BUDDLE FINDLAY

# Legal update on insolvency law - March 2016

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## No value given for fictitious profits

The majority of the Court of Appeal has upheld the High Court decision (see Buddle Findlay's summary here) that the liquidators of Ross Asset Management Limited (RAM) can recover the fictitious profits obtained by Mr McIntosh ($454,047), but not his initial investment ($500,000).

Mr McIntosh's defence of giving 'value' or 'valuable consideration' under section 349 of the Property Law Act and section 296(3) of the Companies Act was upheld as "real and substantial" and "quantifiable and equivalent" in respect of his initial investment. When RAM misappropriated the funds into the Ponzi scheme, Mr McIntosh's intent to give value or lack thereof was irrelevant: RAM had breached the bare trust arrangement with Mr McIntosh and, objectively, that breach gave corresponding value to RAM's assets.

The majority considered that the liquidators could recover the fictitious profits because payment of this amount did not discharge RAM's liability to Mr McIntosh in equitable damages and was "notionally calculated from a fabricated foundation of non-existent securities"; Mr McIntosh had given no value for the $454,047, so could not retain it.

Miller J dissented, stating that Mr McIntosh should fully disgorge both amounts and share rateably in the liquidation; Mr McIntosh was not a trade creditor, instead supplying money – not an identifiable asset. Mr McIntosh's initial investment was immediately misappropriated and pooled, as RAM was insolvent at all material times due to its Ponzi scheme.

Both sides might therefore seek leave to appeal to the Supreme Court.

See Court decision here.

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## Late investors allowed to trace their funds

The decision of *Graham & Jackson v Arena Capital Limited (In Liquidation)* concerned an application under the Companies Act 1993 by liquidators seeking direction on the application of liquidation funds.

Christchurch based Arena Capital Limited, which traded as BlackfortFX, was operating what the High Court described as a "simple ponzi scheme". Arena was subsequently placed into liquidation in August 2015, and an asset preservation order (APO) was imposed over Arena's bank accounts. Several deposits were made by investor clients into Arena's accounts following the imposition of the APO. The liquidators of Arena sought direction from the High Court as to whether the post-APO depositors had any different rights, namely, any form of priority, in the liquidation proceeds over pre-APO investors.

In the circumstances, the High Court was unwilling to accept the argument that monies paid post-APO were subject to a constructive remedial trust (or a resulting trust, noted obiter) in favour of the post-APO investors. However, Justice Mander ruled that the imposition of an APO was a "material and influential factor", which altered the position of the post-APO investors and the status of their deposits. The APO allowed the funds to remain "unmixed" in their original form, and therefore capable of being directly traced back to the post-APO depositors. On this basis, the High Court concluded that the post-APO depositors' funds were the subject of a statutory trust and should be paid out in priority to any other distributions.

See Court decision here.

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## Receivers of livestock - conversion and sale at undervalue

In *McCollum v Thompson* [2016] NZHC 28 the High Court heard a claim and counter-claim involving the enforcement of a loan and general security agreement (GSA) over livestock. The plaintiffs loaned the defendants $260,000, which was secured over

livestock listed under the GSA. Upon default, receivers were appointed to sell livestock belonging to the defendants.

In their counter-claim, the defendants claimed that certain livestock seized was not included in the GSA and that the seizure of that unsecured livestock amounted to conversion. The defendants also claimed that the receivers had sold the secured livestock at undervalue, in breach of the duty to secure the best price obtainable.

The Court found that security in the livestock extended only to the livestock identified and listed in the GSA. The GSA did not contemplate security existing over any additional stock that might be added to the herd, or any progeny from existing herd stock.

Under the counter-claim, the Court held that the receivers had sold the stock under market value. In particular, the receivers had failed to obtain available herd breeding information, which meant the livestock had been sold at a price that was based on this information not existing.

Further, the seizure of livestock not secured by the GSA amounted to conversion by the plaintiffs. The Court granted the defendants damages for conversion and for consequential loss of income as a result of not being able to milk the livestock.

See Court decision here.

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## Interest payable despite delay

Following the determination of the substantive High Court case earlier last year (see our previous summary here), this case concerned a dispute in respect of a right to claim interest for the five-and-a-quarter-year period between the appointment of the liquidators and the date on which the respondents were formally notified of the liquidators' intention to set aside the transactions.

Ebert argued, unsuccessfully, that it had changed its position to its detriment due to the lengthy delay between the liquidators' appointment and the notification of the claim. However, without proof that the costs of borrowing would have been less than the award of interest for this period, the Court could not conclude that Ebert had suffered any detriment by later having to pay interest for that period. Accordingly, with no detriment and no entitlement to the money (but nevertheless having the benefit of it), interest was found to be payable for the entire period.

