Legal update on insolvency law - June 2013

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Statutory demand inappropriate for potentially insolvent transaction

A recent decision of the High Court suggests that a creditor who has not objected to a notice given under section 292 of the Companies Act may be able to defend the claim at a later stage.

In *Grant v Lotus Gardens Limited*, the creditor failed to serve a notice of objection to an application for orders setting aside payment under section 292 of the Companies Act. Subsequently, and without obtaining any court order under section 295 of the Act, the liquidators issued a statutory demand requiring payment. The creditor disputed the validity of the statutory demand.

The Court found that the creditor was still able to raise a defence against the liquidator. After the time for the creditor to give a notice of objection has passed, the liquidators ought to have applied to the Court for orders under section 295, which are required before the creditor could become indebted. Accordingly, the Court found that it was improper for the liquidator to have issued the statutory demand and the liquidation application was dismissed. The liquidators were ordered personally to pay Lotus Gardens' costs.

Security interests of secured creditors during liquidation reinforced

In the recent case *MSI (Holdings) Pty Ltd v Mainstreet International Group Ltd*, the Queensland Supreme Court confirmed that receivers of a company in liquidation can commence legal proceedings in the name of the company without leave of the court, when those proceedings relate to the recovery of secured property.

Central Coast was a secured creditor of MSI. MSI had lent funds to Mainstreet. The MSI loan to Mainstreet was subject to Central Coast's security interest. MSI defaulted on its obligations to Central Coast, which appointed receivers. MSI was then put into liquidation by a court order. The MSI receivers sought and obtained default judgment against Mainstreet for the debt owed to MSI. However, Mainstreet successfully applied to have the default judgment set aside on the basis that MSI did not have the permission of the court to commence proceedings as required when a company is in liquidation by section 471B of the Corporations Act.

MSI appealed the decision to set aside the default judgment on the basis that the restriction in section 471B does not apply to a secured creditor realising secured property. Although it was MSI, and not the secured party, Central Coast, that commenced the recovery proceedings, MSI argued that the exception for secured creditors applied because the receivers of MSI had the same rights under the security document as Central Coast to bring proceedings for recovery of secured property in the name of the company. The Court accepted MSI's argument and characterised the steps taken by MSI to recover the loan as the realisation of Central Coast's security interest, albeit by the receivers acting through MSI.

See court decision here.

Marshalling inappropriate when single creditor is knocking

Tegel sought summary judgment against Mr and Mrs Arnensen as guarantors of the obligations of Coastal Cuisine NZ Limited (In Receivership). The Arnensen's argued (in reliance on the equitable doctrine of marshalling) that Tegel ought not to be allowed to pursue the guarantees until the receivership of Coastal Cuisine had run its course.

The Court rejected the Arnensen's arguments and allowed Tegel to proceed ahead of the completion of the receivership. The Court found that marshalling (an exception to the normal rule that allows creditors to have their choice of remedies in the order in which they choose) could not apply given that there was only one creditor (the Arnensens made no claim to the security that Tegel held over the accounts receivable of Coastal Cuisine). In any event, the guarantees were drafted to leave Tegel with the full range of remedies available to it, effectively excluding the doctrine of marshalling from operation.

Additionally, the Court pointed out that the fact of some future prospect of recovery from a receivership will not be enough to prevent a Court giving judgment. Short of cogent evidence of an impending payment from the receivers that would clear the debt in full, the Court would not be prepared to exercise its discretion in such a way as to restrict a creditor's choice of remedies.

See court decision here.

Do you have the numbers? Court may examine the value of debts to determine whether a proposal has the requisite 75% support of creditors

Re Tames involved an application for the Court to approve a debtor's proposal to creditors under section 333 of the Insolvency Act. The applicant was the provisional trustee for the proposal and sought the Court's approval of the proposal's terms. If the proposal was accepted, Ms Tames (the debtor) would only pay $0.05 on the dollar to her unsecured creditors. The application for approval was opposed by ASB, one of Ms Tames' unsecured creditors.

One of the grounds (amongst others) on which ASB opposed the proposal was that it did not have the requisite 75% approval of creditors by value. As a result, the Court had to look into whether it actually had the power to examine the value of the debtors' debts to see whether the 75% threshold had been met. The provisional trustee argued that once a trustee had accepted a creditor's claim at a certain value, it was not the role of the Court on an application for approval to unravel the trustee's decision.

