BUDDLEFINDLAY

Legal update on insolvency law - September 2016

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High Court sets aside creditors' compromise

In *Advicewise People Ltd v Trends Publishing International Ltd*, four creditors of Trends Publishing International Ltd (Trends) successfully challenged a compromise approved under Part 14 of the Companies Act 1993.

Heath J set aside the compromise after finding that the challenging creditors, who had voted against the compromise, had been unfairly prejudiced by the decision to call only one meeting of creditors. That decision had allowed three insider creditors, including a director of Trends and a company controlled by another director of Trends, who together controlled more than 75% by value of the unsecured debt (one of the statutory thresholds for passing the compromise), to vote on the compromise, even though they had waived the right to a distribution under the compromise.

In Heath J's view, the insider creditors should have been put into a different class for voting purposes because their economic interests were not such that they could properly consult with the other unsecured creditors for a common purpose.

The judge also found that the decision to include the insider creditors in the one class was a deliberate manipulation of the process in order to manufacture the statutory majorities and ensure the compromise was passed. As that manipulation was a fundamental misuse of the compromise procedure, the consequent prejudice suffered by the challenging creditors was unfair.

Ultimately, Heath J considered it appropriate to set aside the whole compromise rather than just excluding the challenging creditors from the compromise because of, among other factors:

- The fundamental error caused by the deliberate manipulation of the voting
- The fact that no good-faith proposal had ever been put forward
- The fact that no creditors had been paid pursuant to the compromise.

Heath J also considered it relevant that there was no clear evidence that the proposed compromise managers had control of the funds to be paid out under the compromise. He was also critical of the fact that the compromise manager, Mr Khov, was not called to give evidence at the hearing.

Buddle Findlay represented the applicant creditors in this matter.

See Court decision here.

Shadow director and shady dealings brought to light

In *Petterson v Hutt* a liquidator sought an interim injunction preventing any enforcement steps being taken under two general security agreements (GSAs). In the substantive proceeding, the liquidator sought to have the GSAs set aside.

Five weeks before entering voluntary liquidation, High Street Management Limited (HSM) entered into two GSAs with the first respondents; Mr Hutt, a former director of the company, and FR Trustee (Hutt) Ltd. A short time after HSM was placed in liquidation, Mr Hutt appointed the second respondents as receivers under the GSAs.

The liquidator argued that Mr Hutt remained a shadow director of the company and that the Court should exercise its power under section 299 of the Companies Act 1993 to set aside a security made in favour of an insider. The liquidator also applied under section 293 of the Act to set aside the GSAs on the ground that HSM was unable to pay its debts immediately after the GSAs were entered into.

In *Petterson v Hutt*, the High Court granted interim orders preventing the respondents from taking any steps to realise or recover assets of HSM. In finding that there was a serious issue to be tried, Toogood J noted that Mr Hutt continued to exercise control over HSM, negotiated with creditors on its behalf and executed the GSAs on behalf of HSM as the debtor. Moreover, Mr Hutt's relatives had been appointed to the directorship and he arranged that one of the company's creditors receive payment directly from him.

See Court decision here.

Liquidity not co-extensive with solvency

In *Madsen-Ries & Anor v Donovan Drainage and Earthmoving Limited* [2016] NZCA 301, the liquidators of a failed property development company, Te Pua, applied to set aside as insolvent transactions a number of payments which Te Pua made to a drainage contractor, Donovan.

After Donovan completed drainage works for Te Pua, Te Pua advised Donovan that it did not have the funds to pay its account, but that it would be able to make payments in the future. Following this discussion, Donovan completed and invoiced Te Pua for further drainage works and subsequently received several payments from Te Pua.

In the High Court, Associate Judge Christiansen concluded that the payments could not be set aside as insolvent transactions as Donovan satisfied the defence under s 296(3) of the Act; at the time that the payments were received, Donovan acted in good faith and neither Donovan, nor a reasonable person in its position, would have suspected that Te Pua was or would become insolvent.

