BUDDLEFINDLAY

Legal update on insolvency law - December 2016

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Even Stevens? A surety avoids summary judgment through receivers' potential breach of duties

In *Primary Wool Co-Operative v Stevens*, the High Court considered, among other things, whether there was an arguable case that the receivers of Bruce Woollen Mill Limited (BWM) had breached their duties to a surety and whether this meant (in the summary judgment context) the surety could escape liability to the secured creditor.

While trading, BWM had obtained advances from the Co-Operative. The Co-Operative's lending had been secured by a GSA over BWM's property and a guarantee given by BWM's director, Mr Stevens. After BWM was placed into receivership by a family trust associated with Mr Stevens, there was a shortfall in recovery and the Co-Operative sought summary judgment against Mr Stevens in the amount of $200,000.

In denying the Co-Operative summary judgment, the Court found the receivers had sold the assets of BWM together (to the Co-Operative) when there was evidence that selling the assets individually may have resulted in there being no shortfall. That conduct was an arguable breach of their duties under s 19 of the Receiverships Act 1993 and under the apparent influence of the Co-Operative. In the Court's view, the receivers had also arguably breached their duties by failing to spend a modest sum to ascertain the value of the assets if sold individually. In light of evidence of the Co-Operative's connivance with the receiver's breach, the Court found Mr Stevens had an arguable defence to its claim.

See Court decision here.

Mortgagee acted properly in proceeding with forced sale

The High Court recently considered an application for an urgent interim injunction to restrain a mortgagee sale. The hearing was held on the eve of the mortgagee auction. The applicant was second mortgagee of the secured property and sought an injunction on grounds that a valid PLA notice had not been served, that the marketing campaign was inadequate to satisfy the first mortgagee's duty to exercise reasonable care to obtain the best price and that the first mortgagee was not acting in good faith.

The Court had no difficulty in dismissing the application on all grounds. Although some time had lapsed since the PLA notice was issued, there was no evidence that the first mortgagee had waived its entitlement to rely on the notice and the default had not been remedied. As to the marketing campaign, the Court was satisfied that the first mortgagee was acting reasonably in all the circumstances and the allegations to the contrary were unsupported by any compelling evidence. On the final point, the evidence clearly showed that the first mortgagee was acting primarily for the purpose of recovering its long-standing debt. The Court also held that the balance of convenience weighed heavily in favour of the first mortgagee.

The auction proceeded the following day.

The full judgment is available here.

Backward tracing the misuse of company funds

In *Intext Coatings Ltd (In Liquidation) v Deo*, the High Court was again asked to consider the limits of the equitable remedy of tracing (previously considered here). In particular, the Court was asked to consider the circumstances in which 'backward tracing' (the tracing of trust funds used to repay a debt into the asset over which that debt arose) is available.

In this instance, the director of the liquidated company had used company funds to repay the mortgage over her home.

The Court held that, while backward tracing was available in some circumstances, there needs to be a close causal and transactional relationship between the incurring of the debt and the use of trust funds to discharge the debt. In the circumstances before it, the Court was satisfied that there was not a sufficient link. Ultimately, the Court found instead that

the liquidated company was entitled to be subrogated into the shoes of the mortgagee for the amount of company funds used to repay the loan.

It should be noted that the conclusion in respect of backward tracing is at odds with several previous High Court decisions and further clarity may arise from a decision from the appellate courts.

See Court decision here.

Director to pay compensation for 'head in the sand' approach

In *Kiwi Best Realty Ltd (In Liquidation) v Kashkari*, the sole director of a failed real estate business was ordered to pay compensation for breaching his duties under ss 131, 135 and 136 of the Companies Act 1993.

Kiwi Best Realty was liquidated in September 2014, with over $600,000 owing to the IRD. The High Court noted that the company had been balance-sheet insolvent from year end 2012.

