BUDDLE FINDLAY

Legal update on insolvency law - December 2013

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Statutory trust over PAYE deductions continues to operate upon and during liquidation

The Court of Appeal in *Commissioner of Inland Revenue v Jennings Roadfreight Ltd (in liq)* [2013] NZCA 455 discussed the payment of PAYE to the IRD in the context of the liquidation of an employer company (Jennings). The total PAYE unpaid by Jennings to the IRD on the date of liquidation was $49,889.90, although only $14,076.38 sat in the company bank account at that time.

When an employer has made PAYE deductions, section 167(1) of the Tax Administration Act 1994 (NZ) imposes a statutory trust over the deductions in favour of the IRD. The Court held that such a statutory trust continues to operate upon and during liquidation (overturning the High Court finding that such a trust is extinguished upon liquidation). Any such money held in trust will not form part of the estate of the employer company in liquidation and accordingly can be paid directly to the IRD without regard to the claims of other creditors.

However, when the employer has dealt improperly with any part of the PAYE deduction moneys (for example deducted PAYE, but neither paid it to the Commissioner, nor held it in the employer's bank account for payment), such unpaid tax is not subject to a trust under section 167(1) and forms part of the employer's estate in liquidation. Accordingly upon liquidation, the IRD is an unsecured preferential creditor for its claims over the balance of unpaid PAYE (less any amount recovered pursuant to a trust under section 167(1)).

See Court decision here.

Setting aside transactions: The good faith defence

In *Madsen-Ries v Rapid Construction Ltd* [2013] NZCA 489, the Court of Appeal considered an appeal concerning a liquidator's attempt to have a payment set aside.

For accounting transparency, the directors of Giant and Rapid had chosen to exchange cheques rather than offset their respective debts of $113,551.84 and $90,713.50. Unbeknownst to Rapid, Giant was insolvent at the time of the transaction. Giant's liquidators then applied to have the full $113,551.84 payment set aside. The High Court found that Rapid satisfied all three elements of the good faith statutory defence in section 296 of the Companies Act 1993 (NZ) and ruled that only the balance of $22,838.34 be repaid to Giant.

The Court of Appeal confirmed the approach taken by the High Court. It endorsed a distinction made in the High Court of Australia between '*knowledge of financial difficulties*' and '*knowledge of insolvency*', essentially allowing the directors of Rapid the benefit of the statutory defence despite being aware that Giant was facing financial difficulties.

See Court decision here.

Personal liability to liquidators for failure to account for GST refund after default on property purchase

Rowmata Holdings Limited (in liquidation) (RHL) & Anor v Hildred & Ors [2013] NZHC 2435 involved a sale and purchase agreement whereby land was sold to two trusts, subject to finance. RHL (a company incorporated by the purchasing trusts) claimed and received a GST refund for the purchase. However, on settlement date, RHL defaulted on the purchase, went into liquidation, and the GST refund became repayable to the Inland Revenue Department (IRD).

The liquidators contended that the directors of RHL were personally liable for the GST refund owing to breached duties of the Companies Act 1993.

The High Court found in favour of the liquidators and ordered the trustees to pay $720,000 plus interest.

On the breaches of duties in the Companies Act, the High Court held that the directors had believed on reasonable grounds to have committed RHL to a contractual obligation that the company could not perform. Williams J concluded that ASB bank's support and sympathy, coupled with the optimism of the market rising, was insufficient to constitute a reasonable basis for belief that the obligation would be satisfied. Further, the long period of time until settlement was necessary was of limited relevance as RHL had no money or prospective income upon receipt of the GST refund, nor any financial assistance from ASB.

The Court also believed that the directors had not exercised proper care, diligence and skill by using the $720,000 to repay the two trusts during the global financial crisis. The prudent course of action, in the Court's view, would have been to retain the refund so that it could be returned to the IRD in the event of default. Moreover, the purchase transaction was not in the company's best interests, as it was highly probable from the outset that it would fail.

The liquidators argued that the directors were responsible for the entirety of the loss. However, owing to difficult economic conditions unforeseen by the directors, the Court held that the directors were accountable for only 70%.

The liquidators were, however, entitled to recover the entire amount expended by RHL, as the purchase transaction was voidable under the Companies Act. RHL paid the $720,000, and was therefore a party to the deposit transaction. However, RHL did not receive any value in return, as the trusts were having the land vested in them, not RHL. Accordingly, the liquidators recovered the entire $720,000 being the difference between what RHL paid, and what they received.

