BUDDLE FINDLAY

Legal update on insolvency law - April 2013

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Court of Appeal rules in favour of liquidators on good faith defence to voidable transaction claims

In our last newsletter we reported on three decisions from the High Court on the good faith defence under section 296(3) of the Companies Act 1993 to voidable transaction claims, amongst others.

Late last week the Court of Appeal issued its judgment in *Farrell and Rogan as Liquidators of Contract Engineering Limited (in receivership and liquidation) v Fences and Kerbs Limited* [2013] NZCA 91 on the interpretation of the meaning of the words "*gave value*" in that subsection. Section 296(3) stipulates a transaction cannot be set aside if the recipient of property shows that the creditor acted in good faith, did not suspect insolvency, and that gave value for the property or altered its position in reliance on receiving it.

On 7 February 2012 the Court of Appeal had heard three appeals by the liquidators. In all of the cases the High Court had held that a creditor could be considered to have "given value" where goods or services were provided prior to payment.

The Court of Appeal overturned these rulings and held that an antecedent debt or value given prior to receipt of property by the creditor did not constitute giving of value under section 296(3)(c). In reaching this conclusion it focussed on differences between New Zealand and Australian provisions that appeared to indicate Parliament intended to adopt a much narrower interpretation in a temporal sense, by constraining the giving of value to value given at the time of payment.

The creditors are entitled to apply for leave to appeal to the Supreme Court, although the judgment of the court is an interim judgment, so any appeal might be some time away.

See court decision here.

Liquidators to face personal claims for interference with third party property

Warren Metals v Grant [2013] NZHC 263was a successful appeal against a District Court decision that struck out the appellant's cause of action on the basis that the District Court did not have jurisdiction to review the acts of liquidators.

The appellant, Warren Metals Ltd, was a company that dealt with scrap metal. They traded with a number of companies run by Mr Conway which obtained scrap metal from the public and then on sold it to the appellant. Mr Conway's companies were placed into liquidation and administration with the respondents appointed as liquidators and administrators.

The appellant alleged that the respondents had acted unlawfully in dealing with two containers of scrap metal and a scrap metal press (which was itself later scrapped by the respondents), the ownership of which was disputed by the appellant. This claim was initially struck out by the District Court on the grounds that the operation of sections 248 and 284 of the Companies Act 1993 (Act) meant that only the High Court had the jurisdiction to review matters relating to the decisions of liquidators.

On appeal, Asher J found that the subject of the proceeding was a personal claim against the respondents for interfering with a third party's property. As this was a personal claim and not a review of a liquidator's act, sections 248 and 284 of the Act did not apply as these sections were not designed to protect liquidators from their unlawful actions against the property of third parties. As a result, Asher J set aside the strike out order and ordered the substantive proceedings back to the District Court to be heard.

This case serves as a useful reminder for insolvency practitioners that they could face a personal claim in the District Court when dealing with property in the course of their appointment over which the ownership is in dispute.

See court decision here.

Liquidators fail in application for pooling of assets

In *Grant v Independent Livestock 2010 Limited* [2012] NZHC 3458, the liquidators of ILA sought to hold the sole director of ILA and IL2010 (a company to which ILA's assets had been transferred) liable for debts incurred by ILA.

The liquidators argued that IL2010 was a "related" company of ILA, as defined by section 2(3) of the Companies Act (Act), having received all of ILA's assets by way of transfer. The liquidators sought a pooling order pursuant to section 271(1) of the Act, to allow the liquidations of ILA and IL2010 to proceed together as if they were one company. The Court held that there was a lack of jurisdiction to grant the pooling order sought. The companies did not operate contemporaneously, and thus there was not a sufficiently strong relationship to deem them "related". ILA had essentially seamlessly transferred its business to IL2010, leaving the business as IL2010 was entering it.

