BUDDLE FINDLAY

Legal update on insolvency law - June 2014

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Voidable transactions and running accounts - continued rejection of the peak indebtedness principle

Two recent High Court decisions applied the 'running account' test in relation to voidable transaction claims by liquidators, and considered when the running account begins. The running account test treats a series of transactions as a single transaction for the purpose of determining whether a creditor has received a preference, so long as the transactions form an integral part of a continuing business relationship.

In *Levin v Z Energy Ltd* [2014] NZHC 688 and *Grant v Nauhria Precast Ltd* [2014] NZHC 800, the Court considered when the running account begins under section 292 of the Companies Act 1993. In both cases, the liquidators sought to select the point of peak indebtedness as the start date of certain transactions. In practice, this would mean that the value of the voidable preference payments made to the respondent company was the difference between the peak indebtedness of the company in liquidation, and the closing figure at the end of the parties' trading relationship. The amount of any reduction of debt to the respondent company would be the value of the preference that the respondent company had received. The Court rejected the liquidators' contentions that the date of peak indebtedness is to be applied in both cases.

In support of its conclusion, the Court in *Levin v Z Energy* cited *Shephard v Steel Building Products* (which we wrote about here) and, after careful analysis, concluded that the peak indebtedness approach is inconsistent with the underlying policy, which focuses on assessing the overall effect of all transactions making up the running account. We understand that this decision has been set down for appeal. In *Grant v Nauhria Precast*, the Court noted that, increasingly, the Court's approach will be to look at the whole course of trading in the continuing relationship, and reject liquidators' attempts to select the point of peak indebtedness when analysing the single transaction.

See full decisions here and here.

Statutory demands to recover insolvent transactions

Liquidators are no longer restricted to seeking orders under section 295 of the Companies Act to recover insolvent transactions. In *Grant & Anor v Lotus Gardens Limited* the Court of Appeal permitted the liquidators' use of the statutory demand process for recovery of an insolvent transaction. The Court also held that the section 296 defences and considerations under section 295 remain available and relevant to the Court's decision, regardless of whether the liquidator chooses to use the statutory demand procedure or seek orders under section 295 to recover a transaction that has been set aside.

After confirming that the statutory demand process was available to liquidators, the Court found Lotus Gardens had no arguable defence to the liquidators' application and made orders placing Lotus Gardens in liquidation, reversing the personal costs order against the liquidators made in the High Court and awarding the liquidators costs.

Nonetheless, the Court of Appeal issued a caution to liquidators (at paragraph 46):

We would not wish to be seen as encouraging the use of s 289 processes as a remedy for liquidators claiming recovery for set aside transactions. The s 295 procedure is designed to deal with remedies following setting aside, and it is good practise to utilise that section. … Liquidators who use the s 289 procedure, as has been the case here, could well find that they have taken an unnecessary step and are faced with a Court refusing to make an order for liquidation, ordering costs, and having to apply under s 295, having wasted creditors' funds on an unnecessary step."

Issuing a statutory demand to recover the proceeds of a transaction that has been set aside is an option for liquidators. However, statutory demands cannot be issued when a debt is disputed. If the creditor objects to the transaction being set aside, or if there is potential for a defence under section 296, issuing a statutory demand could expose liquidators to a personal costs award, and result in the liquidators still needing to apply for orders under section 295.

See full decision here.

KiwiSaver funds as property upon bankruptcy

This case raised a simple but very important question: can the Official Assignee (OA) get access to the KiwiSaver funds of a bankrupt for distribution to his or her creditors? In May 2013 some 2,000 bankrupts in New Zealand held over $7.6 million in KiwiSaver funds. This was therefore a test case, watched with interest by those in the retirement funds industry.

The OA argued that:

- Interests in KiwiSaver accounts are "*property*" for the purposes of the Insolvency Act 2006
- Such property vests in the OA upon a person's bankruptcy
- Bankruptcy is invariably an example of "*significant financial hardship*" which justifies early withdrawal of the funds.

The Judge agreed with the first two points, but refused to declare that bankruptcy was always proper grounds for the "*significant financial hardship"* withdrawal criterion. He held that every case would need to be examined on its merits to determine whether a withdrawal would actually alleviate financial hardship. The Judge said that if, for instance, a withdrawal would not be sufficient to pay the bankrupt's debts in full and annul the bankruptcy then it could not be said that it would alleviate the bankrupt's financial hardship – whereas if the withdrawal would enable the bankrupt to repay his debts in full and annul his bankruptcy then the trustee might well agree that his financial hardship would be alleviated.

If the KiwiSaver trustee accepted the OA's application for withdrawal, the funds would be paid to the bankrupt's creditors. But if the trustee denied the application, the OA would have to wait until the KiwiSaver interest became available (for example, on the bankrupt turning 65) before applying the accumulated funds to the original creditors.