Mr Kashkari defended his failure to address the debt, explaining he had decided to prioritise trade creditors to keep the company running, and therefore give the real estate market time to improve in the wake of the GFC. The Court was not satisfied with this 'head in the sand' approach, calling his priority decision and his failure to file returns for an extended period a serious error of judgement.

In assessing the quantum of compensation payable by Mr Kashkari, the Court noted his behaviour went well beyond blind faith or muddle-headedness, and the default period was lengthy. On the other hand, the fact that the IRD had inexplicably delayed the liquidation petition for so long despite the company's serial failure to provide returns justified a 25% reduction in the compensation. Mr Kashkari was ordered to pay the total debt owed to IRD less 25%.

See Court decision here.

Applications to remove liquidators - the rights of other creditors

In *Palmerston North City Council v Farm Holdings* (4) Ltd (In Liquidation), liquidators were appointed to Farm Holdings by a creditor. Two District Councils applied to review the appointment of the liquidators. The appointing creditor sought to become a party to their application. The two District Councils opposed the appointing creditor becoming a party.

The High Court found that the fact the appointing creditor had voted to retain the current liquidators in a previous (unsuccessful) attempt to remove the liquidators at a creditors' meeting did not grant the creditor the right to be heard on the Councils' application. The Court said that, while the views of other creditors were a consideration in applications to remove liquidators, they were not sufficient (on their own) to require the other creditors to become parties to such applications.

See Court decision here.

Loans to wife for husband's purposes not subject to the CCCFA

Mr Maharaj owned a building company. Ms Nandani, his wife, owns a residential property. Mr Maharaj needed funding, which he could not obtain. However, the necessary funds were loaned to Ms Nandani and secured over her property. Ms Nandani subsequently contended that:

- The loans were taken under undue influence
- The loans were unconscionable
- The loans were oppressive (per Part 5 of the Consumer Credit Contracts and Consumer Finance Act 2003 (CCCFA).

Ms Nandani's claim failed on the first and third issue. In particular, the circumstances were such that the loan was not a consumer credit contract under the CCCFA.

However, Ms Nandani succeeded in part on the second issue. The initial loans themselves did not amount to an unconscionable bargain, but allowing the loans to roll over several times when it was clear that the couple could not service the loans, did amount to unconscionable conduct. In particular, the initial loan of $90,000 had become a $648,787 debt.

See Court decision here.

High Court stays liquidation proceedings permanently

Jellie v Tannenberg Limited concerned an application by the defendant, Tannenberg, to stay liquidation proceedings against it. Tannenberg claimed not to have been served with a copy of the statutory demand or liquidation proceedings. Instead, Tannenberg alleged that it first heard of the liquidation proceedings when they were advertised in the New Zealand Herald. In addition to the issue in respect of service, Tannenberg disputed the underlying debt on which the statutory demand was based.

Fitzgerald J considered that it was within the Court's jurisdiction to stay the proceedings permanently and that it was appropriate for the Court to do so in the circumstances. Her Honour considered that it would be "unfair", given the service issues and the substantial and genuine dispute as to the underlying debt, for the issue regarding the debt to be "resolved with the spectre of liquidation proceedings hanging over the company."

See Court decision here.

Second personal costs award against liquidator

Liquidator Mark Norrie has been hit with a second order to pay costs this year in relation to liquidation proceedings. In *Norrie v Time3 Global Ltd*, the High Court addressed the issue of costs resulting from a quashed order to set aside a transaction made pursuant to s 295 of the Companies Act 1993.

Although costs will not normally be awarded against a liquidator personally when he or she brings a claim in the name of the company, Mr Norrie had brought the proceeding in his own name, exposing himself to an award of costs personally. Time3 Global Ltd was the successful party and a costs award was made against Mr Norrie personally.

Earlier this year, Mr Norrie was ordered to pay costs for issuing a statutory demand on Waiwera Water Ltd with full knowledge that the debt was genuinely disputed. We reported on that judgment in our June 2016 Update.

