BUDDLE FINDLAY

Legal update on insolvency law – December 2018

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High Court orders the liquidation of CBL Insurance

The High Court considered for the first time an application by Reserve Bank of New Zealand (the Bank) in its capacity as regulator under the Insurance (Prudential Supervision) Act 2010 for the liquidation of an insurer, CBL Insurance Limited (CBLI) (in liquidation). It followed the orders made on 23 February 2018 in which CBLI was placed into interim liquidation (reported on in our earlier insolvency update).

CBLI is a subsidiary of LBC Holdings New Zealand, which in turn is owned by CBL Corporation, a company which is dual listed on the NZX and ASX. CBLI is the group's largest operating entity, and provided insurance to a small number of New Zealand policyholders, as well as insurance and reinsurance to companies in a variety of jurisdictions worldwide with a particular focus on builders' warranty insurance in France. CBLI had experienced a period of rapid expansion between 2011 and 2017, leading to concerns on the part of the Bank and offshore regulators about the adequacy of its reserves. Investigations by the Bank revealed further concerns, prompting its application for liquidation.

The liquidation application proceeded unopposed, after all opposition parties withdrew their opposition in the days leading up to the liquidation hearing.

The Court found that there had been a serious failure to comply with the required solvency margin under the Act. The failure to comply with the solvency margin alone was sufficiently serious to justify liquidation. The Court also found there to have been a serious failure by CBLI to comply with the Bank's directions not to pay monies away to a Danish reinsurance company.

The Court further found that it was just and equitable to order liquidation. In considering what was just and equitable in the circumstances, the Court determined that it was appropriate to take into account the company's balance sheet position and any evidence of a lack of probity. The Court determined that there was a significant deficit in CBLI's asset position, which was 'a matter of serious concern' justifying liquidation. The conduct of the directors, on which the Bank also relied, was also material, with the Court finding that there "had been aspects of CBLI's management that indicated a lack of commercial probity". The Company was placed into liquidation, with Kare Johnstone and Andrew Grenfell of McGrath Nicol appointed as liquidators.

Scott Barker and Bridie McKinnon of Buddle Findlay acted for the Reserve Bank.

See the decision here.

Scope of powers of interim liquidators considered by the High Court

In another decision concerning the collapse of CBL Insurance, the High Court was asked to consider whether the powers of interim liquidators extended to allowing the interim liquidators to enter into a commutation agreement with the company's largest creditor; a ceding insurer.

In *Re CBL Insurance Ltd (in liquidation)* [2018] NZHC 2547, the interim liquidations applied for directions under section 284 Companies Act that they had the power to enter into the commutation transaction. The effect of the transaction would be to extinguish CBLI's liabilities to Elite in return for a mixture of cash and non-cash assets.

The Court considered whether the direction sought was within the scope of section 284, finding that it was, even though it was declaratory in nature. However, when the Court considered the specific transaction in contemplation, Courtney J determined it to be outside of the powers of an interim liquidator, whose role was to maintain the value of assets. Interim liquidators could only exercise their powers to that end. The transaction in question has the effect of crystallising and eliminating CBLI's net liability to one of its creditors in circumstances that involved the divestment of CBLI's assets in doing so.

The decision can be found here.

Subcontractors' entitlement to retentions held by insolvent head contractor

Under the Construction Contracts Act 2002, Ebert Construction Limited was required to hold on trust for its subcontractors any retentions to secure their performance.

Ebert's receivers successfully applied to be appointed receivers of the account in which the retentions were held (Retention Account). Churchman J then considered which subcontractors were entitled to the funds in the Retention Account.

The Act required head contractors to hold retentions on trust, but didn't create deemed trusts. Accordingly, Churchman J applied the standard test for the creation of a trust and looked for the three certainties: certainty as to the intention to create a trust, its subject matter and its beneficiaries.

Some retentions had been calculated but not transferred to the Retention Account. Others had not even been calculated. Churchman J held that there was no certainty of intention and no trust existed in respect of these types of retentions.

Other retentions had been transferred into the Retention Account. Of those funds, some had been marked for release to subcontractors but not paid. These categories of funds were held on trust for the subcontractors.

Churchman J ordered that the applicants could make payments to subcontractors entitled to a share in the Retention Account on a *pari passu* basis.

The decision can be found here.

Keeping up with the Joneses - voiding third party transactions

In our September 2017 update, we summarised the High Court's decision to find that payments to Robt. Jones Holdings (RJH) by entities related to Northern Crest Investment Limited (In Liquidation) (NCI) had been made by NCI and were, accordingly, voidable preferences. RJH appealed that decision to the Court of Appeal.