On appeal, the liquidators challenged the High Court's finding that Donovan had discharged its onus on the question of suspicion of insolvency. The Court of Appeal dismissed the appeal and held that:

- Liquidity is not co-extensive with solvency. A temporary liquidity problem, including an inability to pay debts when legally due, will not necessarily establish insolvency
- Donovan reasonably understood the delay in payment was due to a temporary cash-flow problem. Neither Donovan nor a reasonable person in its position would have suspected at the time of the payments that Te Pua was, or would become, insolvent
- If anything, the payments that Donovan received suggested to Donovan that Te Pua was back on track.

See Court decision here.

Limits of the equitable remedy of tracing better defined

The recent High Court decision of *The Fish Man Ltd (In Liq) v Hadfield* [2016] NZHC 1750 explored the limits of the equitable remedy of tracing – in the context in which misappropriated funds had been used to pay mortgage liabilities.

Mr Hadfield owned a business, The Fish Man Limited (The Fish Man), which raised and sold ornamental fish from his home where he lived with his wife. The Fish Man fell behind in its PAYE and GST tax liabilities, but Hadfield continued to use revenue of the company to meet mortgage payments over his home. The Fish Man was put into liquidation in 2010 and later obtained default judgment against Mr Hadfield. Mr Hadfield was put into bankruptcy in 2013.

The liquidator of The Fish Man argued that as Mr Hadfield had paid the mortgage of his home through misappropriated funds, The Fish Man had gained a proprietary interest in the property through the equitable remedy of tracing.

The High Court noted that tracing is a practical remedy of following money when it is converted into property. In this instance, the small amount of money pursued by the liquidator could not be said, in any meaningful sense, to be the cost of acquiring the property. The bulk of the sum would be paying the interest on the mortgage, so to prevent the relevant bank from exercising a power of sale. Repayment of a debt will not normally be treated as the use of money to purchase an asset.

The Court, therefore, held that any attempt to turn the mortgage payments into a proprietary interest in the equity of the home was pushing tracing out of its natural confined scope and that The Fish Man had no proprietary interest in the property.

We understand that the decision is being appealed.

See Court decision here.

Lies, damned lies and a liquidator

In the recent High Court case of *McKay v Johnson & Smith* [2016] NZHC 1691, a liquidator, Geoff Martin Smith, allegedly sent a notice under s 305 of the Companies Act 1993 to the bank that had security over a company in liquidation. The bank did not respond to the notice and Mr Smith alleged that the bank had lost its security. The bank maintained it never received the notice.

The Court was satisfied that the notice had been fabricated because:

- Forensic examination of the relevant computer found that the notice had been created only recently
- The document was addressed to an officer of the bank who had not had contact with Mr Smith until about four months after the date of the alleged notice
- The stamp depicted in the photo (that had been supplied as proof of service) had not been published until 22 months after the alleged service took place
- Mr Smith had a history of dishonesty, including convictions for tax evasion, theft, fraud and falsifying documents.

The Court ordered him to pay back the funds he had received over which the bank had security, totaling $540,402.82 plus interest.

This case highlights the lack of regulation for liquidators in New Zealand: a liquidator does not need to be a 'fit and proper person' and requires no training, qualification, registration or licensing.

See Court decision here.

No need to trace when a title is held by a bare trustee

The High Court's ruling in *Priest v Ross Asset Management Ltd (In Liq)* [2016] NZHC 1803 arose out of the devastation of the Ponzi scheme effected by David Ross of Ross Asset Management Limited (In Liquidation) (RAM) and Dagger Nominees Limited (Dagger). For many years RAM and Dagger reported spectacular returns for investors before their illusion was revealed, the Financial Markets Authority became involved and liquidators were appointed.

Duncan and Nora Priest (Priests) subsequently argued that their investment in RAM (Priest Holdings) had been held on bare trust for them and that as a consequence the Priest Holdings did not form part of the pool of assets that the liquidators could distribute amongst all of the investors, but rather could only be returned to the Priests. The liquidators disagreed.

The Court found in favour of the Priests, noting that they had separated themselves from the other investors, in that the Priests directed the purchase of all shares, provided valuable consideration for the same and there were no fictitious profits involved. The Priests had not given Mr Ross discretionary powers to manage investments on their behalf and so had remained the equitable owners of the shares purchased through Dagger and RAM as bare trustees.