The Court warned that the case should not be construed as providing for an absolute right to interest, regardless of the time taken to initiate proceedings. Each case will necessarily turn on its own facts and in particular it was noted that (i) it was always known that the transactions might be set aside on insolvency and (ii) the liquidators had a reasonable explanation for the delay in notifying the claim.

See Court decision here.

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## Personal liability for failure to keep proper financial records

In *Madsen-Ries and Vance v Petera* the High Court found that the directors of Petranz Limited (in liquidation) had breached certain directors' duties under the Companies Act and, as a consequence, were liable to pay compensation to the Company. In particular, the directors failed to keep proper financial records and produce financial statements.

The Court also found that the shareholders of the company (who were also the directors) had used a significant amount of the company's funds for their own purposes. The Court characterised the funds as "debts owed by the shareholders to the company, and are repayable on demand" and found that the company was entitled to recover those payments.

See Court decision here.

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## Guarantor obligations not compromised

For the first time in New Zealand, the High Court has considered whether a compromise under Part 14 of the Companies Act 1993 can release guarantors of a company's debts. Silverfern proposed a Part 14 compromise to its creditors and, as part of that compromise, the guarantees given by Silverfern's directors and shareholders, Mr and Mrs O'Connor, of Silverfern's debts, would be unconditionally released. The compromise was approved by the required majority but opposed by the plaintiffs.

The plaintiffs, as creditors of Silverfern, sought declaratory orders that a Part 14 compromise does not permit the "confiscation" of standalone rights possessed by a company's creditors against a third-party guarantor. Muir J found in favour of the plaintiffs, holding that a compromise between a company and its creditors does not mean a compromise between the company, its creditors, and the company's guarantors. The Court was persuaded that much clearer language would be required before the courts would impute an intention on the legislature to "expropriate or extinguish valuable rights without fair compensation."

See Court decision here.

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## Xero public interest - justifying the lifting of a suppression order

In *Havenleigh Global Services Ltd and FM Custodians Ltd v Henderson*, relating to the bankruptcy of David Henderson, the Official Assignee had issued a notice under section 171 of the Insolvency Act to Xero for the provision of company records. Associate Judge Osborne prohibited publication of a ruling about the lawfulness of the notice pending the public examination of Mr Henderson and judgment. The Official Assignee applied for directions allowing publication because the prohibition prevented Xero from commenting on media articles about how it responded to the notice. Mr Henderson opposed the application.

Associate Judge Osborne held that:

- When making a non-publication order, the Court must weigh the interests of the parties (here, a fair examination process) against the public interest in open justice and freedom of expression. An order for suppression in a civil proceeding requires exceptional circumstances
- There were no exceptional circumstances justifying a continuation of the suppression order because:
  - the public examination process was over (although no judgment had been given). Publishing the details of the ruling after the public examination of Mr Henderson would not affect the examination process and therefore not prejudice Mr Henderson's interests as to that process
  - the order was having a gagging effect on Xero and the Official Assignee, who were not able to refer to the ruling to correct statements made by the media
  - Mr Henderson's right to a fair trial in a separate criminal proceeding would not be affected because the ruling was irrelevant to the issues in that proceeding.

See Court decision here.

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## Liquidators obliged to pursue information requested

A recent interlocutory decision (*Action Media Ltd v Mitchell* [2015] NZHC 3121) in ongoing litigation between the liquidators and the former director and shareholder of Action Media Ltd (In Liquidation) gives some guidance on the relationship between the liquidators' powers under section 261 of the Companies Act 1993 and their obligations to discover relevant documents under their control. The defendants had requested discovery from the liquidators of certain correspondence between the liquidators and the IRD, and of pre-liquidation correspondence between the company and the IRD. The liquidators had already made a request under section 261 for the pre-liquidation correspondence between the company and IRD but had received only some of it.

While the Court held that there was no obligation on liquidators "to spend time and money on speculative pursuit of documents" under section 261 at the defendants' behest, this situation was clearly distinguishable. Here, the documents sought were clearly relevant and the liquidator had already made a section 261 request, which meant that "the Liquidators have the power to seek enforcement of compliance with the notice thus a right to possess the correspondence." However, the liquidators only had the right to request company documents and could not request correspondence between IRD and the former director in relation to the director's personal affairs nor could they demand unredacted copies of IRD case notes on the matter. In a later interlocutory decision (available here), the trial ordered for February 2016 was adjourned to allow time for the discovery of the relevant IRD files in storage, as the contents would potentially benefit both parties.