In dismissing the appeal, the Court of Appeal found that the High Court was correct to find that the licencing agreements between NCI and the related entities were not shams, and it had not erred in finding that the payments had not, in substance, been made by NCI.

The Court affirmed its previous decision in *Levin v Market Square Trust* and firmly rejected RJH's argument that, to meet the definition of an insolvent transaction, a transaction must have the ultimate effect of diminishing the pool of assets available to creditors – all that need be shown is that the creditor received more than it would have received in the liquidation.

The Court also held that there was nothing objectionable about the liquidators pursuing recovery even if part of the purpose was to recover their fees in the liquidation.

The Supreme Court has granted leave to Robt. Jones Holdings to appeal on the question of whether the payments made to Robt. Jones Holdings by MSH on behalf of NCI were insolvent transactions as defined in s292 Companies Act.

The Court of Appeal decision can be found here.

Moratorium on creditors' claims in administration permissible under Deed of Company Arrangement

In *Mighty River International Limited v Hughes* [2018] HCA 38, the High Court of Australia upheld the validity of a deed of company arrangement, which sought to place a moratorium on creditor's claims, and to give administrators a longer period of time to investigate the company's affairs.

The applicant creditors, who were seeking to have the deed declared void, argued that the deed:

- Was inconsistent with the object of part 5.3A of the Act
- Sought to avoid the statutory requirement that the court approve an extension to the convening period (s 439A(6))
- Had not specified any property to be available to pay to the creditors (s 444(A)(3)).

These submissions were rejected by the Court:

- It was a valid purpose of the deed to seek to maximise the chance of the company's survival and to suspend creditors' claims pending a clearer assessment of the company's financial position. These purposes were not undermined by the creditors deciding to enter into a longer moratorium than what they otherwise might have made outside of administration

- The extension to the convening period was only incidental to the granting of more substantial rights under the deed, which was permissible under s 439(A)(6))
- It was not a requirement under s 444(A)(3) for a deed to specify 'some' property to be payable to creditors. There are numerous examples where no property will be payable to creditors, and this will not be grounds for a deed to be declared void.

New Zealand's voluntary administration regime is modelled on the Australian regime. As such, this decision should be of interest to New Zealand practitioners.

See the Court's decision here.

Court of Appeal of Western Australia allays concerns arising from Hamersley decision

The Western Australian Court of Appeal has recently released a decision overruling a decision from the Supreme Court that had caused widespread unrest in insolvency circles. The first instance judge in *Hamersley Iron Pty Ltd v Forge Group Power Pty Ltd (in liquidation)* had ruled that insolvency set-off was not available when the debts of the company in liquidation were subject to a security interest in favour of a third party. The Court reasoned that no mutuality of interest exists in those circumstances. The decision had the potential to significantly limit the operation of set-off in liquidation proceedings because a high proportion of companies grant third party security interests over their personal property, including accounts receivable.

The first instance decision was recently overturned on appeal. The Court of Appeal found that:

- The concept of mutuality applies under s 553C of the Corporations Act (equivalent to section 310 of the Companies Act 1993) because the companies retained the right to use amounts under the contracts for their own benefit, despite any existing security interests
- Set-off is not confined to unsecured debts. The position of the secured party under the relevant financing documents must be considered in the context of the PPSA
- Section 553C can operate concurrently with the PPSA. The PPSA priority rule under s 102 is not excluded from the liquidation context as the set-off provisions under the Companies Act do not operate as a code.

The decision can be found here.

What better a creditor than Her Majesty's Revenue & Customs?

On 29 October 2018 Chancellor of the Exchequer Phillip Hammond, the UK's equivalent of a Minister of Finance, released his Autumn Budget. One of the leaves to fall from Hammond's Budget was a change to Her Majesty's Revenue and Customs' status as a creditor in insolvencies, returning the HMRC to the preferential creditor status it enjoyed prior to the introduction of the Enterprise Act 2002.

Following the change, HMRC will be a preferential creditor in respect of tax collected and held by businesses on behalf of other taxpayers (Value Added Tax, PAYE income tax, employee National Insurance Contributions and Construction Industry Scheme deductions). Its status will remain unchanged in respect of taxes owed by businesses themselves, such as corporation tax and employer National Insurance Contributions.

The effect of the change in terms of the priority that will now be given to repaying a tax debt owed to HMRC when a company's assets are liquidated and distributed to creditors is to shift HMRC in front of unsecured creditors. It will, however, remain behind other preferential creditors, including financial institutions. Commentary from industry experts thus far has focused on the potential for the changes to disadvantage trade creditors and employees, who may now receive significantly less from a trading partner or employer when it goes into liquidation.