The Court found that it could review compliance with the voting requirements, particularly if non-compliance affected the outcome of the vote. However, on the evidence, the Court could not determine conclusively whether or not the 75% threshold had been reached. Instead, this was one factor of many going towards the Court's discretion to approve the proposal. Ultimately the Court refused to approve the proposal as it was not expedient and its terms were not reasonable.

Bank undertakes duties beyond that of a mere lender

In *National Westminster Bank v Frankham*, the English High Court considered the issue of whether the bank exceeded its role as a lender by taking over the management of a funded development.

The bank brought proceedings against Mrs Frankham for the recovery of moneys lent to her. By way of amended defence, Mrs Frankham raised the claim of equitable set off and made a counter claim based on the allegation that the bank, without her consent, gave instructions and made unauthorised payments to fund a development, leading to delay and further adverse consequences.

On appeal, the High Court reiterated that a bank does not ordinarily take on any obligations in relation to a funded project. Nonetheless, it might assume responsibility for additional obligations by acting, for example, as project manager, as asserted by Mrs Frankham. The bank would then owe a duty to "carry out those acts with appropriate skill and care". In relation to the issue of equitable set-off, the court found that the cross-claim was sufficiently connected with the bank's claim and that limitation was not a bar. As concerns damages for the asserted delay of the development, it was found that loss in the market value can be recoverable in certain situations. Therefore, it was held that Mrs Frankham's allegations had a real prospect of success and that this part of her amended defence should have been permitted.

See court decision here.

UK court finds withdrawal of letters of support by parent company is not a voidable transaction

In *Carillion Construction Ltd v Hussain*, the English High Court held that the withdrawal of letters of support given by a parent company to the directors of its subsidiary was not a transaction defrauding creditors under the Insolvency Act 1986 (UK).

Simon Carves Ltd (SCL) incurred significant losses between 2008 and 2011. However, SCL continued to trade on the basis of annual letters of support from its parent, Punj Lloyd Ltd (PLL). The letters provided that PLL would provide financial support to allow SCL to continue as a going concern. In July 2011, PLL withdrew the letters of support and SCL was placed into administration.

Carillion Construction Ltd (Carillion), a creditor of SCL, sought leave to commence proceedings against SCL and PLL. Carillion argued that SCL and PLL had an arrangement or understanding that SCL would not enforce its rights under the letters of support. Carillion submitted that this arrangement or understanding should be set aside as a transaction defrauding creditors.

The Court refused to grant leave. It held that the purpose of the letters was to enable SCL's directors to consider whether the company's financial statements could be prepared on a going concern basis. The letters did not legally bind PLL to any enforceable obligation.

The Court noted that even if this finding was wrong, the transaction relied upon by Carillion was purely speculative. There was no evidence of an arrangement or understanding between PLL and SCL to release PLL from any liability incurred under the letters.

See court decision here.

When will the court terminate a Deed of Company Arrangement?

A creditor of a company subject to a Deed of Company Arrangement (DOCA) was recently successful in seeking termination of the DOCA by the court. As a result of the company's non-compliance with the DOCA, the majority of creditors resolved to extend the term of the DOCA and increase the amount to be paid by the company. The applicant creditor alleged that the DOCA should be terminated because the company had failed to make payment in accordance with it, and the variation had not taken effect.

The Court made an order terminating the DOCA on the grounds that:

- There is no valid variation of a DOCA unless its administrator consents to it. In this case the deed administrator had indicated that he did not consent to the variation of the DOCA and that he did not oppose its termination
- The creditors' resolution contemplated that the DOCA would be varied by a deed that was to be effective from the date the last person signed it. The last person to sign the deed was to be the administrator, but he never did so. Therefore, the deed never came into effect
- As four and a half years had passed since the DOCA was originally entered into, and there was no evidence to suggest that the company could ever comply with it, the DOCA could not be given effect without injustice or undue delay
- The DOCA contained discriminatory provisions such that creditors who had obtained guarantees from the company's director were to be paid double their debt.

When is a company insolvent: "cash-flow" v "balance-sheet" insolvency

The UK Supreme Court recently considered the scope of the following tests for whether a company is unable to pay its debts (as set out in section 123(2) of the Insolvency Act 1986):

- The company is unable to pay its debts as they fall due (the *"cash-flow test"*) and
- The value of a company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities (the *"balance-sheet test"*).