The Judge accepted the result was unattractive for all concerned and called for legislative relief.

See full decision here.

Personal liability, receivers and body corporate levies under the Unit Titles Act 2010 - clarifying the scope of section 32(5)

The High Court in *Body Corporate 162791 v Gilbert & Anor* [2014] NZHC 567 held that receivers are not personally liable under section 32(5) of the Receiverships Act 1993 for body corporate levies under the Unit Titles Act 2010.

Section 32(5) of the Receiverships Act provides that receivers are liable for "rent and any other payments becoming due under an agreement subsisting at the date of the appointment of the receiver relating to the use, possession, or occupation by the grantor of the property in receivership".

Applying a purposive interpretation, Associate Judge Abbott held that section 32(5) does not apply to body corporate levies because:

- Levies are not payments "due under an agreement". The plain meaning of the word "agreement" imports an element of consent or mutual understanding. Levies are imposed unilaterally on owners by body corporates.
- Levies are not payments "becoming due under an agreement…relating to the use, possession, or occupation by the grantor of property in receivership". Rather, they are payments relating to ownership.

See full decision here.

Recovering bankruptcy costs when the principal debt is settled prior to adjudication

In *Smith & Partners* [2014] NZHC 389 the High Court overturned a previous decision about a creditor's right to claim costs in a bankruptcy proceeding after accepting payment of the principal debt.

In *Smith & Partners* the creditor accepted payment of the outstanding principal debt in return for abandoning its bankruptcy application. However, the creditor still sought solicitor/client costs.

The High Court's position at that time (in *Re Peacock* [1956] NZLR 365) was that a creditor was required to choose between:

- Either maintaining a bankruptcy application and a claim for costs; or
- Accepting payment of the principal debt and abandoning the bankruptcy application together with the claim for costs.

In holding that the remedies of adjudication and costs are not inconsistent with each other, the High Court in this case declined to follow the 'either/or' approach in *Re Peacock*. As such, when parties fail to settle the issue of costs prior to the hearing of a bankruptcy application, creditors can pursue such costs even if the principal debt has been repaid and the application abandoned.

See full decision here.

Cross-border insolvency and the protection of local interests

The recent decision of the Federal Court of Australia in *Akers as a joint foreign representative of Saad Investments Company Limited (in Official Liquidation)* demonstrates how courts may be willing to exercise discretion in cross border insolvency proceedings to protect the interests of local creditors.

Saad Investments, a private investment company registered in the Cayman Islands, sold its assets in Australia and in doing so incurred a capital gains liability of $83m. Prior to any repayment of this liability, Saad Investments was placed into liquidation by the Grand Court of the Cayman Islands.

The Cayman Islands liquidation was the foreign main proceeding under the *UNICITRAL Model Law on Cross-Border Insolvency* (Model Law) with the effect that enforcement or execution against Saad Investments' Australian assets was stayed. The liquidators in the Cayman Islands sought to remit Saad Investments' Australian assets back to the Cayman Islands, so they could be offset against creditor liability there. Given that Cayman Islands law prevents a liquidator from admitting a proof for a foreign tax debt, the assets were the only means available to the Australian Taxation Office (ATO) for satisfying Saad Investment's liability in Australia. Accordingly, the ATO sought orders preventing the removal of the assets from Australia.

The Court of Appeal considered the operation of the Model Law noting that it took a Universalist approach, promoting the interests of creditors as a whole. When the interests of local creditors were unfairly prejudiced by the operation of the Model Law (as they would be here given the narrow range of assets available to the ATO as creditor) it was appropriate for the court to grant relief.

In these circumstances, the Court of Appeal was satisfied that it was appropriate for it to exercise its discretion to preserve the position of the ATO. The result highlights the importance of equality in an insolvent administration and the willingness of the courts to step in and exercise discretion to ensure such equality.

See Court decision here.

Co-operation and coordination under the UNCITRAL Model Law

In *Global Tradewaves Ltd* [2013] FCA 1127 the Federal Court of Australia (FCA) granted leave to the liquidators of Global Tradewaves Limited (GTL) (appointed by the British Virgin Islands court) to examine a former director of GTL in Australia, notwithstanding that there was no evidence that GTL had ever carried on business in Australia or had any creditors in Australia.

The liquidators applied to have the liquidation proceedings recognised in Australia as "*a foreign main proceeding*" under the UNCITRAL Model Law on Cross-Border Insolvency (the Model Law). Logan J confirmed that proceeding fell within the Model Law definition of "foreign main proceedings" as the BVI was the jurisdiction where GTL has its registered office and, therefore, the proceeding was presumed to be taking place where GTL has "the center of its main interests".