The Court further refused the liquidator's request to hold the former director personally liable for the debts of ILA under section 386C of the Act, which deems directors of phoenix companies personally liable for the debts of those companies. The liquidators argued that the pooling order would merge the assets and liabilities of ILA and IL2010 (as the phoenix), leaving the former director liable for the pooled debts of both companies. The Court was not required to make a ruling on the validity of this argument, having denied the pooling order.

See court decision here.

Liquidator's application of the running account test to voidable transactions

Shephard v Steel Building Products (Central) Limited [2013] NZHC 189 is a recent decision of Associate Judge Abbott which applied the "running account" test introduced into New Zealand's voidable transaction regime in 2007. The test treats a series of transactions as a single transaction for the purpose of determining whether a creditor has received a preference, so long as the transactions form an integral part of a continuing business relationship.

Steel Building Products (trading as Metalcraft) manufactured and installed roofing products. Metalcraft engaged Hightower Roofing Ltd (in liquidation) as a roofing contractor to provide installation services to Metalcraft's. Hightower also acquired roofing products off Metalcraft.

From time to time, Metalcraft and Hightower would do a reconciliation of the amounts owed to the other, setting off the price of roofing services provided against the purchases Hightower had made from Metalcraft.

The day before Hightower was put into liquidation, it made a $12,500 payment to Metalcraft which the liquidators sought to set aside. The Court held that when applying the "running account" test, liquidators cannot pick the peak point of indebtedness from which to start the analysis. The full period of the trading relationship must be considered with regard being given to the context and purpose of payments made. In this case, only the last payment of $12,500 was set aside on the basis it was made at a time when the nature of the relationship had changed and the continuing business relationship had come to an end.

Metalcraft had no defence under section 296 because a reasonable creditor would have suspected insolvency and it had not provided 'new' value or altered its position in reliance after payment was received.

See court decision here.

Evidence by formal proof sufficient for "inquiry" into director's conduct

In *Rabson v Croad* [2013] NZSC 3, the Court of Appeal dismissed Mr Rabson's appeal of a High Court order pursuant to section 301 of the Companies Act 1993 (Act) that he reimburse $58,084.31 to a company in liquidation of which he had been a director. Mr Rabson sought leave to appeal to the Supreme Court to challenge the Court of Appeal's substantive determination on the basis that (among other things) the High Court failed to comply with section 301 of the Act which confers on the Court the power, in the course of a liquidation, to inquire into the conduct of certain persons and if appropriate order that they repay money to the liquidated company.

The Supreme Court confirmed the Court of Appeal's finding that inquiry through the formal proof proffered by the liquidators in the High Court when Mr Rabson failed to appear, despite notice, fulfilled the requirement of section 301.

See court decision here.

Liquidator is not appropriate appointee to trust

Justice Dobson has recently reversed his interim ruling that section 17A Judicature Act 1908 gives the Court jurisdiction to appoint a liquidator to a trust if satisfied there are reasons for doing so. He found that a trust is not an "association" to which section 17A applies, and instead appointed receivers with selected powers given to liquidators under the Companies Act 1993.

Dobson J found that "*it would be forced and somewhat artificial to describe trustees of a trust as an association merely because in literal terms they constitution an unincorporated body of persons.*" This was supported by the fact that section 17A would arbitrarily exclude trusts with a sole trustee or a corporate trustee as they could not be an "association" within the section.

While Dobson J acknowledged that there was an issue of increasing trust use "by unscrupulous debtors to separate assets from those liable for debts incurred," he found that section 17A was not the way to address this issue. He therefore followed the approach taken in respect of Five Star Consumer Finance Limited, in which receivers were appointed over all trust property, and given the powers conferred on liquidators under sections 261 to 267 and sections 273 to 274 of the Companies Act 1993. These powers include access to documents and the ability to apply to the Court to order a person to provide documents required by the receiver. The receivers also have powers to identify, trace and follow assets of the trusts and to realise the trusts' assets.

See court decision here.

