BUDDLE FINDLAY

Legal update on insolvency law – January 2021

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The real lesson from Debut Homes – don't stiff the tax (wo)man

The Supreme Court has overturned the 2019 Court of Appeal decision *Cooper v Debut Homes Limited* (in liquidation) [2019] NZCA 39 and restored the orders made by the earlier High Court decision, reminding directors that the broad duties under the Companies Act require consideration of the interests of all creditors, and not just a select group. This is the first time New Zealand's highest court has considered sections 131, 135 and 136 of the Companies Act, making this a significant decision.

Debut Homes Limited (DHL) was a property development company which was placed into liquidation on 7 March 2014 by the IRD. Prior to liquidation, Mr Cooper, DHL's sole director, expected there to be a shortfall whether he continued to trade or not but decided to continue trading for a short period to reduce the company's liabilities in order to pay off secured debts, but accruing GST obligations as a consequence. The High Court found that in doing this, Mr Cooper had breached his duties under ss 131(1), 135(b) and 136 of the Companies Act 1991 and made a number of orders in favour of DHL. Mr Cooper successfully appealed the High Court's decision, with the Court of Appeal finding that Mr Cooper's decision to continue trading was for the benefit of all the creditors, despite incurring a greater GST debt obligation (read about the Court of Appeal decision in our summary here).

The main issue for the Supreme Court was whether Mr Cooper was in breach of his directors' duties under the Companies Act by continuing to trade in the circumstances. The Supreme Court allowed the appeal and restored the High Court's orders.

Breach of s 135 – reckless trading

The Supreme Court found that Mr Cooper's decision to continue trading in circumstances where loss to creditors was not merely a substantial risk, but a certainty, must be a breach of s 135. The Court went on to say that it was not an answer to s 135 that the action taken was a "sensible business decision" that would benefit some of the creditors. If continued trading would result in a shortfall, then there will be a breach of s 135, whether or not some creditors would be better off, or any overall deficit would be reduced.

Breach of s 136 – performance of obligations

The Supreme Court rejected Mr Cooper's argument that s 136 was directed towards contractual obligations, finding that Mr Cooper's decision for DHL to enter into sale and purchase agreements, knowing that GST obligations on sale prices would be incurred but would not be met, was within the scope of s 136. At the time the GST debts were incurred, Mr Cooper knew they would not be paid. Consistent with its discussion about assessing creditors interests as a whole, the Supreme Court went on to say that it is not legitimate for directors to enter into a course of action to ensure some creditors have a higher return where this is at the expense of incurring new liabilities which will not be paid.

Breach of s 131 – good faith and best interests

Although emphasising the subjective nature of the test, and the difficulties of courts second-guessing business decisions made by directors in what they honestly believed to be in the best interests of the company, the Supreme Court agreed with the High Court's finding that Mr Cooper had breached his duties under s 131. The Court acknowledged that there would be no breach of s 131 if a director honestly believed they were acting in the best interests of the company. However, where a director, in an insolvency or near insolvency situation fails to consider the interests of all creditors, there will be a breach of s 131. The Supreme Court found that Mr Cooper breached his duties by considering the interests of only some of the creditors, and further acted in his own interests and in direct conflict with DHL's best interests when he sought to pay off secured debts thereby reducing his own guaranteed liability and that of his family trust.

This decision serves as an important reminder from New Zealand's highest court that professional advice should be sought if a company is facing financial difficulty.

The decision can be found here.

Supreme Court emphasises importance of getting guarantees in writing

The Supreme Court in *Brougham v Regan and Tuffin* [2020] NZSC 118 has highlighted the importance of ensuring guarantees are clearly written and signed by all intended guarantors. Mr Brougham successfully appealed against the Court of Appeal's finding that Mr Brougham was liable as guarantor.

The case concerned liability for unpaid loans. A loan was provided without a deed of guarantee and indemnity as was required by the loan agreement. Mr Brougham however signed the loan agreement as guarantor. Loan repayments ceased, and an action was brought against Mr Brougham for liability as a guarantor.

The Court considered the elements of s 27(2) of the Property Law Act 2007 which requires a contract of guarantee to be recorded in writing and signed by a guarantor. The court outlined that merely signing a document as guarantor does not alone constitute a contract of guarantee for the purposes of section 27(2). To satisfy the 'in writing' requirement an agreement must be sufficiently clear as to debt and default liabilities. Additionally, a guarantee must be signed by all named guarantors if on its face, it can be demonstrated that the guarantee is intended to be given jointly unless the contract provides otherwise. The Court upheld the consumer protections of section 27(2) to dismiss arguments of estoppel and specific performance.

This case emphasises that the wording of contractual documents is key. Anyone seeking a guarantee should ensure the terms are recorded clearly and that the agreement is signed by all guarantors.

The decision can be found here.