Further, the liquidators sought a summons for the former director of GTL to be examined in relation to the company's affairs and to compel him to produce certain company records in his possession. Logan J found that he could order such a summons pursuant to the powers under Article 21(1)(d) of the Model Law, which provides that a court may provide for an examination of witness, and article 21(1)(g) which allows the court to provide "any additional relief that may be available" in certain sections of the Corporations Act.

The decision illustrates the impact that the Model Law has in encouraging co-operation and coordination between jurisdictions in relation to liquidation proceedings for multi-national companies. As a result of the outcome, offshore liquidators are provided with confidence that at least some overseas courts will be open to recognising offshore jurisdictions as the debtor's centre of its main interests and, as a result, grant ancillary relief to the liquidators – in addition simply to staying the enforcement action in other jurisdictions.

See full decision here.

Equitable lien for liquidators' costs in Australia

The High Court of Australia recently recognised the significance and standing of a liquidator's equitable lien for his costs in realising assets of a company in liquidation. The principle that a liquidator is entitled to an equitable lien over a fund that he or she creates in liquidation, and that that lien ranks in priority above any creditor (including secured creditors who assert an entitlement to the fund), was originally promulgated by the 1933 case of *Universal Distributing.*

In this case the liquidator initially issued proceedings to impugn Atco's (the secured creditor's) interest. During the proceedings, which were ultimately unsuccessful, the liquidator obtained a settlement with another party to the litigation. Atco, as a secured creditor, attempted to recover that settlement sum, ahead of the liquidator's equitable lien over the sum.

Atco's five arguments as to why the principle from *Universal Distributing* should not apply were all unsuccessful. The Court held that because the costs and expenses of the liquidator were incurred in realising the asset that created the fund, in the course of the liquidator performing his duty, the principle of *Universal Distributing* applied. As such, the liquidator was held to have an equitable lien over the fund for its costs, which took priority over Atco's secured interest.

See full decision here.

The "contributory rule" is applicable in liquidation but not administration

The insolvency questions in this case arise because of the unique combination of Lehman Brothers International Europe (LBIE) being, for tax reasons, a private unlimited company and the fact that there is projected to be a surplus remaining after all the unsubordinated proved debts are paid. The purpose of the case was to determine the claims that can be made against the surplus, in which order they rank and also to resolve the extent of liability of the shareholders, in their capacity as such, to an unlimited company in liquidation.

Given the background, it is no surprise that the case was long and complicated with Justice David Richards eventually giving nine separate declarations in order to direct how the waterfall of payments should be properly apportioned. Many of the conclusions are couched heavily in the special facts of the case, and may not have much precedent value.

Perhaps the most generally applicable of those conclusions was in relation to the contributory rule, that a contributory (the legal description given to a shareholder post-liquidation) of a company in liquidation cannot recover anything as a creditor until he has fully discharged his obligations as a contributory. It was found that this rule is only applicable in a liquidation and has no place in administration, thus an administrator cannot refuse a proof of debt or to pay dividends on the ground of liability for calls on unpaid shares.

See full decision here.

Serving bankruptcy notices in Australia - impact of the Trans-Tasman Proceedings Act 2010

Creditors have customarily been required to seek leave from the New Zealand courts before the courts would assume jurisdiction over and allow the initiation of a proceeding against a foreign debtor. With the passing of the Trans-Tasman Proceedings Act 2010, creditors are now able to serve documents which initiate a proceeding on a debtor resident in Australia without the leave of the New Zealand court.

In reliance on the Trans-Tasman Proceedings Act 2010, Westpac Bank recently served a bankruptcy notice on a debtor resident in Australia without seeking the leave of the court under the High Court Rules or permission from the court under the Insolvency Act 2006. At the adjudication hearing, the court found that there had not been valid service of the bankruptcy notice on the debtor due to the creditor Bank's failure to seek leave. In particular, the court held that the bankruptcy notice does not itself initiate a proceeding. Rather, it is a form of formal demand, and accordingly, despite the Trans-Tasman Proceedings Act 2010, leave of the court is still required to serve a bankruptcy notice in Australia.

See full decision here.

Undisclosed interests and bankruptcy - dishonesty pays off?

Bill Madden, while an undischarged bankrupt, purchased a property in New South Wales with his partner, Margaret. Bill contributed half the purchase price, but was not registered on the title. Bill's part payment gave rise to an equitable interest in the property. Bill's interest was "after-acquired property" for the purposes of the Commonwealth Bankruptcy Act 1966 Act (Act), and he should have notified the Official Trustee so that his interest in the property could be realised to satisfy his debts. Bill did not declare his interest in the property, which only came to the attention of the Official Trustee more than 20 years after Bill had been adjudicated bankrupt.