The defendants also sought orders under section 286 of the Companies Act 1993 preventing the liquidators from continuing to issue section 261 notices to the first defendant, as the defendant alleged that the liquidators were no longer investigating any further claims. The Court dismissed this application. A later interlocutory application to clarify that decision was rejected (available here).

We understand that an appeal has been filed in respect of the conclusion that documents that are the subject of a section 261 notice are within the control of a liquidator for discovery purposes even when the third party has not complied with the section 261 notice.

See Court decision here.

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## The importance of registering your security interest, particularly in Australia

In March 2013, four portable gas turbines worth about AU$50m had been leased to Forge Group Power Pty Ltd (Forge) by GE

International Inc (GE) as lessor. In February 2014 and March 2014 Forge was placed in administration and liquidation respectively.

Under the Australian PPSA and the New Zealand PPSA, the interest of a lessor in goods under a lease or bailment for a term of more than one year will be deemed to constitute a security interest, irrespective of whether that interest secures payment or performance of any obligation. However, under both Acts, a lease by a lessor who is not 'regularly engaged in the business of leasing goods' is excluded from the scope of that deemed security interest.

The NSW Supreme Court held that the turbine lease was a deemed security interest for the purposes of the Australian PPSA:

- GE was 'regularly engaged in the business of leasing' goods. In its analysis the NSW Supreme Court did not follow the view of the New Zealand Court of Appeal in *Rabobank v McAnulty* [2011] 3 NZLR 192 (CA) as regards the meaning of the phrase 'regularly engaged in the business of leasing', finding instead that the reference to 'regular' means normal in the context of the lessor's business, rather than being solely focused on the frequency of actual leasing transactions.
- The leased turbines did not constitute a fixture (so as to be beyond the scope of the Australian PPSA).

GE had not registered a financing statement in respect of its deemed security interest in the leased turbines on the Australian PPSR. Accordingly, GE's security interest was unperfected due to the failure to register. Under the New Zealand PPSA this would mean that the unperfected security interest faced losing priority to all other perfected security interests in the relevant collateral assets.

However, in addition to a potential loss of priority, under the Australian PPSA the consequences of a failure to perfect by registration are even more severe for a lessor. Section 267 of the Australian PPSA provides that unperfected security interests vest in the grantor (debtor) upon its winding up or bankruptcy. This vesting rule has no equivalent under the New Zealand PPSA. The effect of such rule for GE in this case was that GE lost any claim to the turbines and was treated as simply an unsecured creditor in the liquidation of the Forge. This windfall to the company and potentially its unsecured creditors as a group raises significant questions about the policy impact of the section 267 vesting rule in the context of leases which are deemed to constitute security interests by the Australian PPSA.

See Court decision here.

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## What does it take to oust a liquidator?

In the recent case of *Queensland Mining Corporation Ltd v Butmall Pty Ltd (in liq),* the Court held that the liquidators' relationship with a major creditor of the company in liquidation (Butmall) did not per se amount to a conflict of interest.

Butmall applied to have its liquidators removed as they were the auditors of its major creditor (QMC), against whom Butmall purported to have considerable counterclaims.

The Court pointed out that removal of liquidators requires a real, and not only theoretical, possibility of conflict of duty or interest. The mere fact that the liquidators were the auditors of QMC was not sufficient to establish a "real" conflict of interest.

The threshold of evidence required to remove a liquidator therefore remains high, as evidence of a relationship between a liquidator and a creditor, alone, is unlikely to justify removal of the liquidator.

See Court decision here.

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## Ignorance is no guarantee of bliss

The Queensland Court of Appeal has upheld a personal guarantee given by a woman (the appellant) to a bank to secure a loan to a company that she claimed was controlled by her husband. The Court rejected the appellant's claims that she did not understand the nature and effect of the transaction or that she was at a special disadvantage in all of the circumstances.

The appellant had a history of property ownership, and had given two previous guarantees to the bank. The Court held that the bank was entitled to explain the consequences of the guarantee in general terms, and was not required to list every possible consequence of the transaction (like bankruptcy). Here, it was material that the appellant knew her properties were "on the line" and sale of them was "a worst case scenario". Ultimately the creditor must have "reasonable grounds for believing that [the] party does have an adequate understanding of the nature and purport of the transaction".

The Court left open whether the appellant qualified as a volunteer in the transaction.

See Court decision here.