See Court decision here.

Liquidators not entitled to recover the costs of rectifying their own mistake

Re Finnigan concerned the costs of a successful application to be appointed as liquidators after the liquidators had overlooked a disqualification.

The liquidators were appointed by shareholder resolution. They accepted the appointment, apparently unaware that they were disqualified under s 280(1)(ca) of the Companies Act 1993. The liquidators sought to claim, as expenses in the liquidation, their solicitor/client costs of subsequently applying for the Court's leave to be appointed. A preferential creditor who had withdrawn its liquidation application following the shareholder resolution, and whose claim ranked after liquidation expenses, opposed the application for costs.

The High Court declined to allow the liquidators to recover the costs of rectifying their mistake. It noted that the ruling provided "a stern test" for liquidators accepting an appointment at the request of the company. That test is appropriate, particularly when the liquidators had a continuing business relationship with the company within two years of liquidation and when the company was at that time subject to a creditor's application for liquidation.

See Court decision here.

No conflict of interest for special purpose liquidators despite involvement in contractual compliance audit

In *State of Victoria v Goulburn Administration Services (In Liquidation) & Ors* [2016] VSC 654, the Victoria Supreme Court appointed two partners of Ernst & Young (EY) as special purpose liquidators (SPLs) of two companies, despite EY's involvement in carrying out contractual compliance audits before those companies went into liquidation.

The Court held that the proposed SPLs were not disqualified from appointment as 'auditors' under s 532(2)(c)(iii) of the Corporations Act 2001. They had not been personally involved in the contractual compliance audits carried out by EY. In any event, the disqualification for auditors related to financial auditors appointed by the company. There were good reasons why the partners should be appointed, and the Court retained overall supervisory control should any conflict arise.

'Auditors' are also disqualified in New Zealand under s 280(1)(c) of Companies Act 1993.

See Court decision here.

Funding a liquidator's investigations into the affairs of a corporate trustee

In *Re PrimeSpace Property Investment Limited (In Liquidation)* [2016] NSWSC 1450 the Supreme Court of New South Wales was asked to consider whether it could make directions in respect of the investigation of the affairs of a corporate trustee (whose only assets were held on trust). The company, as trustee, had guaranteed a loan from a third party and also granted that third party first option on several apartments. Subsequent to the liquidation of the corporate trustee, the third party sought to exercise its option on the apartments and brought proceedings against the corporate trustee.

The liquidators sought directions under s 511 of the Corporations Act 2001(Cth) to the effect that it could use trust resources (among other things) to conduct examinations and obtain a legal opinion regarding the transactions underlying the claim brought against the trustee company. The liquidators sought directions so they would be better placed to assess whether the claim should be defended.

The Court found that it could make directions, as whether or not to pursue the investigation with trust funds was an issue of propriety and reasonableness (as opposed to a mere commercial decision). In granting the orders sought, the Court found further that the transactions at issue raised questions that the liquidators could properly consider warranted further inquiry.

See Court decision here.

Deep divisions over assets held in Purpletuity

Deep Purple was, and still is, a rock music band. Its members included Mr Gillan, Mr Glover and Mr Paice. In 2005, band members entered into an agreement with HEC Enterprises Limited (HEC) and Deep Purple (Overseas) Limited (DPO). Under that agreement, the parties agreed to form a new company named Purpletuity, to which various copyrights and other assets were to be transferred. In 2015, Mr Gillan, Mr Glover and Mr Paice commenced proceedings against HEC and DPO to enforce that agreement.

In 2016, HEC and DPO went into administration. Mr Gillan, Mr Glover and Mr Paice subsequently applied to continue the proceedings against HEC and DPO. In *Gillan v HEC Enterprises Ltd*, the Court held that Mr Gillan, Mr Glover and Mr Paice could continue the proceedings. The Court also considered the application of the Berkeley Applegate principle. The Berkeley Applegate principle provides that administrators will be entitled to the expenses of investigating and taking appropriate advice in respect of trust claims. However, the court held that the administrators were not entitled to any indemnity from the companies' trust assets to cover their remuneration, costs and expenses in these circumstances.