The Supreme Court confirmed that:

- The cash-flow test is concerned with debts presently falling due as well as those falling due in the reasonably near future. What constitutes the *"reasonably near future"* will depend on all the circumstances including, in particular, the nature of the company's business.
- Once the court has to consider more than the reasonably near future, the cash-flow test becomes entirely speculative and the balance-sheet test becomes the only sensible test for insolvency.
- The balance sheet test is a legal test that requires the court to determine what value to attribute to the prospective and contingent liabilities of a company. The court must compare present assets with present and future liabilities and, making allowance for contingencies and deferred payments, assess whether the company can be reasonably expected to meet all of its liabilities.
- Characterisation of the company having reached "*the point of no return because of incurable deficiency in its assets"* is not the correct test for balance-sheet insolvency and should not pass into common usage.

Liquidator's ability to extinguish leasehold estate under appeal

Our September 2012 insolvency update featured the article "*Disclaiming Landlord's Interest in a Lease - an Australian Perspective"*. This article discussed the Victorian Court of Appeal's ruling that section 568(1) of the Corporations Act 2001 (Cth) (similar to our own section 269 of the Companies Act 1993 (NZ)) allows a liquidator to exercise his power of disclaimer to extinguish the leasehold estate of a tenant.

Last month, the Australian High Court granted leave for that decision to be appealed. The main issue will be whether a liquidator has the power to disclaim a lease, enabling him to deal with a company's land free from the interests of tenants. The outcome may have significance for liquidators, tenants and financiers. Tenants with long term leases may be more alert to the likelihood of the landlord company being liquidated when investing in premises and when seeking funding. Furthermore, there may be changes to the willingness of financiers to fund business heavily dependent on long term leasing.

It will be interesting to see whether this decision impacts New Zealand insolvency law, given that the High Court ruled against the liquidator's ability to disclaim in 2008 (see *Capital + Merchant Investments Ltd (In Rec) v Russell Management Limited* here). We will be following this decision closely and reporting on the outcome later this year.

See court decision here.

Appeal rights of company in liquidation not assignable

In the recent UK case of *Williams v Glover & Anor*, the Court considered the novel issue of whether the right to appeal against a tax liability constitutes the "property" of a company in liquidation, in deciding whether such a right was assignable or not. In that case, the applicant liquidator sought directions as to whether it could assign the right to appeal against an assessment of tax liability to the respondent former directors of the company in liquidation. Judge Pelling QC held that while there were authorities that had considered this point, they were not binding. This was because in each case, the decision had turned on the separate issue of whether or not the bankrupt was entitled to commence or continue the challenge under consideration.

Ultimately, it was decided that a bare right of appeal is not "property" that is capable of assignment. The basis for this conclusion was by analogy to the situation of a bankrupt. That is, a bankrupt loses his rights of appeal on being adjudicated bankrupt because the only assets out of which the underlying liability can be met have vested in the trustee, and not because the right to appeal is a chose that vests in the trustee.

Judge Pelling QC stressed, however, that this decision was not intended to be of general application, and would only apply to rights of appeal similar to those at issue in this case. Other considerations may apply, for example, where the appeal right is incidental to a property right that is itself capable of assignment.

See court decision here.

Liquidators exempt from having to send out six monthly reports

The High Court recently granted an application for an exemption from the requirement to send the liquidator's six monthly report to every preference shareholder of the company in liquidation. In *FCS Loans Ltd (in liq) v Fisk & Anor,* the High Court granted the liquidators' application for an exemption on the basis that the cost of supplying six monthly reports to the 3,141 preference shareholders (estimated to be $4,719.16) is not proportionate to any likely benefit to those shareholders from having the reports mailed to them. It was also noted that the money saved by not sending the reports may well increase the dividend paid to eligible creditors.

The exemption was granted on the basis that the reports would be made available via the Registrar of Companies and the PricewaterhouseCoopers websites, and that the shareholders would be informed of the exemption, and of the availability of the reports online.

See court decision here.

Double take – are expenses of liquidator reviewable by shareholders?

In *Bunting v Buchanan*, the applicant shareholders sought discovery ahead of a hearing of their substantive application which involved the level of costs charged by two liquidators as a consequence of a drawn-out liquidation.

Under Part 8 of the High Court Rules there is no specific provision for discovery in relation to originating applications. Prior to the introduction of the High Court Amendment Rule (No. 2) 2011, the Court had discretion as to whether to order discovery for cases on the swift track. The distinction between standard and swift track cases has been removed by the amendment and the Court is now required to make an order, unless satisfied that the case can be justly disposed of without any discovery. Associate Judge Abbott found that the agreement reached between the parties was an appropriate application of the approach for tailored discovery. He ordered the respondent liquidator to make his files available for inspection by the applicant shareholders and to provide samples of time records from other work for comparison.