Previous engagement of administrators does not amount to a conflict of interest

Two recent UK decisions have determined challenges to administrators' independence and found in favour of the office-holders. *Zinc Hotels (Investment) Ltd v Beveridge* considered whether previous engagements of a company administrator constituted a conflict of interest. In that case, the insolvency practitioners, who were engaged by the lenders to undertake a contingency plan, were later appointed as administrators. The shareholders of the company alleged that the administrators were not sufficiently independent due to their past engagement with the secured creditors.

The Court confirmed that a prior relationship between an administrator and creditor does not bar the administrator from taking up appointment. It reasoned that any administrator involved in a complex insolvency will usually have been involved at the

preparatory stage prior to becoming appointed, whether engaged by a creditor, director, or regulator. The Court held that there was no conflict of interest in this circumstance, as the administrators' prior engagement was not unusual, and there were no continuing duties owed to the lenders which would conflict with their duties. However, it considered that this kind of pre-engagement was distinguishable from some 'pre-packaged insolvency' cases when the administrator's own alleged misconduct would necessarily need to be investigated, in which case an obvious conflict of interest would arise. The case can be found here.

The *Zinc Hotels* case echoes another recent decision of *Davey v Money,* which held that there is no bar to the appointment of an administrator who is recommended by a secured creditor. The essential question established by the Court was whether the administrator is competent and able to discharge her/his fiduciary duties to the company.

The decision can be found here.

Standing to challenge a liquidator's decision

The Eastern Caribbean Court of Appeal considered whether a shareholder of a company has standing to challenge a decision made by the liquidator of the company's subsidiary.

The liquidators of Chesterfield United Inc (Chesterfield), a subsidiary of Trenvis Limited (Trenvis), entered into a settlement which included the admission of a creditor's claim against Chesterfield's liquidation. Stanford, being the shareholder of Trenvis filed an application under section 273 of the Insolvency Act 2003 (the Act) to reverse the liquidators' decision by arguing that he had a legitimate interest in the liquidation and was aggrieved by that decision.

In order to challenge a liquidator's decision, the applicant needs to be a contributory, a creditor or a person affected by the liquidator's exercise of power. The Court found that Stanford, being a 'shareholder of a shareholder of Chesterfield' did not have legitimate interest in the liquidation and as such, the Court was unable to exercise its statutory power to reverse or modify the liquidators' decision.

The Court also clarified that the test for setting aside a liquidator's or office holder's exercise of power under the Act is that of perversity. Accordingly, a court will only interfere if a liquidator has done something so perverse and manifestly absurd that no reasonable person would have done. The Court found that the liquidators' decision was the only option available to the liquidators in the circumstances.

The decision can be found here.

Abuse of corporate personality results in personal liability for inducing a breach of contract

The High Court of England and Wales has found the director and shadow director of a failed limited liability company liable in tort for inducing breach of contract and unlawful means conspiracy. The company, HHL, had contracted with PB for refurbishment works at a manor house. HHL became unable to pay PB's invoices. When money did become available, the shadow director set it aside for HHL's successor company, CSEL (which PB's shadow director also directed). HHL then advised PB that their contract would be terminated and invoices would not be paid, because HHL was to be put into liquidation. PB brought claims in tort against the director and shadow director of HHL personally. The Court found that by the shadow director ensuring HHL was put into liquidation that conduct qualified as inducing a breach of contract. The Court also found that the defendants' collusion to have HHL placed into liquidation amounted to an unlawful means conspiracy. The Court rejected the argument that PB were attempting to pierce the corporate veil. Rather, the Court found the defendants' actions were an abuse of HHL's separate corporate personality.

The decision can be found here.

Undischarged creditor claim prevents company's removal from the Register

The High Court recently accepted an application to prevent the Registrar of Companies from removing a company from the Companies Register, on the basis that the sole creditor of the company had claims against the company under section 321(d) of the Companies Act 1993 for pursuing insolvent transactions.

South British Nominees Limited (SBN) (a company controlled by Messrs Peter Harris and Alistair Hutchison, also of CBL Insurance Ltd, referred to above) had funded the activities of CDZNT01 Limited (CDZNT) (previously named The New Zealand Dairy Company) to start a pharmaceutical grade infant formula business. SBN discovered during the construction of the business' plant that progress was slow, creditors were owed over $400,000 and $1.6m had been paid to a related company of the director,

Stephen Owsley. SBN funded creditor claims and applied to place the company into liquidation. SBN then successfully paid all creditors in exchange for an assignment of their debts. The liquidators subsequently sold the assets of the company to SBN, and when completing their final report, they had identified a number of potential insolvent transactions but had no means to fund claims. They therefore applied to remove CDZNT from the Companies Register, to which SBN objected under section 321(d) of the Companies Act 1993.

