BUDDLEFINDLAY

Legal update on insolvency law - March 2014

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Related company sheepish following liability for conversion

A bank lent Te Rimu Station Limited (TRU) $2,275,000 under a term loan. Security for the loan included a general security agreement (GSA). Shortly before the term loan expired, Shaun Currie, a director of TRU, arranged for 2,351 sheep to be transported from TRU to Waewaepa Station 2002 Limited (WSL). Mr Currie was also a director of WSL, and TRU was a 50% shareholder in WSL.

WSL did not pay TRU for the sheep and claimed that it was entitled to set off the purchase price for the sheep against advances it had previously made to TRU to fund its operations. The bank claimed that these sheep formed part of the collateral under the GSA.

The Court accepted that the bank had the right to possession of the sheep because TRU had allowed the sheep to be removed without the bank's consent. As a result, WSL's refusal to comply with the bank's demands for return of the sheep constituted an act of conversion. This was further supported by WSL's failure to keep the sheep it received from TRU separate from its own livestock.

WSL's had argued that the sale of the sheep was in the ordinary course of TRU's business (being a defence under section 53 of the Personal Property Securities Act 1999). However, the Court identified a number of factors that established that this sale was not in the ordinary course of TRU's business. The factors included that: TRU was in serious financial difficulties; it was a related-parties transaction; Shaun Currie had full appreciation of the situation and his knowledge could be attributed to WSL; and the effect of the transaction was to enable WSL to receive more in reduction of the debt that TRU owed than it would in liquidation.

See Court decision here.

Restructured debt not due

The New Zealand High Court recently rejected an application by the liquidators of Maclean to set aside certain payments received by the respondent, Westcon, as voidable transactions. The transactions in issue were 53 payments totalling $274,617.49 made by Maclean to Westcon in the two years preceding Maclean's liquidation.

Under section 292 of the Companies Act, the applicant liquidators had the onus of proving that the transactions:

- Were entered into at a time when Mclean was unable to pay its debts
- Enabled Westcon to receive more towards satisfaction of its debt than would likely have been received in Maclean's liquidation.

The liquidators ran into problems proving that Maclean was unable to pay its debts as they became due.

Maclean had been put into liquidation in July 2012. Prior to this, between February and March of 2011, Maclean had entered into debt rescheduling arrangements with its bank, the IRD and its two major suppliers, including Westcon. Westcon argued that these rescheduling agreements formally rescheduled the debts and that Westcon and other creditors were required to abide by the terms of (and await payment under) the agreements. The payments that Maclean made to Westcon during the relevant time met Maclean's obligations, albeit restructured by agreement, as they fell due.

The Court accepted that whether a debt has or has not become due is to be determined by reference to the legal agreement of the parties. In this case, Maclean's rescheduling proposals offered a viable proposition for the purpose of meeting its debt obligations as they fell due. The liquidators' application therefore failed.

See Court decision here.

Arbitration agreement 'trumps' usual winding up procedure

The recent English Companies Court case of *Rusant Ltd v Traxys Far East Ltd* [2013] EWHC 4083 established that, where a winding up petition is based on a disputed debt identified in a statutory demand, and that dispute is the subject of an arbitration agreement, it must be referred to arbitration first. On this basis, the Court granted an injunction preventing the defendants from relying on the statutory demand.

In seeking the injunction the claimant relied upon the arbitration agreement between the parties and section 9(1) of the Arbitration Act 1996, which permits a stay in proceedings where a party to an arbitration agreement faces a claim, or counterclaim, regarding a matter which is subject to arbitration under that agreement (see section 8 of the New Zealand Arbitration Act 1996).

In this case, the Court indicated that it was the existence of the arbitration agreement, and not the strength of the claimant's arguments, that resulted in the injunction being granted. The judge suggested that on his assessment of the claimant's "shadowy defence" in relation to the dispute, he would have allowed the winding up petition to continue.