The Court distinguished the case from Berkeley Applegate primarily because much of the work done by the administrators was for the benefit of unsecured creditors of the companies, rather than the trust beneficiaries. The Court also considered that the administrators had wasted considerable time and expense opposing the application to continue the proceedings and that those costs would be covered by litigation cost principles, rather than the Berkeley Applegate principle. As such, the Court saw no reason for the trust assets to be used to indemnify the administrators.

See Court decision here.

Director's entitlement to receiver's books justified

In *Navarac v Pty Ltd v Carrello* [2016] WASC 327, the court-appointed receiver and manager of Esperance Cattle Company Pty Ltd had applied for orders from the court to conclude the receivership.

In order to prepare evidence and submissions to oppose the receiver's application, a director of the company applied to inspect certain documents, which she asserted were or might be held by the receiver.

A key issue was whether and to what extent the appointment of a receiver affects a director's exercise of the right to inspect the books, financial records and documents of a company under the Corporations Act 2001 (Cth) (Act) and at common law. The court held that the director had rights to inspect the books and financial records of the company under sections 198F, 290 and 421 of the Act (similar to New Zealand's Companies Act 1993, s 191) and at common law (For NZ see *Berlei Hestia (NZ) Ltd v Fernyhough* [1980] 2 NZLR 150).

The court noted that the common law right of inspection draws a distinction between documents in the possession of the company (including documents created or received by the receivers as agents of the company) and documents prepared by

the receiver for his own benefit or protection and which are held by him in that capacity.

See Court decision here.

Beware the costs of preparatory compliance with liquidators' disclosure orders

The liquidators of two Cayman Island companies obtained orders under s 195(3) of the Bermudan Companies Act 1981 for PwC, as the companies' auditor, to provide information and documents to the liquidators. PwC decided to appeal but, in the meantime, did US$250,000 of preparatory work necessary to enable compliance, if required, with the orders.

As a result of the appeal, both orders were set aside. In *PricewaterhouseCoopers v SAAD Investments Co Ltd & Anor (Bermuda)* PwC applied to recover from the liquidators the costs of preparing to comply with the orders.

The Privy Council dismissed PwC's claim. The Privy Council considered that PwC should have applied for an extension of time to comply with the order or for a stay of execution pending appeal. An extension or stay would have been granted unless the liquidators had then undertaken to cover costs incurred if the orders were set aside on appeal. The Privy Council also considered that there was no practice or obligation on the liquidators, legally or morally, to pay the costs of compliance.

In New Zealand, under s 261 of the Companies Act 1993, there is an entitlement to recover some costs, but no right to refuse to comply with an order to produce documents on the basis that the costs of compliance have not been met.

See Board advice here.

Insolvency, marshalling, subrogation and a dog

In *Mclean v Trustees of the Bankruptcy Estate of Dent* [2016] EWHC 2650, the High Court considered the application of the equitable doctrines of marshalling and subrogation in relation to a fixed charge over (among other things) a dog.

A company and partnership borrowed funds from two sources – Barclays Bank and Lady Morrison. Barclays held, among other things, charges over farms owned by individual partners and an agricultural charge under the Agricultural Credits Act 1928 (UK), including a charge over a dog. Lady Morrison only held charges over the farms.

The company and partnership entered administration and bankruptcy orders were made against individual partners. Barclays had multiple sources from which to recover its debt but only sold the farms. The proceeds covered Barclays' full debt and the majority of that owed to Lady Morrison.

The Court held that Lady Morrison could use the equitable doctrine of marshalling to access funds through the agricultural charge, effectively claiming the surplus proceeds available to Barclays. It did not matter that, as an individual, Lady Morrison could not create an agricultural charge; the security was capable of assignment and therefore capable of being marshalled.