Of note, at all times the Priest Holdings were recorded accurately in RAM's and Dagger's books as allocated to the Priests, so the other investors could not demonstrate any proprietary right to the Priest Holdings.

The Court made it clear that, to the extent that it might be argued the other investors temporarily funded the purchase of the Priest Holdings, the value of that contribution was restored to the trust funds of the other investors when the Priests discharged their debt to RAM and Dagger.

The case raises complex issues as to fungibility and tracing and, as is always the case in such matters, turned on its own facts.

The liquidators are reported to be making an appeal against the judgment.

See Court decision here.

Former directors found to be in breach of their duties

In *CGES Limited (in liquidation and receivership) v Kelly* [2016] NZHC 1465, the liquidator of CGES Limited brought claims against the former directors of the company for breaches of duties owed to the company. The High Court held:

- The directors failed to act in good faith and the best interests of the company by allowing the company to continue trading and incurring further debts to creditors after it had become insolvent

- Despite being aware of the troubled circumstances that the company was in, the directors continued to incur further liabilities, thus creating a substantial risk of serious loss to the company and to its creditors
- At the time the liabilities were incurred, the directors could not reasonably have believed that the company would be able to satisfy its debts
- The directors failed to exercise the care, diligence and skill that a reasonable director would exercise in the circumstances.

As a consequence, the High Court ordered the directors to reimburse the company for the loss which it suffered as a consequence of their breaches of duty.

See Court decision here.

High Court refuses to look behind judgment debt and Assignee decision

The High Court in *Wilkins v Official Assignee* [2016] NZHC 1742 considered the circumstances in which a court may look behind a judgment debt following a contested hearing.

From 2004, Mr Wilkins applied to become a tenant of Housing New Zealand (HNZ) and was successful in obtaining income related rent subsidies from HNZ. It came to light that Mr Wilkins had failed to disclose, among other things, that he was the sole shareholder and director of a company that owned Auckland properties. Mr Wilkins pled guilty to using a document to defraud.

The District Court, in the civil context, awarded the sum of almost $120,000 in HNZ's favour. Mr Wilkins was adjudicated bankrupt. HNZ claimed the debt owing from his estate and the claim was accepted by the Official Assignee. Mr Wilkins applied to the High Court to look behind the judgment debt awarded by the District Court and set aside the Assignee's decision.

The High Court accepted the following approach laid out by the Australian High Court in *Corney v Brien* (1951) 54 CLR 343 for these circumstances:

- The court can generally accept a judgment debt as sufficient proof, particularly when the judgment results from a defended hearing
- The circumstances where the court may inquire into the validity of a judgment debt are not closed – there are no inflexible rules
- Fraud, collusion and a miscarriage of judgment are examples of when the court may choose to inquire into a judgment debt.

Mr Wilkins did not make out a prima facie case of miscarriage of justice or any other circumstance that could justify the court enquiring into the judgment debt. Mr Wilkins' application was dismissed.

See Court decision here.

Litigation funding arrangement not a bare assignment

Property Ventures Ltd (PVL) went into liquidation in July 2010.

In 2012, the liquidator of PVL, along with several other interested parties, issued proceedings against the company's directors, valuers and its auditors. The proceeding was funded by an investment company, SPF No 10 Ltd (SPF), which received a first ranking security interest over PVL's assets. In addition to the funding agreement, SPF negotiated a deed of assignment with one of PVL's main creditors, Allied. Pursuant to the deed, SPF was assigned all of Allied's debts and securities, including rights of action against various parties.

One of the defendants unsuccessfully applied to the High Court to stay the proceeding on the basis that:

- PVL's litigation funding arrangements, together with the assignment, constituted an abuse of process. In particular, that the liquidator was acting for an improper purpose by pursuing a claim that stood to disproportionately (if not exclusively) benefit SPF, to the exclusion of unsecured creditors
- PVL's litigation funding arrangements, together with the assignment, amounted to a bare assignment of PVL's claim, which is unlawful in New Zealand.