Finally, the Court held that the liquidators were entitled to recover the $720,000 from the trusts under the doctrine of unjust enrichment. Williams J described this cause of action as a common law version of the statutory claim that the liquidators had already succeeded on.

See Court decision here.

Creditor's resolution to appoint alternative liquidator set aside for prejudice

In our December 2012 insolvency update we reported on *CP Asset Management Ltd v Grant*, in which the High Court upheld a creditors' resolution to appoint new liquidators. The High Court found that a resolution should only be set aside when it was found that the prejudice to creditors was unreasonable. In the High Court, the minority of creditors who voted against the resolution were unable to establish that any prejudice would warrant setting aside the resolution.

Based on fresh evidence, including a six-monthly report of the new liquidators, the Court of Appeal concluded that the creditors' resolution to appoint alternative liquidators was contrary to the interests of a class of creditors (in this case, the unsecured creditors). The production of fresh evidence showing the course of events since the High Court judgment was crucial to this decision. The case is a reminder of the power of the courts to overturn a resolution passed by majority creditors that unreasonably prejudices minority creditors.

See Court decision here.

Liquidators obtain summary judgment for breach of director's duty

In *Fisk v Fawcet* [2013] NZHC 2811 the liquidators of Luxta Limited sought summary judgment against Luxta's director, Mr Fawcet, for breach of his director's duty to act in good faith and in the best interests of Luxta. Mr Fawcet transferred the titles of two properties owned by Luxta to Contorto Limited (a related party) without first receiving the purchase price of $857,500 (not including an immediate payment of $45,000). Contorto eventually defaulted on its payment, leaving Luxta with a shortfall of $812,500. Luxta was then placed in liquidation. The liquidators sought to recover this shortfall from Mr Fawcet. In evidence, Mr Fawcet stated that the transfer was done to benefit a wider group of related real estate companies. This evidence effectively amounted to an admission by Mr Fawcet that he was not acting in the best interests of Luxta. On this basis, the Court had no hesitation in finding that Mr Fawcett breached his duty and entered summary judgment against him for the shortfall.

This case establishes a useful precedent for liquidators who may seek summary judgment against directors of a company who have breached their duties.

See Court decision here.

Liquidator's disclaimer of lease upheld by Australian High Court

In our September 2012 insolvency update, we reported on *Re Willmott Forests Ltd* [2012] VSC 29, where the Victorian Court of Appeal found that a leasehold interest in land is extinguished by a liquidator's disclaimer of the lease pursuant to section 568(1) of the Australian Corporations Act 2001 (Cth).

This decision was recently upheld on appeal. The Australian High Court agreed that liquidator's disclaimer of the lease brought the rights and obligations of both parties to an end. However, if the tenant suffers loss as a result of the disclaimer, then they may prove for that loss in the winding up of the lessor company.

Section 568 of the Corporations Act is similar to section 269 of the New Zealand Companies Act 1993. Should the decision be adopted in New Zealand, the practical implications for tenants, financiers and liquidators would be significant. Tenants and their financiers would face uncertainty in the event of the liquidation of a landlord company. Conversely, liquidators would be able to sell or dispose of land undeterred by leasehold interests.

See Court decision here.

Australian Court holds priority insurance payments obtained during liquidation subject to the liquidator's remuneration

The Australian Corporations Act 2001 provides that a company in liquidation that holds insurance for the benefit of third parties must pay the proceeds of the insurance policy to those third parties in priority to other creditors. Insurance proceeds payable to third parties under this provision are subject to deductions of "*any expenses of or incidental to getting in*" those proceeds. The liquidator of Brighton Hall Securities Pty Ltd sought directions from the court regarding the liquidator's entitlement to deduct his fees and expenses from the insurance proceeds.

The Australian Securities and Investment Commission appeared before the court to argue that "*expenses*" should be limited to disbursements. The Court did not agree, and held that the wording "*or incidental to*" imported the liquidator's labour as a cost recoverable in priority to other claims to the insurance proceeds, and that in such situations, a liquidator is entitled to assert an equitable lien over the insurance proceeds. The court thought it appropriate that a liquidator receive remuneration for conferring a benefit on a company's creditors, and further, that creditors seeking to obtain the benefit of the liquidation must accept the liquidator's proper costs in liquidating the company.