Australian court allows liquidators to recover remuneration and costs from general trust funds

The recent New South Wales Supreme Court decision *In re MF Global Australia Ltd (in liq) No 2* [2012] NSWSC 1426 confirmed that the remuneration, costs and expenses incurred by liquidators in preserving, recovering and realising trust assets should be paid out of the trust property generally, rather than being restricted to assets held on trust for the benefit of the company itself.

This decision followed an earlier proceeding related to the liquidation of MF Global Australia Limited (MFGA), in which the liquidators sought directions regarding the distribution of money held on trust by MFGA. In reaching its decision, the Court agreed that the purpose of the earlier proceeding was to determine the manner in which trust assets would be distributed, and therefore, that it was appropriate for the costs of that proceeding to be paid out of the trust property generally. The Court also indicated that in this case there would have been a strong case for the Court to exercise its equitable discretion to allow the liquidators to recover their remuneration and the general costs and expenses of the liquidation from the trust property generally. However, given its other orders, it was unlikely that there would be a shortfall in the liquidation, so such an order was unnecessary.

Guarantor not discharged from liability despite side-agreement

Hackney Empire Ltd v Aviva Insurance Ltd [2012] EWCA Civ 1716 concerned the issue of whether a guarantor will still be liable when there are additions or alterations in respect of the original contract. Hackney Empire Limited (HEL) had entered into a contract with Sunley Turiff Construction Limited (STC), under which STC was to restore the Hackney Empire Theatre in London. STC's performance was guaranteed by Aviva Insurance Limited (Aviva) through a bond executed prior to the construction contract being signed.

STC fell into financial difficulty and there were delays completing the work. HEL entered into a side-agreement with STC which provided a new completion date and the provision of extra payments by HEL to STC. STC failed to meet this new date and was subsequently liquidated. HEL made a demand on Aviva under the bond for damages caused by STC's breach of contract. Aviva asserted that it was discharged from liability under the bond because HEL had made extra payments to STC, thus varying the original contract.

The Court of Appeal discussed the legal authorities and history surrounding when guarantees can be said to have been discharged, which made clear that the making of payments in advance of when they were due under an original contract can discharge a guarantee if guarantors have not consented to the alteration of the original contract. The Court found, however, that in this situation, the side-agreements were under a separate contract and did not therefore alter the original contract. Therefore, Aviva was not discharged from its liability. However, Aviva's liability only related to the original construction contract and, as such, it was not liable to HEL to repay the sum HEL had advanced to STC under the side-agreement.

The true intention of the petitioning creditor in winding-up a company

In *Ebbvale Ltd v Andrew Lawrence Hosking (Trustee in Bankruptcy of Andreas Sofroniou Michaelides*) [2013] UKPC 1, the Privy Council upheld a winding-up order against a Bahamian company, even though the principal purpose of the petitioning creditor may have been related to obtaining an advantage in separate proceedings in the United Kingdom.

Mr Michaelides was the registered proprietor of a group of properties in London that together formed the Sunnyside Service

Station (Sunnyside). Mr Michaelides was adjudicated bankrupt in December 2000 and a Trustee in bankruptcy was appointed. Two days prior to the adjudication, Mr Michaelides transferred Sunnyside to Messrs Andreou, who then sold it to a recently formed Bahamian company, Ebbvale Ltd (the Company), who purchased the property with assistance from a bank loan. The Trustee alleged that the sale of Sunnyside to the Company was an attempt by the bankrupt to hide his continued ownership of it. Accordingly, the Trustee commenced proceedings in England to establish the ownership of Sunnyside.

To reclaim the property, the Trustee purchased an assignment of Company's debt to the bank and the mortgage over Sunnyside. The Trustee then served a statutory demand and petitioned in the Bahamas for an order winding up the Company. The Company opposed the petition, alleging an abuse of process on the basis that the Trustee's underlying intention was to replace the Company's directors with a liquidator, thereby weakening the Company's position in the English proceedings. The Bahamian Supreme Court ordered that the Company be wound up, which was upheld by the Court of the Appeal and the Privy Council. In dismissing the appeal, the Privy Council added that when a winding up order was likely to be of substantial advantage to the Trustee in his capacity as the petitioning creditor, it was not necessary for the Trustee to show that it was his principal purpose.