Australian new 'debtor in possession' corporate insolvency regime to commence from 1 January 2021

The Australian Government has announced it would introduce new legislation to give effect to two new insolvency regimes for companies with liabilities of less than AUS$1m:

- A 'debtor in possession' restructuring plan process
- A simplified liquidation process

During the new restructuring process, there will be a moratorium preventing creditors enforcing unsecured and some secured claims against the company. The company has 20 working days to prepare a plan to restructure the business' debts which is then voted on by the creditors. If approved by creditors, the plan will bind all unsecured creditors.

The simplified liquidation process will retain the general framework of the existing liquidation process with some modifications including:

- Reduced circumstances in which a liquidator can seek to clawback an unfair preference payment from a creditor that is not related to the company
- Removing requirements to call creditor meetings
- Simplifying the proof of debt and distribution process
- Using technology in voting and other communications.

The reforms are earmarked to commence on 1 January 2021 however legislation has not yet been introduced. More information on these reforms can be found here. A summary of insolvency law changes in New Zealand can be found here.

Environmental responsibilities of liquidators

The Supreme Court of Victoria's judgment in *EPA & Anor v Australian Sawmilling Company Pty Ltd (in liq)* [2020] VSC 550 considered the ability of a liquidator to disclaim company property.

The case concerned a decision by the liquidators of the Australian Sawmilling Company Pty Ltd (in liq) (ASC) to disclaim company land that was contaminated and unsaleable. The Environmental Protection Authority and the State of Victoria applied to have the disclaimer set aside, on the basis that the disclaimer would cause prejudice to the applicants that was grossly out of proportion to the prejudice that would be suffered by ASC's creditors if the disclaimer was set aside, as the taxpayer would have to bear the cost of decontamination.

The Court found in favour of the applicants and set aside the disclaimer. Central to the decision was the fact that the liquidators had been indemnified for any shortfall in relation to environmental costs by Dongwha Australia (Dongwha), a creditor and the sole shareholder of ASC. The Court distinguished between Dongwha's position as a creditor and its position as indemnifier, finding that any payment made in accordance with the indemnity would not prejudice Dongwha as a creditor of ASC. Accordingly, setting

aside the disclaimer would cause no prejudice to ASC's creditors (beyond some time delays). The Court also noted that companies should not use liquidation to avoid their environmental responsibilities, or to overly burden the taxpayer.

The judgment serves as a reminder for liquidators to think carefully about disclaiming property when the cost that property represents has been indemnified. Equally, creditors considering indemnifying liquidators should take care when considering the scope of indemnity.

The decision can be found here.

Australia court appoints referee to determine questions of insolvency

The Federal Court of Australia in *Jahani (liquidator) v Commissioner of Taxation, in the matter of Delta Coal Mining Pty Ltd (in liq)* [2020] FCA 1642 recently made orders appointing a referee to investigate and report on factual issues of insolvency.

The plaintiffs are liquidators of four related companies. The liquidators brought proceedings against the Commissioner of Taxation claiming certain payments were voidable insolvent transactions. The key issue is whether the relevant company was insolvent at the time each payment was made.

The liquidators sought orders pursuant to ss 37P(2) and 54A of the Federal Court of Australia Act 1976 (Cth) that the Court appoint a referee to inquire into and report on the questions of whether each of the companies was insolvent during the relevant period of time.

Given that there are 15 defendants, the Judge considered that the insolvency questions would be most efficiently, effectively and justly determined in an investigative inquisitorial process undertaken by a referee rather than in an adversarial adjudicative process of a trial.

In New Zealand, the High Court has the power to appoint an independent expert "to inquire into and report upon any question of fact or opinion": HCR 9.36. It does not appear this rule has been used in an insolvency context to assess when a company became insolvent. This Australian decision highlights the approach that New Zealand courts may adopt in the future.

The decision can be found here.

A decent burial for the Bell Litigation

The Supreme Court of Western Australia's judgment to dismiss a winding up application in *Bell Group (UK) Holdings Limited (In liq)* [2020] WASC 347 puts an end to Australia's longest-running legal saga, the Bell litigation.

The Bell Group were a group of companies who sought financing from two groups of banks by way of unsecured loans. In the early 1990s when the Bell Group encountered financial difficulties, the banks restructured these financial arrangements and the Bell Group released more security in favour of the banks. When the companies in the Bell Group were placed into liquidation the banks realised these securities and were subsequently pursued by the liquidators.

The initial hearing between the banks and liquidators spanned 404 sitting days between 2003 and 2006 and the judgment, delivered in 2008 in favour of the liquidators, was over 2500 pages. Appeals and counter-appeals followed until 2013, when the banks agreed to settle for AUD$1.75b to be distributed among the creditors. Further issues then arose over how this amount was to be divided, leading to the creation of the Bell Group Companies (Finalisation of Matters and Distribution of Proceeds) Act 2015 which was later struck down for being unconstitutional and resulted in further litigation.

Justice Sanderson described this final judgment as a 'requiem', titling it an 'Ode to a dying corporation'. In it, he likened the litigation to a post-war battlefield where "the guns have [now] fallen silent". The Court acknowledged the thousands of people who had been involved in this litigation over the past 25 years before concluding the final orders with an "Amen".