The Court noted that a contract between creditors may affect the application of the doctrine. Here the deed of priority between Barclays and Lady Morrison promoted rather than excluded the possibility of marshalling.

A second issue considered by the Court was whether the trustees in bankruptcy of the partners were entitled to claim in the administration of the partnership by operation of the doctrine of subrogation. The trustees claimed that the creditors of the partnership were unjustly enriched at the expense of the creditors of the partners when the farms owned by the partners were sold to satisfy the claims of the creditors of the partnership. The Court rejected the trustees' claim and held that the trustees in bankruptcy were not entitled to prove in the administration of the partnership.

The judgment does not record the fate of the dog.

See Court decision here.

Complex logistics - the Court's power to amend a creditor's petition

In *Re Hin-Pro International Logistics Ltd* the Hong Kong Court of Appeal had to consider whether it had jurisdiction to grant leave to amend a creditor's petition, and if so, whether it should do so.

In the first instance, the Court had allowed the creditor's winding-up petition to include debts that had accrued after the petition's presentation. On appeal, the Court of Appeal considered the continued applicability of the rule in *Eshelby v Federated European Bank Ltd.* The Eshelby rule provides that "...without the consent of the parties, the Court [cannot] amend a writ as completely to change the cause of action so as to bring in a cause of action that was not existent at the

time the writ was originally used".

The Court of Appeal dismissed the appeal and held that post-petition debts can be introduced in a winding-up petition, the only question being whether the court should introduce such debts. The Court of Appeal highlighted that "the rule in Eshelby is a rule of practice rather than a rule of law. It can be departed from whenever the justice of the case requires".

In New Zealand, leave is also required to amend a statement of claim to put a company into liquidation and leave has previously been refused when the application to correct the amount claimed was made at a late stage (see *Rudd Watts & Stone v Rustauk Forty Ltd* (1992) 6 PRNZ 650).

See Court decision here.

The dangers of playing fast and loose when trading carbon credits, rare earth metals and coloured diamonds

The English High Court in *Re Caledonian Ltd* considered whether the business practices of two companies justified the winding up of these companies on a just and equitable basis.

Caledonian Ltd and Caledonian Commodities Ltd (Companies) in concert marketed and sold (among other products) carbon credits, rare earth metals and coloured diamonds (Products) to individual investors.

The Secretary of State for Business, Innovation and Skills brought a petition for the winding-up of the Companies on the grounds of public interest, including that the Companies had overpromised, used marketing material that was misleading and charged inflated commissions on their products (such as mark-ups of 170%-345%). In determining whether it was just and equitable to wind up the Companies, the Court noted that:

- The Companies had been conducted in a way which did not meet accepted minimum standards of commercial behaviour
- The Companies' failings were serious and the sums involved were significant for many of the individual investors.

The Court made an order winding up the Companies.

While there is no express power for the Court here to liquidate a company on public interest grounds, liquidation orders would be made in similar circumstances in New Zealand on the 'just and equitable' ground.

See Court decision here.

Nortel Developments

The latest development in what has been a long-running (and expensive) cross-border insolvency proceeding involving Nortel (see our June 2015 and September 2015 legal updates for previous instalments) is a settlement between:

- 19 European, Middle Eastern and African (EMEA) companies in the Nortel Group and other entities in the Nortel group
- The EMEA companies and certain UK pension schemes and regulators
- The EMEA companies themselves.

The settlement agreement required the administrator of the EMEA companies, and the conflict administrator for one EMEA company, to obtain court approval to implement the settlement. The High Court approved the implementation of the settlement for various reasons, including the certainty and finality it provided creditors of the entities. Following the Court's approval, the settlement now needs to be approved by creditors and the courts in Canada and the USA.