Administration – the importance of accurate, reliable evidence

A recent decision passed down in the Chancery Division of the High Court (Companies Court) in the UK, has emphasized that evidence presented in support of an application for administration must be accurate, true and reliable, and that a nominee administrator must form an independent and competent view on the evidence as to the prospects of the purpose of administration being achieved.

In *Re Integral Ltd* [2013] EWHC 164 (Ch), there were two matters before the Court: a winding up petition presented by Inestco Plc, in respect of an unpaid costs order against Integral Limited (the Company); and an application by the sole director of the Company for an administration order in respect of the Company. The judge ultimately dismissed the Company's application for an administration order, and ordered that the company be wound up. One of the factors that led to the decision to wind up the company was that the evidence presented to the Court in support of an order for administration was incomplete and in some cases inconsistent. Further, the evidence given by the nominee administrators was unreliable, in that the intended nominees had unquestionably accepted what the Company's sole director had told them, and had not undertaken any independent investigation.

The Court also outlined a number of factors that would be relevant to the court’s discretion when deciding whether to make an administration order rather than a winding-up order, including the existence of potential claims against directors, the need for the appointment of an independent office-holder, and the conduct of the insolvent company in its affairs and in the proceedings.

See court decision here.

Ability of directors to access books and records of a company in receivership

The Federal Court of Australia confirmed in the recent decision *Oswal v Burrup Fertilisers Pty Limited (Receivers and Managers Appointed)* [2013] FCAFC 9 that receivers are justified in refusing to grant directors access to company documents when access would interfere with realisation of the secured assets.

Mr Oswal, a director of Burrup Fertilisers Pty Limited, sought access to documents created after the appointment of receivers and concerning the potential sale of secured assets. Mr Oswal said he wanted to ensure any sale was conducted in a proper manner and for market value.

The Federal Court affirmed the trial judge's decision to refuse access to the documents. Receivers are entitled to possession of company documents to perform their duty and realise the secured assets. While directors have common law rights to inspect documents in person or through an agent, directors have no power over assets in possession and control of the receiver. Receivers are therefore justified in refusing to grant access to documents where to do so would impede them in the proper performance of their duties or threaten the secured assets.

In this case, the Court found Mr Oswal intended to "*second-guess or keep an eye on the receivers*" during the process of selling the secured assets. It was likely that the inspection would interfere with the receivers' performance of their duties in circumstances when there was no basis to suggest that the receivers had acted improperly.

Court will not easily side with debtors who are slow to defend bankruptcy proceedings

In *Hutchins v Edwards*[2013] NZHC 336, theHigh Court declined an application for an adjournment by a debtor who sought further time to liquidate property in order to pay a judgment debt.

The initial judgment arose out of relationship property proceedings and required immediate payment of $375,000 by the debtor. Such payment was never made. A bankruptcy notice was issued and served on the debtor, but again, no payment was made. Accordingly, bankruptcy proceedings were filed and served. No steps were taken to file a defence. Before Associate Judge Doogue, the judgment debtor argued for an adjournment of a few months to allow the liquidation of property. The debtor argued that the adjournment was justified given that he had offered the creditor "many deals", but that she kept refusing them.

His Honour declined to grant an adjournment. The debtor had demonstrated his insolvency in that he was unable to pay his debts as they fell due. The fact that he had substantial assets did not cure this insolvency. The judgment had required "immediate payment" of the $375,000, and the creditor was not to blame for not accepting some deal other than cash payment. Accordingly, the adjournment was declined and the debtor was adjudicated bankrupt.

The case gives an indication of the disinclination of the courts to accommodate judgment debtors in circumstances when they have taken no steps to defend proceedings.