The decision can be found here.

Guaranteed liability – the importance of comprehensive drafting

In *Northland Regional Council v Gill*, the Council succeeded in obtaining summary judgment for monies owing under a term loan it had granted to a company (REL) in early 2015. The purpose of the loan had been to support a saw mill operation and create jobs in Northland. REL defaulted under the loan in early 2019. The case highlights the importance of carefully drafting a guarantee so that a creditor retains the power to make variations to the contract with a borrower without the guarantor for the loan being discharged.

As security, Council had obtained a guarantee from the first and second defendants, and Council was to have a second-ranking general security behind ASB Bank over REL's personal property. The relationship between Council and ASB was governed by the terms of a deed of priority. The security under the loan agreement was defined to include that deed of priority. Execution of the deed was also a condition precedent for drawdown under the term loan.

However, the defendants alleged that their liability as guarantors had been discharged and was of no force and effect by reason of the deed of priority, claiming that it was a material variation to their obligations to which they did not consent, principally because the term loan had been executed one week before the deed of priority. The guarantors further claimed that their right of subrogation against REL had been diminished by the deed of priority such that they had suffered harm by the arrangement between ASB and Council.

Importantly, the deed of priority was executed by both guarantors, but in their capacity as directors of REL. As such, the Court found that the guarantors could not claim with any credibility that they were not aware of the deed or that they did not consent to it. In addition, the term loan expressly provided that variations to the obligations of REL would not affect the guarantee. It was also likely that the deed of priority, even if a variation, did not prejudice the guarantors, because without it, ASB would have had a priority in relation to all future advances it made, without limit (s 72, Personal Property Securities Act 1999). However, the Court also considered that the deed of priority was not a variation at all – it was part of the security and a condition precedent for drawdown under the loan, to which all parties consented.

The decision can be found here.

Liquidator of Bernie Madoff's Ponzi scheme claws back millions in profits made by investors

The US Court of Appeals for the Second Circuit has held that investors who received funds from Bernie Madoff's investment company in excess of their principal investment must refund those profits to the liquidator, even though they were unaware of Madoff's fraud. The decision in *In re Madoff Investment Securities LLC* 976 F 3d 184 (2nd Cir 2020) is the latest in the 12-year saga following the now-infamous collapse of Madoff's investment company.

The bankruptcy trustee Mr Picard applied under the Securities Investor Protection Act (SIPA) to recover the transfers, so that they could form part of a fund of investor property, separate from general assets, and over which investors have priority. The defendants' main argument was that their profits were shielded from claw back by the Bankruptcy Code, which allows recipients to retain the transfer if they can demonstrate that they took the transfer "for value and in good faith". There was no question that the profits had been received in good faith.

However, the Appeal Court agreed with the District Court Judge, holding that the transfers were not "for value". The Bankruptcy Code defines "value" as property or the satisfaction of a right to payment or remedy. The Court affirmed that for SIPA liquidations, investors cannot have property rights in fictious profits, only in their principal investment. Moreover, the transfer of those fictious profits does not satisfy a right to payment as only the return of the principal investment or the payment of an investor's net equity could satisfy the right.

The decision affects millions of dollars in profits, though this is a tiny portion of the estimated $17.5b in lost investments. To date, the liquidator has recovered $14.3b for Madoff's investors.

High Court grants leave to allow dispute with insolvent company to proceed by arbitration

The High Court in *Department of Corrections v Decmil Construction NZ Ltd (in liq)* [2020] NZHC 2976 has granted leave for arbitration to proceed between the Department of Corrections (Corrections) and an insolvent construction company.

Corrections had contracted with Decmil Construction NZ Ltd (Decmil) for Decmil to construct nine modular prison units. Decmil purported to terminate the contract claiming performance had become impossible. Corrections responded with a notice of termination on grounds that Decmil had not remedied failures to comply with certain milestones. The contract committed the parties to a dispute resolution process that led to arbitration.

Decmil was then placed into liquidation. The liquidator would not consent to the claims Corrections sought to pursue being determined by arbitration, principally because he considered that the claims would better be resolved using his powers under the Companies Act. Corrections sought the Court's leave under s 248(1) of the Companies Act 1993 to continue with the arbitration. In granting leave, the Court considered that:

- The nominated arbitrator was better equipped than the liquidator to analyse the complex claims and counterclaims
- The liquidator was conflicted in any attempt to determine Corrections' claims, because he had already concluded that the best

path to a return to creditors was through a claim against Corrections (which necessarily required Corrections' claims against Decmil to be rejected)

- Travel restrictions were likely to inhibit the Perth-based liquidator's capability to deal with issues arising in the medium term
- The pursuit of arbitration would not be fruitless, as Decmil's parent company would be able to meet any award
- It was in the interests of all creditors that there be an authoritative determination of the competing claims between Corrections and Decmil.

Buddle Findlay acts for the Department of Corrections on this dispute.

The decision can be found here.

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