On appeal, there was a challenge to the High Court's finding that the agreement and deed, when read together, was not a bare assignment. The Court of Appeal dismissed the appeal on the basis that:

- The funding agreement was not an assignment of a cause of action. The claim remained with PVL and is being prosecuted by the liquidator
- The funding agreement (in itself) was not objectionable. Rather, it was the combination of the funding agreement and the assignment that together were said to give SPF excessive compensation and control
- SPF would receive the net proceeds of the proceeding as secured lender in accordance with the GSA, not in its capacity as litigation funder
- Without knowing exactly how much would be recovered in the proceeding and the costs of the litigation, it was not possible to conclude that SPF would be paid disproportionately to its investment or that there would be no return to unsecured creditors.

See Court decision here.

Recent Supreme Court leave decisions

In our June 2016 update, we discussed the Court of Appeal's decisions in *Madsen-Ries v Petera* [2016] NZCA 103, *Calvert v Reynolds* [2016] NZCA 151, and *Petterson v Browne* [2016] NZCA 189. In all three cases leave was sought to appeal to the Supreme Court. Leave was granted to the applicant companies in *Petterson v Browne,* but declined in all other cases. We will report on the Supreme Court decision once it has been delivered.

See links to the Supreme Court leave decisions below:

- Madsen-Ries v Petera
- Calvert v Reynolds
- Petterson v Browne.

UKSC on revocation of agent's authority and constructive trusts in insolvency

In *Bailey v Angove's Pty Limited* [2016] UKSC 47, the UK Supreme Court affirmed two principles of critical significance to insolvency practitioners. The first is that even if the parties should agree that an agent's authority is irrevocable, it will not be treated as such unless such non-revocation is intended to secure the financial interest of the agent. The second is that when money is paid to an agent for a consideration that the agent knows at the time of receipt must fail because of the agent's imminent insolvency, such receipt will not give rise to a remedial constructive trust over those funds in favour of its principal.

The case concerned an agency and distribution agreement for the sale of wine between Angove's Pty Ltd (Angove's), as principal and seller, and D&D Wines International Limited (D&D), as agent and distributor. At the time of D&D's insolvency, there was A$874,928.81 payable to D&D from its customers, for which it was required to account to Angove's. Angove's purported to terminate the agency on insolvency, and sought to collect the amounts payable directly from D&D's customers, and then separately account to D&D for its commission.

The Supreme Court held that Angove's was entitled to revoke the agency and collect on the outstanding amounts, on the basis that the agency was not expressly or impliedly irrevocable, and even if it were, it did not secure the financial interest of D&D in collecting its commission. Had the Court needed to decide the constructive trust point, it would not have declared that D&D held the outstanding amounts on trust for Angove's.

The decision is significant because it signals the courts' unwillingness to cut across the pro rata distribution of the insolvent's estate by imposing a remedial constructive trust, which transforms an unsecured debt into essentially a secured claim.

See Court decision here.

A Rumsfeldian analysis of contingent assets

In *Evans v Jones* the directors of a liquidated company sought to defend a claim brought by the liquidators that loan repayments were insolvent transactions by asserting that the company was balance-sheet solvent at the time of the transactions. The directors based this claim on the company having contingent assets in the form of dividend payments (to the directors) that were later found to be unlawful.

The liquidators appealed the lower court's finding that the claim should be treated as an asset rendering the company balance sheet solvent at the time of the transactions.

The UK Court of Appeal found the claim was an 'unknown unknown', in that it was unlikely the claims would be discovered or pursued while the company was in the hands of the directors and that the claim was only discovered upon liquidation. Accordingly, as treating the claim as an asset did not accord with commercial reality, the appeal was allowed.

See Court decision here.

Personal injury and bankruptcy

In *Berryman v Zurich Australia Ltd,* the Supreme Court of Western Australia considered the claim of a bankrupt who had brought an action against his insurance company for breach of contract following its denial of his total disability claim (the bankrupt had claimed under the policy for A$2m).