This ruling follows the principle that efficient administration of insolvent companies is key to serving the business community.

See Court decision here.

The equitable remedy of marshalling

The UK Supreme Court decision in *Szepietowski & Anor v National Crime Agency* [2013] UKSC 65 examined whether the remedy of marshalling was available to the National Crime Agency (NCA) in the absence of an underlying debt. The NCA entered into a settlement deed with Szepietowski that established rights over some of Szepietowski's properties, but did not create or acknowledge any debt on the part of Szepietowski. The NCA's claim was secured by a second mortgage over one of the Szepietowski's properties (Property). The first mortgagee, despite having adequate security over other properties, exercised its power to sell the Property. The NCA sought the equitable remedy of marshalling in order to allow it to enforce the first mortgagee's remaining mortgages instead.

Lord Neuberger held that when the mortgagor does not owe a debt to the second mortgagee, the remedy of marshalling is generally not available. This position is not subject to judicial discretion, and only exceptional circumstances may justify marshalling in the absence of a debt. This is because there is simply nothing due after the secured property is sold, and a second mortgagee is effectively in a lesser position than an unsecured creditor. Allowing marshalling would therefore be disadvantageous to the mortgagor and to unsecured creditors in a potential insolvency event.

See Court decision here.

Validity of administrator's appointment questioned

The applicants in *Closegate Hotel Development (Durham) Limited & Anor v McLean & Ors* [2013] EWHC 3237 (Ch)were companies that had borrowed money off Barclays Bank to finance a hotel venture. That funding was secured by floating charges granted by the companies.

The companies encountered difficulties in repaying the debt that was owed. They entered into protracted negotiations with the Bank as to settlement of the debt by way of an alternative lender. Eventually, and after serving a letter of demand, the Bank appointed administrators. The companies considered that there had been a mutual understanding that the Bank would not enforce its security without giving the companies reasonable notice and that therefore the Bank was estopped from appointing administrators.

The applicant companies sought a declaration that the purported appointment of the administrators was invalid and of no effect. They challenged the validity of the appointments on the basis that the UK Insolvency Act 1986 prohibits the appointment of an administrator while a floating charge is not enforceable. The companies contended that the charges were not enforceable because the Bank was estopped from making an immediate demand for repayment of the monies owing to it or from exercising any of the rights under its security.

The court rejected the argument of the companies, as they could not establish that any of the Bank's statements or conduct amounted to a clear and unequivocal representation that the Bank would not enforce its rights to repayment of the companies' debt.

See Court decision here.

Conversion claim may be brought against administrators and liquidators

A case recently heard in the UK suggests that, in certain circumstances, a claim for conversion of assets may be brought against administrators and liquidators of a company. While the claim did not succeed on the facts in *Euromex Ventures Ltd & Anor v BNP Paribas Real Estate Advisory & Ors* [2013] EWHC 3007 (Ch), the case illustrates that claimants may bring a proceeding on the basis of alleged acts of conversion by a company's liquidators and administrators.

The same conclusion was reached in the recent New Zealand case of *Warren Metals Limited v Grant* [2013] NZHC 263, in which the High Court established that in light of section 248(1)(a) of the Companies Act 1993, the liquidator has no better title to a company's assets than the company itself. *Warren Metals* also held that where a liquidator commits an unlawful act against the property of a third party, they may be personally liable for that act. The courts' discussions in both these cases provide a reminder that liquidators cannot sell property which is owned by a third party without permission. If a liquidator is in any doubt about a particular course of action, the appropriate course is to seek directions from the High Court to avoid the possibility of personal liability.

See Court decision here.

Shareholder silence may constitute fully informed consent

In *Sharma v Sharma* [2013] EWCA Civ 1287, the English Court of Appeal considered the defence of fully informed consent in the context of a claim that a company director had breached her duty to act in the best interests of the company. In this case, a director acquired several dental practices for her own benefit. Two company shareholders were aware of this and remained silent on the issue. The issue of breach of director's duty came before the Court of Appeal, which held (amongst other things) that:

- A company director breaches their duty if, for their personal gain, they exploit opportunities which came to their attention through their role as director or any other opportunities which they could and should exploit for the benefit of the company
- When a shareholder, with full knowledge of the relevant facts (which need not extend to them appreciating that the proposed action constitutes a breach of duty), consents to a director exploiting an opportunity for personal gain, then that conduct by the director does not constitute a breach of that director's duty
- A shareholder's acquiescence to the director's proposed conduct, when he has full knowledge of the relevant facts, may constitute consent. However, consent cannot be inferred from silence unless the shareholder knows his consent is required or the circumstances are such that it would be unconscionable for the shareholder to remain silent at the time and object afterwards.