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## Expenses of a trustee in liquidation

The sole role of ICS, the company at issue in the recent decision of the New South Wales Supreme Court in *In the matter of Independent Contractor Services (Aust) Pty Ltd (in liquidation) (No 2)* [2016] NSWSC 106, was to be the trustee of the similarly named ICS Trust. Previous litigation had confirmed that the trust was not a sham and that all ICS's assets were trust assets. In the present decision, the judge held that all expenses incurred by ICS were expenses incurred as trustee, and therefore ICS (and the liquidator) had a right to be indemnified for those expenses from trust assets before any distribution to beneficiaries was made.

The Court also had to decide whether the liquidator's expenses were to be paid out of trust funds and the quantum of the liquidator's remuneration. The Court approved payment for advice in relation to tax proceedings, for debt recovery and for database extraction. In relation to the liquidator's remuneration, the liquidator claimed $49,510.50 plus GST but the Court approved only $30,000 plus GST.

See Court decision here.

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## Distribution to creditors in the context of possible future claims

The English High Court in *Powertrain Ltd, Re* [2015] EWHC B26 considered the issue of whether a liquidator should be authorised to effect further distributions in favour of a company's known creditors without regard to possible further claims that could emerge against the company.

The Court noted that there is a balance to be struck between the desirability of distributing assets to known creditors sooner rather than later and the potential injustice of leaving someone who has a valid claim with no effective remedy.

The Court held that the liquidator should be authorised to distribute in favour of the known creditors as:

- The known creditors had been kept out of the available money for a consider period
- Chances were remote that other creditors would come out of the woodwork (Powertrain had ceased trading more than nine years ago).

See Court decision here.

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## Unusual features provide no hurdle to guarantor liability

In *Deutsche Bank AG v Unitech Ltd* the English Court of Appeal recently heard an interlocutory appeal concerning Unitech (a guarantor), UGL (as borrower) and Deutsche Bank (as lender). In a separate action, UGL had claimed Deutsche Bank has misrepresented the interest rate applicable to the loan, which was calculated based on an average of the London Inter-Bank Offered Rate (LIBOR).

In this action, Unitech sought to avoid guarantor liability on grounds that Deutsche Bank had failed to disclose unusual features of the loan; that Deutsche Bank had breached an implied term not to manipulate LIBOR; that performance of the loan agreement was illegal; and that the loan and guarantee were void due to breaches of UK anti-competitive law by Deutsche Bank.

First, the Court held that the guarantee contained a clause that acted as an indemnity clause. On that basis the doctrine of unusual features did not apply as a defence to guarantor liability. The Court held that the scope of the clause was wide enough to act as an indemnity and that Unitech had agreed to indemnify the Bank against 'any amount not recoverable from UGL for any reason'. The Court held that the non-disclosure of unusual features was captured by this clause.

The Court then held that although funds under the loan would be converted into Indian Rupees (making repayment of the loan illegal under Indian law), illegality was to be determined based on the place of performance of the contract, which in this case was New York. The guarantee was not therefore void for illegality.

Finally, the Court held that an individual credit contract is not sufficiently connected with conduct said to be in breach of anti-competition provisions to make it void. The guarantee was not void for anti-competitive conduct.

See Court decision here.

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## Proceedings involving companies in liquidation or administration

In *Cook v Mortgage Debenture*, Mr Cook applied to be joined to a proceeding that was being continued by a claimant company

after it had been placed into administration. The issue was whether the Court's consent was required on the basis that the application was against a company in administration (the English legislation being similar to section 248 of the Companies Act 1993). The Court concluded that, while the moratorium covered legal proceedings against a company in administration or liquidation, it does not cover defensive steps in proceedings brought (or continued) by a company in administration. Accordingly, leave was not required for the application.

*DHC Assets ltd v Toon* is a recent New Zealand example of the Court granting leave under section 248 for a proceeding to be commenced against a company in liquidation. DHC claimed that Vaco Investments had failed to pay the final payment in a construction contract and threatened adjudication proceedings under the Construction Contracts Act. Vaco was voluntarily liquidated, appointing Toon as liquidator who rejected DHC's proof of debt. The Court rejected Toon's arguments that the debt lacked merit and that time limits prevented the bringing of the proceeding and granted DHC's application for leave to commence adjudication proceedings under section 248.

See Court decisions here and here.

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## Panic stations in UK: Clampdown on no-win no-fee agreements and a possible ban on minor personal injury claims wreak havoc

The Jackson reforms to no-win no-fee agreements and the UK government's proposal to ban general damages for minor personal injuries have sent many UK firms into a tailspin.