See court decision here.

Re-registration of a charge and reduction of a bankrupt's estate

In the case of *Garwood v Bank of Scotland PLC,* the English High Court found that a charge that had been mistakenly released should be re-registered over property in the estate of a bankrupt, although this meant that the estate available to unsecured creditors would decrease.

The Bank of Scotland (BoS) had been induced to lend twice to the bankrupt, Mr Fabumni-Stone on the basis of false declarations. It had taken a charge over a property which it thought was subject to long leases that the bankrupt was purchasing, but instead was owned by the bankrupt. BoS's charge was released on the basis that repayment had been made, although in fact only one of the loans was redeemed. The Bank therefore argued that the mistake would lead to unjust enrichment if the bankrupt's estate was allowed to retain the benefit of the property.

The Court found that BoS did not get the security for either loan that it expected and agreed that it would be unjust enrichment if the bankrupt's estate was allowed to retain the benefit of the mistaken release. It ordered that BoS was entitled to have its charge re-registered over the property.

'Forum shopping' declined in Northern Ireland bankruptcy

The Northern Ireland High Court has annulled a bankruptcy order made with procedural irregularities that would have allowed the debtor to escape the much heavier consequences of a debt in the Republic of Ireland.

The petitioner in Northern Ireland sought bankruptcy on the basis of non-payment of a £1,401.50 debt. In contrast, the debtor owed around €7.2 million in the Republic of Ireland, including a debt of approximately €5.5 million to ACC Bank Limited, which was seeking to bankrupt him in the Republic. The debtor, Mr McCann was bankrupted in Northern Ireland after an expedited hearing at which he was unrepresented. The hearing had been brought forward by the petitioner specifically to ensure that Mr McCann was subject to the jurisdiction of the Northern Ireland courts, and no notice was given to ACC Bank, despite both the petitioner and Mr McCann being aware of its bankruptcy petition in the Republic.

If Mr McCann was bankrupted in Northern Ireland, he would be automatically discharged from bankruptcy after one year. In contrast, if he was successfully bankrupted in the Republic of Ireland, he would be subject to bankruptcy for up to twelve years. The Court found that there was no statutory authority for the expedited hearing, and there was no jurisdiction to make the order for bankruptcy without full evidence from all parties and without notice to ACC Bank. The bankruptcy order was therefore annulled.

Full Federal Court of Australia clarifies rule regarding priority of mortgages

The Full Federal Court of Australia recently clarified the application of the rule in *Hopkinson v Rolt* in respect of priorities between first and subsequent mortgages. In *Naxatu Pty Limited v Perpetual Trustee Company Limited* [2012] FCAFC 163, Naxatu relied on the rule in *Hopkinson v Rolt* in claiming that its second ranking mortgage should have priority over certain money advanced by the first mortgagee (Perpetual). The rule in *Hopkinson v Rolt* provides that advances made by a first mortgagee after the first mortgagee has notice of a second mortgagee's mortgage, are deferred in priority to the second mortgagee's debt.

In giving its decision in *Naxatu*, the Full Court clarified the application of the rule in *Hopkinson v Rolt*, noting that the rule comes into play when the first mortgagee has notice of the second mortgage, and is not dependant on having notice of a further advance

under that second mortgage. The Court noted that each mortgagee, knowing of the other's mortgage, should make enquiries as to the amount owing to the other before making a further advance. The Court also confirmed that the rule in *Hopkinson v Rolt* must give way to any contrary agreement between the parties.

This decision is a reminder that when a mortgagee has notice of other mortgages held over the same property, it is important to have a clear deed of priority in place, and to make enquiries as to the amount owing to the other mortgagees before making further advances to the mortgagor.

Relief from forfeiture not limited to rights over real property

In *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd* [2013] UKPC 2, the Privy Council held that a borrower may claim relief from forfeiture notwithstanding that the forfeited security has been appropriated by the lender in satisfaction of a debt.