On the facts of the case it was held that the shareholders' silence did amount to fully informed consent.

See Court decision here.

English High Court imposes greater accountability upon shadow directors

The definition of director outlined in section 126(1) of the Companies Act 1993 (NZ) encompasses shadow directors – people with '*whose directions or instructions the board … is accustomed to act*'. Courts have traditionally been reluctant to impose fiduciary duties on shadow directors on the basis that they exert only an indirect influence over the company. However, in *Vivendi SA Centenary Holdings III Ltd v Richards & Ors [2013] EWHC 3006 (Ch)*, the English High Court held that a shadow director will ordinarily owe fiduciary duties both to the company and its creditors, at least in respect of the directions and instructions given to the directors of the company. Justice Newey reasoned that a shadow director can reasonably be expected “to act in the company's interests rather than his own separate interests when giving such directions and instructions".

Thus a shadow director will not be immune from personal liability following insolvency merely because he is not formally registered as a director.

See Court decision here.

Interim injunction preventing bank from terminating services

In *Dahabshiil Transfer Services Ltd v Barclays Bank PLC* [2013] EWHC 3379 (Ch), the English High Court considered an interim injunction application to restrain the defendant bank from terminating, or requiring it to continue to provide, banking services to three money service business claimants. Barclays decided to withdraw these services following the introduction of new government policies aimed at preventing money laundering.

There was no dispute that Barclays was contractually entitled to terminate these services. Instead, the claimants contended that ceasing to provide such services constituted a breach of Barclays' dominant position in the relevant markets, contrary to EU and UK competition law.

The Court granted the interim injunction, with reference to well-established interim injunction principles, finding that:

- Whether Barclays had a dominant position in the relevant markets was a triable issue
- Similarly, whether a party could abuse their dominant position in the relevant market by reducing their participation was a question of law to be determined at trial. Barclays defence of justification also needed to be fully examined at trial
- Damages would not be an adequate remedy and the balance of convenience favoured granting interim relief.

While it is interesting that the Court was prepared to entertain these arguments in the context of an application for interim relief, ultimately a substantive decision will determine whether a money lender in Barclays' position is obliged to continue to provide lending services.

See Court decision here.

Letter of tender must be unconditional to release and transfer security to third party lender

In *Shearer & Ors v Spring Capital Ltd & Ors* [2013] EWHC 3148 (Ch),Shearer and Spring Capital were in a borrower-lender relationship. Shearer sought to refinance through a third party lender and sent a letter of tender (ie a redemption) to Spring Capital. The third party lender required the securities held by Spring Capital to be released either before or at the same time as making the new money available to Shearer. However, the tender did not make this clear and provided security release documents to be executed by Spring Capital. Capital claimed that the tender was invalid due to it being conditional as to the timing of the release and sought to enforce its securities.

Shearer sought summary judgment orders requiring Spring Capital to release and transfer the security to the third party lender. Summary judgment was not granted on the basis that tenders had to be unconditional and that it was questionable as to whether the tender had further conditions to be satisfied (ie timing of transfer, agreement of the form of the release documents and costs), such that a trial was required to determine these issues.

See Court decision here.

Ability of foreign liquidators to require production of documents considered by Bermuda CA

PricewaterhouseCoopers (PwC) v Saad Investments Company Limited (SICL) and Singularis Holdings Ltd (SHL) involved an application by PwC for the setting aside of orders made by the Supreme Court of Bermuda in favour of the liquidators that required the production of documents relating to SICL and SHL. Included among the grounds on which PwC relied to set aside the order were that:

- The Supreme Court erred by issuing a winding up order in respect of SICL

- The Supreme Court had no jurisdiction at common law to make a production order in the absence of statutory jurisdiction. This was argued in an attempt to have the SHL order set aside
- Foreign liquidators in Bermuda cannot be granted powers broader than those possessed in their home jurisdiction. This was relevant to whether the liquidators could have access to PwC's audit working papers.

The Court was split 2-1 in favour of the liquidators.