First Stop Legal Services, trading as GT Law Solicitors, from a base in Liverpool, entered administration in October after income nose-dived in 2014/15. At its 2013 peak, GT Law employed more than 100 people and had 20 offices nationwide. The firm posted turnover of £7.9m for the 2013/14 financial year. However, in 2012 the firm became involved in a large group action following the Sonae chipboard-plant fire in Kirkby, Merseyside. While it secured 5,000 clients, making it the second-largest client base arising out of the action, the presiding judge dismissed the test cases. GT Law had invested "significant working capital" in funding the action. In addition to this financial pressure, the firm was also referred to the Solicitors Regulation Authority over its alleged conduct during the litigation process.

The firm's administrators also cited the introduction of the Jackson reforms on no-win no-fee agreements as being a direct contributing factor to the company's demise. Three firms were found to buy different portions of GT Law's files. Pre-administration costs come to around £43,000, of which £18,000 are due to law firm Mishcon de Reya for legal costs. Mishcon de Reya and Ashford Solicitors are also owed more than £73,000 in total for pre-administration expenses.

The reforms relate to no-win no-fee agreements in April 2013. It was therefore surprising timing that AA teamed up with national law firm Lyons Davidson to handle personal-injury and car-accident-related litigation on behalf of its members and customers. Two years later, AA Law had been declared a write-off.

However, AA Law's exit was surprising for some. Its books for 2014 showed a turnover of £1.94 million and profit after tax of almost £500,000. In November 2015 the Chancellor of the Exchequer proposed a ban on general damages for minor injuries - such as whiplash - and suggested a new small claims limit of £5,000 on all personal injury matters. Given that this move, if implemented, could be the nail in the coffin for firms that rely on road-traffic-accident and personal-injury work, some consider AA Law's departure a sensible strategic move.

Australian-listed Slater & Gordon's profit forecasts and share price took a hit late last year for this same reason. In March of 2015 Slater & Gordon announced the “transformational” $1.3 billion acquisition of the claims management business of UK company Quindell Plc. Slater & Gordon were hailed as the future of legal services; website *Legal Futures* graced it with headlines such as “The rise and rise of Slater & Gordon". The Quindell deal was certainly “transformational” but, unfortunately, for all the wrong reasons. Slater & Gordon lost around 90% of its value over the course of 2015, including a write-off of the entire purchase price for Quindell.

Group managing director Andrew Grech alluded indirectly to the chancellor's proposed reforms and the fact that the firm is already anticipating the effect they could have on the value of the UK business: "Having regard for recent events, including the impact of those events on the company's share price, the company will test its goodwill values for impairment of the UK business at the half year ending 31 December 2015." He further noted that the impairment review will assess matters including the risks associated with the proposed changes to UK law (which may or may not be enacted). Mr Grech said that if the company considers that "it is appropriate to impair goodwill related to the UK business, any impairment will not impact cash flow from operations but will impact statutory profit".

Since then, things have gone from bad to worse for the market darling, Slater & Gordon. In late February, the firm unveiled huge losses and suspended its shares from trading. Office closures and redundancies lie waiting in the wings.

All of which leaves the firm open to a shareholder class action, of the type on which the firm's reputation was built.

However, the most recent PI firm casualty is that of Raleys, which went into administration on 11 March 2016. While there is no

comment yet on what caused the 130-year-old firm's demise, it was known as a miners' firm that specialised in personal injury. Raleys also lost a key client, the National Union of Mineworkers, in 2014 after firm documents were leaked which called miners "as thick as two short planks". The Union had been Raleys' client for 90 years. Raleys had also suffered some high-profile court defeats in recent years relating to the negligent way it had handled some miners' claims.

As if these financial woes were not enough to deal with, these firms are also trying to dodge the additional cost and administrative headache of dealing with investigations by market watchdogs. The Australian Securities and Investment Commission has been investigating Slater & Gordon since June, when it revealed its first surprise downgrade. Administrators of GT Law did not consider selling the company whole as it would have created bad publicity that could have led to intervention by the SRA.

And all of this is yet to hit the UK insolvency market. The Jackson reforms relating to no-win no-fee agreements came into effect generally in April 2013, but were delayed in respect of insolvency proceedings. Provisions relating to insolvency cases are due to come into force in April this year.

See below articles:

- Daily Mail UK 20 July 2014
- UK Parliament 17 December 2015
- The Law Society Gazette 17 December 2015
- The Law Society Gazette 17 December 2015
- Legal Cheek 22 January 2016
- The Law Society Gazette 27 January 2016
- The Guardian 24 February 2016
- Fool.com 24 February 2016
- The Law Society Gazette 15 March 2016

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