Section 127 of the Act bars the Official Trustee from "making a claim" to any property if 20 years has lapsed since the bankrupt was adjudicated bankrupt. After that period, any remaining property revests in the bankrupt.

The Federal Court of Australia (FCA) considered the meaning of the word "claim" in section 127. Was it open to the Official Trustee to sell the property and use the proceeds to pay Bill's debts without "making a claim" for the purposes of section 127?

The FCA held that a bankrupt's property would only revest in the bankrupt if the Official Trustee had not perfected its interest in the property. In this case, in order to "perfect" its interest in the property, the Official Trustee would have needed the assistance of the Court to define the extent of the equitable interest. The FCA held that an application to the Court for such assistance would be "making a claim" for the purposes of section 127.

The effect of this decision in Australia is that if a bankrupt keeps an interest in property hidden from the Official Trustee for a period of 20 years, the Official Trustee cannot make a claim on that property thereafter as the property automatically reverts to the bankrupt. As a result, creditors may be deprived of recompense because of a dishonest act by a bankrupt. However, the Federal Court did recommend that the Official Trustee look into charging Bill with an offence under the Act for his actions.

See full decision here.

Olé! - hedge funds permitted to 'fish' for Argentinian sovereign assets in USA

In 2001 Argentina defaulted on its external debt. The lower courts in the United States have held it liable to repay its debt to all creditors involved. This month, the United States Supreme Court declined to hear Argentina's appeal.

In *Republic of Argentina v NML Capital Ltd* (No. 12-842) the Supreme Court ruled on the narrow issue of whether information about a foreign-sovereign debtor's world-wide assets can be sought by a creditor.

A creditor subpoenaed key banks, seeking information about Argentina's world-wide assets. Argentina in response argued that the subpoenas would be improper if these assets could not be seized under the relevant foreign law.

The majority of the Supreme Court held that the subpoenas were valid as the potential for some of these assets to satisfy the debt owed to creditors in the United States was reason enough to issue the subpoenas. These subpoenas would provide creditors with the relevant information they needed.

The lone dissent reversed the burden and held that the subpoenas were improper unless the creditors could show there was something to be seized.

See full decision here.

"My cousin Vinny" and "Enron-style" fraud: Dewey & LeBoeuf bosses indicted

Initially, it seemed that the demise of Dewey & LeBoeuf was simply a cautionary tale of partnership dysfunction and maladministration in the wake of a misguided merger. However, the Manhattan District Attorney's office paints a much more sinister picture. In a 106 count indictment released by New York prosecutors on 6 March, it is alleged that the firm’s leaders knowingly falsified its accounts in a futile attempt to keep the firm afloat. At its peak, the firm had 26 offices around the globe and employed 3,000 staff, including more than 1,300 lawyers. With US$550m worth of claims against Dewey's estate, it is the largest law firm bankruptcy on record. Analogies to the infamous Enron saga are already being drawn.

Foolishly, much of the incriminating activity was documented in emails. In one email the then CFO referred to their conduct as "cooking the books". Other emails refer to millions of dollars' worth of “accounting tricks” and “fake income” and calling their auditors “clueless”. Unsurprisingly, Dewey's auditors have issued a statement that the defendants in the case lied to its auditors and withheld information in order to conceal their activity.

Three of those charged with larceny and securities fraud were Dewey's former leaders: Steven Davis, Dewey’s former chairman; Stephen DiCarmine, the firm’s former executive director and Joel Sanders, the former chief financial officer. Also charged was a junior employee, Zachary Warren, a former client relations manager.

The apple did not fall far from the tree in the case of one defendant, Steve DiCarmine. It transpires that one of Mr DiCarmine's cousins is Vinny "Gorgeous” Basciano, who ran the Bonnano crime family and is now serving a life sentence in federal prison.

But the same cannot be said for Zachery Warren, employed straight out of college, who had an exemplary record. His role at Dewey's involved chasing partners to collect on unpaid invoices. He left in 2009 to attend law school at Stanford University and has since had two judge's clerkships.

Nonetheless, prosecutors have come down hard on Warren. They were content to accept guilty pleas for mere misdemeanors from a string of Warren's seniors (which attract only community service sentences and no jail-time). However, no such opportunity was given to Warren, who has been indicted with felonies that would destroy his legal career if he is convicted.

The prosecution acknowledges that Warren was not a “mastermind” (like his co-defendants) but simply “a willing foot soldier”, so something has ruffled the DA's feathers. It may have been Warren's brazen request for immunity from prosecution in their first interview. It may have been that even as a junior employee, he received a salary of $100,000 and a bonus of $115,000, which was among the highest in the firm – even including bonuses paid to legal staff. What we can be sure of, however, is that this will be a case to watch because the juiciest details are yet to be revealed.

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