On the first ground, PwC contended that the Court of Appeal's previous decision in *PwC Bermuda v Kingate Global Fund Ltd (Ct of Appl)* [2011] Bda LR 32, which held that a winding-up order cannot be impeached in the context of an application made under it, was distinguishable on two grounds. First, that SICL was not a company that the relevant legislation applied to. The Court rejected this contention due to the complexity of argument from both sides which meant that SICL did not fall within the "patent irregularity" exception. Secondly, PwC alleged they were a stranger to the liquidation. The Court rejected this argument owing to PwC's status as the company's auditor.

PwC then argued that there is no inherent jurisdiction of the Court to make production orders in circumstances that do not fall within the terms of the relevant legislation. The Court accepted this argument on the basis that there is no binding authority to afford judicial assistance to a foreign liquidator outside the terms of the statute and therefore allowed the appeal against the SHL order.

On the third ground, PwC alleged that a balancing exercise must be conducted prior to a production order being issued. Moreover, that the joint liquidators had not demonstrated a need for any non-company documents. The Court rejected this argument, holding that all documents (including PwC's working papers) were both necessary and relevant to the affairs of SICL and SHL.

Justice Auld dissented and found in favour of PwC on the question of production of the documents.

It is understood that leave to appeal to the Privy Council will be sought.

See Court decision here.

Court finds City of Detroit eligible for bankruptcy in US history's largest municipal bankruptcy

A recent ruling by US Federal Judge Rhodes has held that the city of Detroit is eligible to file for bankruptcy under US federal bankruptcy laws and can now attempt to re-organise its US$18.5b debt.

In a nine-day trial, Detroit's labour unions, retirees and pension funds (who would bear the brunt of proposed austerity measures) argued against the city's eligibility for bankruptcy on the basis that it was contrary to Michigan's state constitution. In permitting the bankruptcy, Judge Rhodes found the law permitting Detroit to file for bankruptcy was constitutional and that the city met every test for federal insolvency as it was unable to pay its debts, was failing to provide a minimum level of basic services to its residents and would face an unfeasible task in negotiating with its thousands of creditors. Importantly, he also ruled that public pension benefits (which are protected under Michigan's constitution as contracts) could be reduced in a municipal bankruptcy as federal law trumped state law. The result will now allow Detroit to take steps in re-adjusting its debt, chiefly by forcing creditors to take a discount on what the city owes them.

See Court decision here.

"A profession without shame": Struggling UK firms reach a new low

Frustration amongst creditors of struggling UK law firms continues to grow. Administrators of Challinors have concluded that the partnership's unsecured creditors, owed approximately £7.1m, are likely to receive nothing. Meanwhile the Solicitors Regulation Authority (SRA) has advised 141 firms that they must prepare to shut-down following their failure to obtain professional indemnity cover. These firms are currently in the middle of a 60 day cessation period during which they may remain in business, but cannot accept any new instructions. While some have blamed the increasing regulatory and compliance requirements imposed by the SRA, others have expressed frustration that the SRA have not named these firms and accordingly the public are unable to protect themselves and their funds.

The 450 partners of failed US firm, Dewey & LeBoeuf, are being pursued by the firms' former landlord for £1.6m of outstanding rent. Similarly, banking giant, Barclays, is seeking summary judgment against three former Dewey partners for outstanding debts. After emails emerged of one Dewey partner calling his colleague a "f*ckw*d", "little prick" and "pathetic", this is all negative publicity the former partners, trying to make a fresh start, do not need.

However, when insolvent UK firm Manches was bought out by its rival Penningtons, huge criticism was directed, not only at the individuals involved, but also at the profession as a whole. The terms of the sale saw Manches' massive debt wiped, but its business survive. Some commentators claim that the case illustrates that law seems to be "*becoming a profession without any shame*" and others have called for the SRA to provide guidance as to whether this method of clearing debt is acceptable behaviour by solicitors.

The outrage directed at Manches has been exacerbated by revelations of the firm's management practises from the firm's administrators, PwC. The firm increased its £6m overdraft facility by £400,000 after it became clear that it was going to breach the facility. This was before the firm was faced with a £715,000 tax bill (of which it could only pay £90,000) which was ultimately the cause of its demise. However, despite such onerous debts, the firm had work in progress (WIP) of £4.7m, approximately half of which was over 120 days old and therefore difficult to recover.

See articles here, here, here and here.

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