Alfa Telecom Turkey Limited (Alfa) lent USD 1.35 billion to a company in the Cukurova group of companies (Cukurova). The lending was secured by charges over Cukurova's shares in a number of BVI companies including a shareholding in Turkcell, the largest mobile telecommunications company in Turkey. If Cukurova defaulted on the loan, Alfa could appropriate the charged shares.

Alfa accelerated the loan on the basis that various events of default had occurred and demanded immediate repayment of the outstanding balance. When Cukurova failed to pay, Alfa appropriated the charged shares. A month later, Cukurova gave Alfa notice that it intended to "prepay" the full amount due and purported to proffer the sum eight days later. Alfa rejected the tender on the basis that it was too late.

At first instance, Bannister J held that none of the events of default were made out. On appeal, the Court of Appeal held that three of the alleged events of default had been made out and therefore Alfa had been entitled to accelerate the loan and appropriate the charged shares. The Privy Council upheld the decision that the acceleration and appropriation were valid, but concluded that it had jurisdiction in equity to grant relief from forfeiture.

The Privy Council found as a matter of principle that relief from forfeiture extends to forfeiture of proprietary or possessory rights, and not just contractual rights, and is not limited to rights over real property. The Privy Council is yet to determine the nature of relief to be granted in this instance.

The ‘stench’ of financial failure at Cobbetts

The tight economic climate has claimed a professional services casualty in the UK market with Manchester based law firm Cobbetts falling into administration in January 2013 with debts estimated at £41 million (including a substantial amount of unpaid rent). Shortly after Cobbetts called in KPMG as administrators, English national law firm DWF announced its intention to acquire the assets of Cobbetts in a pre-pack deal.

DWF has now completed its 'rescue' purchase of Cobbetts from administrators KPMG, paying £3.8 million for the debts and work in progress of DWF, resulting in more than 400 jobs being retained together with a promise by DWF to honour all training contracts. However, despite the rescue there are reports that Cobbett's former employees have been deprived of basic necessities. A disgruntled Cobbetts employee stated that two weeks following the acquisition, the bathrooms at Cobbetts offices had not been cleaned and staff were having to bring their own toilet paper into work. Ex Cobbetts staff aren't the only ones who are facing a lot of uncertainty, with unsecured creditors expected to recover only a small fraction of what they are owed.

See related article here.

Survival of the fittest – international law firms still struggle to keep heads above water in difficult commercial environment

In our June 2012 Newsletter, we reported on the very messy and public fall from grace suffered by UK firm Halliwells LLP and American firm Dewey & Le Boeuf. In early October 2012, a US judge approved a $71.5 million settlement with former partners of failed law firm Dewey & LeBoeuf LLP. Given the firm only filed for bankruptcy on 28 May the same year, this swift resolution could set a benchmark for unwinding failed partnerships.

As part of the plan, more than 400 former partners have agreed to fork over a portion of money they were paid in 2011 and 2012 in exchange for immunity from future lawsuits. Individual contributions range between $5,000 and $3.5 million. In addition, the UK liquidators have reached agreement with Dewey & Le Boeuf's US LLP to hold back for UK creditors approximately £165,000, roughly 30% of the London and Paris partners' claw backs.

However the flood of new work for liquidators from struggling law firms shows no signs of abating. Fresh figures from the Solicitors Regulation Authority (SRA) in the UK show that the number of law firms in England and Wales has plummeted by over 500 since May 2012, to the lowest since records began in 2009. Most recently, Scots firm Semple Fraser appointed an administrator in March this year. Another British firm, Marsden Rawsthorne has been bought out by its former partners in a management buy-out after going into administration early this year. Evidence that this is not just bad management but a reflection of difficult market conditions is reflected by the lack of new firms popping up in their place. Just 19 new firms opened in December 2012 in comparison with 64 in 2011. However, despite the local law society looking frantically for answers, the complaint of fewer lawyers is one that is yet to make headlines outside legal circles.

See related article here.

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