The process of "winding up" in the Companies Court is akin to that of "liquidation" in the New Zealand High Court. Therefore *Rusant Ltd* can be seen as a helpful warning to those who think they can avoid complying with an agreement to arbitrate by presenting a statutory demand and proceeding with liquidation.

See Court decision here.

Multiple contribution notices - the benefits of a scattergun approach

In December last year, the UK High Court handed down a judgment concerning the liabilities of certain Lehman Brothers entities to pay contributions toward a pension scheme in the context of the UK Pensions Act 1995. Under this Act, where an employer company enters into an insolvency process while there is a deficit in its pension scheme, an amount equal to the employer company's share of that deficit will become a debt due from the employer company to the trustees of the pension scheme, who rank as unsecured creditors of the employee company.

The trustees of the pension scheme issued contribution notices to the Lehman Brothers group. Some notices sought payment of the total shortfall from individual members. The Court determined that, in circumstances where multiple companies within the same group are potential targets for contribution notices issued by the trustees of the UK pension scheme, the aggregate maximum amount which may be specified in the notices or recovered pursuant to them may exceed the total shortfall owing to the pension scheme. The trustee was able to claim the full shortfall from individual group members.

See court decision here.

Bankruptcy annulled but who pays the Official Assignee's costs?

An annulment of a bankruptcy order is often accompanied by an order for payment of the Official Assignee's costs. Although these types of costs are usually paid by the bankrupt, the recent English Court of Appeal decision *Oraki v Dean & Dean* [2013] EWCA Civ 1629 suggests that in some situations it may be more appropriate for the petitioning creditor to pay these costs.

In this decision, Mr and Mrs Oraki (the bankrupts) had successfully applied to have their bankruptcy orders annulled as a result of the petitioning creditor's fraud. Prior to the annulments, the Official Receiver (equivalent to the Official Assignee) and Trustee (a professional insolvency practitioner) had incurred substantial costs in managing the Orakis' bankruptcies. The High Court ordered that these costs be paid by the Orakis to which the Orakis appealed. The Court found (amongst other things) that it had an unfettered discretion in deciding whether to award these costs and deciding who should pay them. In exercising this discretion, the Court noted it could take into account the general entitlement of a trustee to its costs and the ability of the petitioning creditor to pay these costs. On the facts, the Court dismissed the appeal as the trustee was entitled to its costs and the petitioning creditor was unlikely to be able to pay them.

See Court decision here.

Solid Energy - creditor compromises

In *Bank of Tokyo-Mitsubishi UFJ Ltd v Solid Energy New Zealand Limited* [2013] NZHC 3458, Bank of Tokyo (Bank) challenged (unsuccessfully) two compromises (under Part 14 of the Companies Act 1993 (Act)) implemented by Solid Energy.

In finding against the Bank, the Court clarified the law on three areas of the statutory regime:

- Giving notice to "each known creditor"
- The proper scope of a compromise under Part 14 of the Act
- What constitutes an unfairly prejudicial compromise.

The Bank argued that a creditor will be a "known creditor" if any of their economic rights are affected. The Court held that this was too broad and determined that a creditor will be "affected" if their legal rights or economic interests are adversely affected by the proposed compromise. A compromise will only be binding on those creditors to whom notice of the proposal is provided.

The Bank argued that Part 14 compromises were for straight forward arrangements and could not be used to sanction debt for equity swaps and/or complex restructures. It further argued that such arrangements required Court supervision under Part 15. The Court disagreed and held that Parts 14 and 15 of the Act were not intended to operate as "watertight compartments" and that Part 14 compromises can include complex arrangements. Part 15 compromises dealt with compromises that could not be implemented without the Court's assistance.

The Bank made a number of arguments about the compromises being unfairly prejudicial including that some creditors were treated differently in the compromise; some creditors were not part of the compromise and there were hypothetical alternatives that would have resulted in a better financial outcome for the Bank. The Court held the fact that some creditors were not included in the compromise and that some were treated differently did not, in itself, constitute an evidential basis for prejudice. Overall the Court held that its role is not to substitute its views for that of the required majority of creditors, but to ensure there is a proper evidentiary basis for establishing unfair prejudice.