Under the Bankruptcy Act 1966 (Cth), the right to recover damages in respect of a personal injury does not pass to the estate in bankruptcy; nor is a bankrupt disentitled from continuing a proceeding in respect of a personal injury. The insurer sought to have the claim struck out on the basis that the insurance claim was a contractual dispute rather than one in respect of a personal injury.

After considering numerous authorities, Tottle J found that the legal basis for the claim was not determinative as to whether the claim was in respect of a personal injury and that the interposition of the insurance claim did not alter the essential character of the claim as being one for compensation of a personal injury.

While the decision was made with particular reference to the relevant Australian statutory provisions (which do not have equivalents in New Zealand), it should be noted that Tottle J's reasoning encompassed a thorough review of common law authority.

See Court decision here.

Another stress test for UK legal market: Top PI insurer collapses

Professional indemnity insurer Enterprise Insurance (Enterprise) has gone belly up. The Gibraltar-based firm has been a central insurer in the legal professional indemnity market and insures many of the UK's law firms. However, in July, the Gibraltar Financial Services Commission ordered the unrated insurer to stop writing new business after it was declared insolvent and entered liquidation. This collapse is believed to affect 50 law firms in the UK. However, the problem is in fact more widespread. Enterprise has been in the professional indemnity insurance market since 2011 and still provides run-off cover for many more practices that have since closed down.

Policyholders have been advised that their policies will remain in play for the time being but more information will be provided in due course. While the UK Financial Services Compensation Scheme (FSCS) has confirmed it will cover UK policyholders if Enterprise cannot meet the cost of claims made against it, FSCS will only do so if they meet certain criteria (such as having a turnover of less than £1m). But the headache does not end there. Under Solicitors Regulation Authority rules, law firms are forced to find alternative insurance cover within 28 days or be forced into the assigned risks pool (ARP), in which policy rates are charged at a premium. If firms are still unable to find affordable cover within three months, they will be forced to cease trading because they do not carry adequate professional indemnity insurance.

Back in September 2013, reports estimated that 1,300 UK firms were put at risk after Latvian insurer, Balva, was put into liquidation. Initially the Latvian Board of Financial and Capital Market Commission (FCMC) assured the market all was well, as all Balva's insurance policies would simply be transferred to its underwriter, Berliner. However, when Berliner backed out, declining to cover the Balva policies, panic hit the UK legal market. Berliner's exit was described by one broker as the "biggest hand grenade into the bottom end of the market for many years."

With an already vulnerable economy and the uncertainty created by Brexit, this event will be a cold cup of tea for the UK legal market.

See articles here, here and here.

Slater & Gordon's losses continue

Australian-listed Slater & Gordon, the world's first publicly traded law firm, is preparing to post what is understood to be legal sector's biggest ever annual loss. A profit warning filed with the Australian Securities Exchange, reveals the firm's full-year net loss after tax for the year ended 30 June is expected to total A$1,017.6m.

While the extent of the damage is shocking, it is not entirely unsurprising. Slater's profit forecasts took a hit after it lost around 90% of its value over the course of 2015. At the time, Group managing director Andrew Grech indirectly pointed to the proposed Jackon reforms to no win no fee agreements and the UK government's proposal to ban general damages for minor personal injuries which have sent many UK firms into a tailspin.

In early May, Slater & Gordon revealed that following a devastating 2015 lenders had given the firm an ultimatum to present a turnaround plan or face having to repay debts by April 2017. Slaters agreed restructuring proposals with its lenders, although it was not clear how many jobs are threatened. Last month, however, Grech was promising a turnaround: "*Slater & Gordon's FY16 performance is a story of two different halves. The results for the first half were extremely disappointing and well below expectations. In the second half we have taken significant steps towards turning around the performance of the UK business. Whilst the UK performance improvement programme is still in its early stages, the second-half results indicate that our efforts are beginning to bear fruit*."

Slater and Gordon had bought the legal services arm of Quindell in a £637m deal last year but the company's share price has since nosedived and the value of claims included in the purchase has fallen significantly. Slater & Gordon has confirmed that it intends to sue the successor company to Quindell over that acquisition.

See articles here and here.

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