In relation to the issue of privilege, Associate Judge Abbott considered that the liquidator may have an entitlement to privilege separate from the company. On this basis he held that the liquidator must be able to make a claim for privilege and the shareholders must have a corresponding entitlement to challenge that claim.

Associate Judge Abbott concluded that the proper approach was to treat the costs of the discovery as part of the costs of liquidation, subject to review as part of the substantive application.

See court decision here.

Dench v Gates [2013] NZHC 1133

In *Dench v Gates,* the New Zealand High Court considered its inherent jurisdiction to set aside a bankruptcy notice to prevent an abuse of process. Mrs Gates, the judgment debtor, had applied to the High Court to set aside a bankruptcy notice. The bankruptcy notice was based on an award of costs against Mrs Gates in respect of earlier District Court litigation initiated by her against Mr Dench, a solicitor, on the basis that he had conducted himself dishonestly while representing his client in a separate matter, in which Mrs Gates was the plaintiff. The District Court in that proceeding found no basis upon which Mrs Gates could sue Mr Dench. It held that a lawyer engaged in litigation on behalf of his client owes no duty of care to his client's opponent.

On the application to set aside the bankruptcy notice, the High Court found that it was inappropriate in this case to exercise its inherent jurisdiction on the basis that there was no abuse of process in the underlying decision and further, although Mrs Gates was at a disadvantage because she was self-represented, this factor alone is not sufficient to suggest there was any miscarriage of justice.

See court decision here.

Interpretation of a material adverse change clause

Recently, the English Commercial Court in *Grupo Hotelero Uravasco S.A v Carey Value Added SL & Anor* considered how to interpret a material adverse change (mac) clause. In this case, Grupo as borrower brought a claim against Carey as lender for failing to advance funds under the loan agreement between them.

The lender's argument was that the borrower was in default under the loan agreement for breaching the representation that there had been no material adverse change in the obligors' financial condition.

The lender argued that the term "financial condition" in the mac clause should be broadly construed to include all aspects of the borrower's finances as well as the state of the markets in which the borrower operated. The borrower contended for a narrower construction, where a company's financial condition should be based on an assessment of its position as shown in financial statements at the relevant date.

The court preferred the borrower's view and stated that the borrower's emphasis on its financial information was correct. The court also held that in order to be material, the adverse change must significantly affect the borrower's ability to perform its obligations under the loan agreement, in particular its ability to repay the loan.

In our August 2010 banking and commercial law update, we reported on *Brighten Pty Ltd v Bank of Western Australia*, in which the Australian court took the broad construction of an identically worded mac clause. In that case, the court held that the lender has an absolute discretion to assess whether the mac clause has been triggered, so long as the lender's decision was not made in bad faith, arbitrarily or capriciously.

The narrow interpretation given to a mac clause in *Grupo Hotelero Uravasco S.A* serves as a reminder to lenders to consider carefully how to draft mac clauses and whether they can be relied upon to call an event of default.

See court decision here.

From the media

Size really doesn't matter: Top UK firms latest victims of credit crunch

In what seems to be an unrelenting trend, new figures released this month by the British Solicitors' Regulation Authority (SRA), have disclosed that 30 of the top-200 UK law firms are in serious financial difficulty and have entered into "intensive engagement" with the SRA. While no names were named, it was revealed that these firms were among a wider group of 400 UK firms that were under active management by the regulator.

North-West firm, Cobbetts LLP, is one of the latest UK firms to kick the bucket. Administrators, KPMG, blame the LLP's failure on the significant drop in corporate and property deals since 2009 and the firm entering into expensive new leases back in 2006.

Another handful of firm insolvencies have been blamed on over-dependent relationships with litigation financing funds (who fund risky litigation in exchange for a share of the pie at the end of the day) as a quick fix. While it may seem like a convenient solution for firms in trouble, firms should be warned that jumping into bed with dubious litigation funders may only serve to hasten their demise.

See related articles here.

Failure of Latvian insurer affects insurance cover for 7% of UK legal firms

As if UK law firms didn't have enough financial issues with which to contend, a number also need to find new professional indemnity cover after the collapse of unrated Latvian insurer, Balva. 1,300 firms in all, comprising 7% of the UK solicitors' PI market, were insured with Balva. They have less than a month to find replacement cover. Balva's former broker is now reported to be inviting firms to transfer their business across to another unrated insurer, Berliner Versicherung AG, but the Law Society is counselling firms to consider the risks associated with such a move.

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