The case is considered a leading authority on Part 14 and 15 compromises and that anyone considering implementing/challenging a compromise should be familiar with the above-mentioned findings.

See Court decision here.

Payment of rent during administration

In *Pillar Denton v Jervis* the UK Court of Appeal considered the issue of the payment of rent in an administration situation. The Court allowed an appeal against two earlier first instances decisions, known as *Goldacre* and *Luminar. Goldacre* had held that where quarterly rent is payable in advance and payment fell due during the period of administration, the whole of the rent will be treated as an expense of the administration and therefore paid in priority to other debts of the company. In *Luminar* the Court held that where a quarterly rent payment is due before the period of administration commences, the outstanding rent is deemed to be an unsecured debt rather than an administrator's expense and will rank equally with other unsecured debts.

The Court had little difficulty in overruling both cases and concluding that an administrator must pay rent for the entire period during which the administrator retains possession of the premises, as an administrator's expense. The rent is to be treated as accruing day to day. The judgment was founded on the application of the salvage principle, an equitable principle based on "common sense and ordinary justice". The decision should bring to an end the increasingly common practice in the UK of appointing an administrator immediately after a quarterly payment is due so as to take advantage of the principle in *Luminar* and avoid liability to pay the quarterly rent in full, as had occurred in the *Pillar Denton* case itself.

See Court decision here.

No access to insured defence costs when claim exceeds the policy limit

The claims against the directors of Bridgecorp has given rise to the recent decision of *BFSL 2007 Ltd v Steigrad* [2013] NZSC 156, in which the Supreme Court held that section 9 of the Law Reform Act 1936 creates a charge (the "section 9 charge") that operates in favour of a claimant as soon as a claim covered by the policy is made. The section 9 charge prevents an insured from accessing the charged amount under the same policy to cover their legal costs until final liability to the claimant is known.

The section 9 charge applies to all insurance funds and attaches to money payable as compensation or damages from the time of the event that resulted in the claim (the Liability Event). The charge does not arise, though remain dormant, and then subsequently attach following a specific event– it arises, and becomes fully operative, simultaneously at the Liability Event. From that time it operates as a complete barrier to any payments eroding the amount subject to the charge. This is so even where the value of the claim may not actually be known at the Liability Event.

Where the policy has one limit both for third party liability and legal costs, the legal costs cannot be paid out of any money subject to the charge. Legal costs can only be paid out of any amount that exists over and above the charged amount. As the claims in the case exceeded the D&O policy limit, the directors were denied access to the insurance to cover their legal costs.

See Court decision here.

Consideration of the rescission and stay of winding up order in the UK

Credit Lucky Ltd & Anor v National Crime Agency [2014] EWHC 83 (Ch) involved an application seeking the rescission or stay of an order winding up a money services company that was subject of an investigation by the Serious Organised Crime Agency. Rescission was sought on the grounds that: (1) there was now an "offer on the table" which was not available when the winding order was made and that it was intended that the relevant company be put into administration with a view to the goodwill, name and database of the company being sold to a third party; and (2) the Registrar would not have made the winding order absent the company not paying an undisputable debt, which it was asserted the provisional liquidator should have paid from available company funds.

The Court found that neither of these grounds, whether taken singly or in combination, represented circumstances which are either exceptional or materially different from those before the relevant Registrar and the Court was not persuaded to exercise its discretion in any event. The Court was not minded to stay the winding up order either. To do so was considered to be disproportionate given that the only purpose for this could be to enable the company and its director/shareholder to continue a tax appeal, which the liquidator of the company was not minded to pursue, and which could be achieved by another, less drastic, route (provided the Court considered doing so was appropriate).

See Court decision here.