The court ordered that the company should not be removed from the Companies Register on the basis that SBN, based on its evidence provided, had an undischarged claim against the company.

Stephen Owsley had previously worked for his father, Merv's company, IPS, which had become embroiled in litigation over the construction of the NZ Dairies factory at Studholme, South Canterbury, before the latter's receivership in 2012.

The decision can be found here.

Receivers cannot be appointed in bad faith

The Court of Appeal in *Fatupaito v Harris* NZCA 497 considered whether a creditor's appointment of receivers can be invalidated when that appointment was made in bad faith.

The case centred on CIT Holdings Ltd (CIT), in liquidation. CIT's sole director was Mr Gregory Olliver. He was also the sole director of The Bankhouse Trust Ltd, CIT's second-ranking secured creditor. Following various unsuccessful attempts to purchase CIT's properties through the liquidators, Mr Olliver appointed receivers who arranged a conditional sale to GMO Trust Ltd (GMO), of which he was also sole director.

One condition allowed GMO to inherit CIT's debtors, including Mr Olliver's ex-wife Ms Sarah Sparks, with whom he was in an acrimonious relationship property dispute. The conditions on sale were not met, and the receivers retired.

Following assessment of case law in the area, the Court found that the power to appoint a receiver may not be exercised in bad faith (this also finds support in s 25 of the Personal Property Securities Act 1999). Bad faith exists in circumstances where a creditor acts for "a predominant purpose which is collateral to… its interests as a [creditor]".

The predominant purpose for Mr Olliver's appointment of receivers was found to be to advance his personal dispute with his ex-wife. No commercial reason justified the acquisition of CIT's debtors, and it would not have occurred but for him specifically seeking it out. While collateral benefits beyond debt recovery are acceptable when they flow on from a conventional receivership, they cannot be the driving force behind an appointment.

Find the judgment here.

Joint owners of debt must present bankruptcy petition together to succeed

Another hearing has reached an inconclusive result in the ongoing petition for the bankrupting of Mr Glenn Maud has taken place in the English High Court *AABAR Block S.A.R.L v Maud* [2018] EWHC 1414.

Mr Maud is a shareholder and co-director of Ramblas, a company owning significant assets in Madrid. He was previously indebted to Royal Bank of Scotland, whose rights to recover were purchased by Aabar Block S.a.r.l and Edgeworth Capital S.a.r.l. Aabar and Edgeworth originally applied to bankrupt Mr Maud in 2015, and this case is a continuation of that proceeding.

Mr Maud argued that the bankruptcy petition was an abuse of process, in that it was concerned with accessing the assets of Ramblas instead of recovering his debts. Assessing the evidence, Snowden J considered there was not a sufficient factual basis to support this argument.

Following the 2015 application, Aabar and Edgeworth's relationship broke down, and Aabar no longer sought an immediate declaration of bankruptcy. Instead, it preferred to delay the bankruptcy, to ensure Mr Maud could extract the most value possible from his position in Ramblas. As no authority existed on situations where joint owners of debt were not in alignment, Snowden J relied on the equitable principle that trustees must exercise powers unanimously, provided neither are acting in bad faith. Applying this principle, Edgeworth and Aabar could not take action to petition for Mr Mau'd bankruptcy unless they took that action jointly.

Finally, Snowden J considered whether there was a class interest in making a bankruptcy order. As various other creditors had opposed the order, and because there was a possible benefit in delaying bankruptcy (as compared to no benefit in ordering it immediately), no order was made. At present, the bankruptcy petition is still pending.

Find the judgment here.

Another fraudster liquidator

On 30 October 2018, Geoffrey Martin Smith appeared in the Auckland High Court facing charges brought by the Serious Fraud Office (SFO). The SFO alleges that Mr Smith stole $270,000 from two companies to which he had been appointed liquidator.

Mr Smith is no stranger to breaking the law. In 2008, he was convicted on 94 charges of tax evasion, and in 2000 he was jailed for nine months on theft and fraud charges. Mr Smith has also been a bankrupt three times according to the Insolvency Register.

As reported in our December 2016 update, this is not an isolated case of a fraudster being appointed as liquidator. Regulation of who can become liquidators is clearly still needed and well overdue. The status of the Insolvency Practitioners Bill currently being considered by Parliament can be tracked here.

The relevant articles can be found here, here and here.

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