervalue.

Zacaroli J applied the test encapsulated in *BNY Trustee Services Ltd v Eurosail-UK* [2013] 1 WLR 1408 (UKSC), which requires the court to make a judgment as to whether a company can met its liabilities from its assets, having regard to, and making proper allowance for, prospective and contingent liabilities. Having regard to the consequences of the distribution in specie, the Judge found that the company was not balance sheet insolvent, and that even if he was wrong on that issue, the directors were not aware that it was insolvent. The Judge found that liability for payment of an unlawful dividend was fault based, and given that the directors were unaware of the facts rendering the payment unlawful (and provided the directors had taken care to ensure their accounts were current), they could not be held liable if they were later proved wrong in their understanding. The plaintiffs' claims failed accordingly.

Read the full judgment here.

English High Court confirms model law applies to liquidations of solvent companies wound up on 'just and equitable' grounds

In *In re Sturgeon Central Asia Balanced Fund Ltd (in liquidation)* [2019] EWHC 1215 (Ch), [2019], [2019] WLR(D) 297, the English High Court held that a foreign proceeding winding up an indisputably solvent company on just and equitable grounds may be recognised as a "foreign main proceeding" under the UNCITRAL Model Law on Cross-Border Insolvency (Model Law). The decision paves the way for regulators and others seeking to liquidate companies on the grounds of mismanagement to secure the orderly resolution of the company's affairs on a worldwide basis.

The provisional liquidators of Sturgeon Central Asia Balanced Fund Ltd (Sturgeon) sought recognition in England of the company's liquidation as a 'foreign main proceeding' under the Cross-Border Insolvency Regulations 2006, which give effect to the Model Law. The Court of Appeal for Bermuda, where Sturgeon had been incorporated, had ordered the liquidation of Sturgeon following a serious breakdown in the basis on which the company was set up and that the investor shareholders were being denied their rights.

The High Court held that the Bermuda proceeding was a 'foreign main proceeding' within the meaning of Article 2(g) of the Model Law because the definition of that term depended upon the characterisation of the law under which the proceedings were commenced, rather than the nature of the particular proceedings. While certain UNCITRAL interpretive documents may have indicated a contrary result, the Court considered its interpretation accorded with the aim of the Model Law provisions, which sought to achieve recognition speedily and without a detailed fact-finding exercise.

The case assists those seeking the winding up of solvent companies on the just and equitable ground to have that proceeding recognised under the Model Law, thereby importing the stay provided for under Article 20 of the Model Law within the recognising jurisdiction.

A copy of the decision is accessible here.

Cross border insolvency regulations 2006 – ancillary relief

Yuri Rozhkov v Larisa Markus [2019] EWHC 1519 (Ch) (Marcus Smith J), 10 May 2019.

The applicant, Mr Rozhkov, was appointed as the bankruptcy trustee and financial administrator of the respondent, Ms Markus, following a bankruptcy order made by the Moscow State Commercial Court. At Russian law, the applicant is the only person authorised to represent the respondent's estate and exercise rights over the respondent's property. The applicant had been granted Chapter 15 recognition in the US in February 2019.

The bankruptcy order was made in Russia following Ms Markus's guilty plea in 2017 to a £1.3b fraud on Vneshprombank, a Moscow-based bank that she had previously run. For the purpose of collecting Ms Markus' assets, Mr Rozhkov sought recognition in England under the Cross-Border Insolvency Regulations, and further sought disclosure of certain information relating to the sale of a property acquired by Ms Markus in 2000, but sold two days before an application seeking a preservation order was heard.

The Court determined that the Russian bankruptcy was a foreign proceeding (with the centre of main interest being Russia) and that the applicant was a 'foreign representative', and as such concluded that the jurisdictional requirements were met and the recognition orders could be made.

A copy of the decision can be found here.

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