'Off with their wigs': Legal aid reforms give top barristers' chambers the chop

The slow signs of the recovery in the UK market should spell good times ahead for UK firms. However, it is anticipated that extensive cuts to the UK's legal aid system due to take effect this year will result in a huge shakeout of the legal profession over the next six months. The British reforms come as a result of Britain's legal aid bill having doubled since the 1980s. At around £2b a year the UK has one of the most expensive legal aid systems in the world. The new model aims to cut legal aid by a quarter (£320m) within a year and see lawyers' fees cut by up to 30% in circumstances where criminal cases have already had their budgets reduced by 40 per cent since 1997. The reforms have been hugely controversial, prompting the first barristerial strike in history. The reforms have been blamed for two top Barristers' chambers going under.

High-profile civil liberties and human rights set, Took Chambers, was the first to fold. Led by Michael Mansfield QC, the chambers said that "the dissolution of chambers is the direct result of government policies on legal aid. The public service we provide is dependent on public funding. 90% of our work is publicly funded. The government policies led by justice secretary Chris Grayling are cumulatively devastating the provision of legal services and threatening the rule of law." Tooks Chambers, founded in 1984, has been involved in numeorus high-profile cases, including those of the Birmingham Six (who were prosecuted for the pub bombings of 1991 and later had their convictions quashed), representing the family of Stephen Lawrence (one of the highest profile racial killings in UK history), the inquest into the Hillsborough disaster (a crush at a football stadium that resulted in the deaths of 96 people and injured 766) and the current inquest into the death of Mark Duggan (whose death by police triggered the riots of 2011). It had 55 members, including five silks.

Similarly, Rennaissance Chambers in London's Grays' Inn, headed by Sir Charles Fletcher-Cooke QC in 1989, has also gone belly-up. The chambers specialised in family, immigration and general human rights law, with a particular emphasis on the law relating to children. It is hoped that a restyled, phoenix chambers will be formed from the ruins.

Meanwhile outside of the world of legal-aid, North-west firm Linder Myers and North-East firm Swinburne & Jackson have both filed notice of its intention to appoint administrators. Stephenson Harwood is coping with troubled times by making almost half of its London secretarial and support staff redundant, paying them the absolute bare minimum of redundancy pay. Insiders say that the firm is outsourcing its secretarial work to Scotland. With practitioners struggling to cope with brutal government cuts, it may be only a matter of time before more substantive legal work is outsourced to more cost-effective nations.

See articles here and here.

"Bad news, I've been declared debt adjusted": The EU moves to banish 'bankruptcy'

The EU has proposed that the term 'bankruptcy' is too stigmatising, should be quashed from the European law and replaced with the more neutral term 'debt adjustment'.

The term 'bankruptcy' dates back 500 years and is believed to originate from the Italian phrase 'banca rotta', meaning 'broken bench', derived by the ancient custom of breaking a money-changer's bench to signify his insolvency. While insolvency law has come a long way since the Statute of Bankruptcy 1542, which provided that debtors be imprisoned for their misfortune, the EU says that it has not come far enough.

A report prepared by the department of the EU's Directorate General for International Policies said use of the word bankruptcy was too pejorative and made it difficult for people to rebuild their financial reputation. If the terminology is changed, the authors believe that creditors may be persuaded to assist the funding of new ventures. It is suggested that in order to remove the stigma, reforms must include a ban on the word 'bankrupt' entirely.

The report, prepared for the European Parliament's Internal Market Committee, is being considered as part of wider reforms to harmonise financial services across the EU, including making it easier to open bank accounts in different countries and easier to escape debt. Other controversial proposals include penalising banks if 'inappropriate lending' contributed to a bankrupt's financial woes, and giving unpaid taxes priority over private debts when creditors are being repaid.

Unsurprisingly, the critics have been scathing. Tory MP Brooks Newmark, a member of the Commons Treasury Committee, has described the proposal as "*another flawed, madcap scheme by Brussels […] This shows just how intellectually bankrupt – sorry, debt adjusted – the European Union has become*."

See article here.

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