See Court decision here

The effect of an arbitration agreement on liquidation proceedings

The New Zealand and UK Arbitration Acts generally require court proceedings to be stayed if the parties have agreed to resolve disputes through arbitration.

In a recent address to the Insolvency Lawyers Association, the new Chancellor of the High Court, Sir Geoffrey Vos, discussed briefly the effect of that statutory stay upon winding-up petitions.

In *Salford Estates (No 2) Ltd v Altomart Ltd (No 2)* [2014] EWCA Civ 1575, with which Vos J agreed, the English Court of Appeal concluded that the mandatory stay when there is an agreement to arbitrate does not apply to winding-up petitions. However, the Court considered that (except in exceptional circumstances) when there is a dispute in relation to the existence of a particular debt, the Court should exercise its discretion to stay the winding-up application and compel the parties to resolve the dispute through arbitration.

Read the presentation here.

Proposal to harmonise business insolvency in Europe

On 22 November 2016, The European Commission announced a proposal for a new, more consistent approach to business insolvency across the member states of the EU. It is hoped that the proposed directive will create greater efficiencies in the insolvency process, enhance financial stability and provide greater certainty to investors and companies operating across the EU.

One of the key changes under the proposed directive will be to harmonise the second-chance provisions across the EU by allowing a full discharge from insolvency after a period of three years. Currently, discharge periods in member states range from 1 to 10 years and in some states there is no possibility of discharge whatsoever. Another important change contained in the proposal is the introduction of a framework for restructuring a business' affairs prior to insolvency (4 member states do not provide a defined restructuring period prior to insolvency). Other significant features of the proposal include:

- Access to tools that will enable businesses to better detect a deteriorating financial situation
- A set of common principles across member states to allow flexible restructuring at an early stage
- A four-month non-enforcement period during restructuring to allow negotiations with a view to achieving a successful restructure
- Rules preventing minority creditors from blocking restructuring plans
- Protections for financing of restructured business
- Protection of workers' rights during the restructuring process.

While these proposed rules will apply to business insolvencies (whether through a company or otherwise), the Council also recommends that member states extend the provisions to individual consumer insolvencies as well.

See the Commission's press release here

King & Wood Mallesons' European arm in financial trouble and Croatian woman in Krapina

Joining a number of UK legal service providers experiencing financial difficulties, it has recently been reported that partners of King & Wood Mallesons (KWM) (formerly SJBerwin) in Europe have been told that due (in part) to £35m worth of debt and 54 partner departures over the past year, the firm is unlikely to be able to trade its way out of its debts. With no viable rescue plan available, KWM Europe is no doubt hoping that a merger will happen soon, as its bank took additional security in early December and staff were then reportedly informed that salaries could not be guaranteed past January 2017.

KWM joins 'new breed' personal injury law firm Prolegal Limited (which entered into administration in September), online legal business Rocket Lawyer (recently reported to have liabilities of £3.1m against assets worth £180,000), legal business consultancy service Assure Law Limited (which commenced the liquidation process in late October) and one of the leading costs specialist firms, Just Costs Limited (which in November entered into a Company Voluntary Agreement with its creditors to whom it owed £829,000) as a legal services firm currently experiencing financial difficulties in the UK. And listed legal services business Fairpoint PLC, which bought two national law firms in recent years, has suspended dividends on the back of 2016 results that are 'materially below market expectations'. Its share price value fell 16% in two hours after the announcement.

Staying in the European Union (unlike the UK), a 'former businesswoman' from the town of Krapina recently became the first person in Croatia to declare personal bankruptcy. The Croatian Court found the woman's income of HK$1,400 (approximately NZ$280) was not enough to pay her creditors, to whom she owed HK$1.4m (approximately NZ$280,000). There are reportedly 300,000 Croatians with frozen bank accounts and 600 Croatians together owing HK$300m (approximately NZ$60m) facing bankruptcy proceedings.

See relevant articles here, here, here ,here ,here, here, here, here and here.

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