BUDDLE FINDLAY

Legal update on insolvency law - December 2015

David Perry, Scott Barker, Willie Palmer, Jan Etwell, Scott Abel, Seb Bisley, Susan Rowe, David Broadmore, Myles O'Brien, Kelly Paterson, Peter Niven, Matthew Triggs, Bridie McKinnon

8 December 2015

Court of Appeal confirms liquidator's power to avoid transactions

Castlereagh Properties Limited (Castlereagh) and Gibbston Water Holdings Limited (Water Holdings) were both companies in David Henderson's Property Venture group. Castlereagh and Water Holdings entered into a sale and purchase agreement (SPA), under which Water Holdings sold all of its shares in Gibbston Water Services Limited (Water Services) to Castlereagh for $1. Water Holdings was subsequently put into liquidation.

The Court of Appeal held that the liquidator could set aside the transaction under schedule 6 of the Companies Act 1993. A transaction can be avoided if the vendor company does not receive fair value under the contract. Although Water Services was insolvent, the $1 consideration was not fair value. There was demand for Water Services' Gibbston water scheme, and the company's newly acquired permit to extract potable water until 2043 was in itself very valuable.

See Court decision here.

Receivers' duties to sureties

In *King v PFL Finance Limited & Anor* [2015] NZCA 517, the Kings, a husband and wife team of farmers, arranged finance from PFL Finance Limited but the loan went into default. PFL served PLA notices but failed to serve the Kings as guarantors. A receiver was appointed to the farming operation, who determined to cease trading the day after his appointment.

The Kings claimed (among other things) that the failure to serve them with PLA notices had caused them prejudice. They also claimed that the receiver had breached his duty under section 18(3) of the Receiverships Act 1993 to exercise his powers with reasonable regard to the interest of the Kings, and that PFL was liable for the receiver's breach.

The Court of Appeal agreed with the High Court that, to show that the failure to serve the PLA notices on the Kings resulted in a liability for PFL, the Kings would have to establish that they had the ability to remedy the default, that they were deprived of the remedial opportunity and that they had suffered loss as a result. The Court found against the Kings on this point.

On the issue of the receiver's liability, the Court found that the receiver did not act unlawfully in closing down the farm operation the day after his appointment. The Court of Appeal noted that section 18 of the Receiverships Act 1993 codifies a receiver's duties and the wording of the section is such that the receiver's primary duty is to act in the best interests of the appointing creditor. To the extent consistent with that primary duty, the receiver must exercise his or her powers with reasonable regard to the interests of sureties. Only in this sense is a balancing of competing interests required. If the course desired by a surety is inconsistent with the best interests of the creditor, the receiver is not bound to adopt it. If it may be consistent with those interests, he must have regard to it, although even then he may, acting reasonably, still reject it.

See Court decision here.

Payments made pursuant to a direct deed voidable

Sanson v Ebert Construction Limited [2015] NZHC 2402 concerned the successful application by liquidators to set aside payments made pursuant to a direct deed arrangement, as they were payments made on behalf of the insolvent developer. *Sanson* was the first New Zealand case where a liquidator has raised this argument but it is unlikely to be the last. Direct deeds are a common contractual tool in construction projects to give financiers the right to step into the place of the developer and directly arrange for payments to the contractor to ensure that the development is completed.

Importantly, direct deeds do not create an independent obligation on the financier to make payments, rather they allow the

financier to elect to make payments in place of the developer and prevent the contractor cancelling the contract upon a default. Such payments are made from the loan facility available to the developer and are accordingly limited to the extent of that facility. It is on this basis that the liquidators in *Sanson* argued that the payments made by BOS International (Australia) Limited (BOSI) were actually the property of the developer, Takapuna Procurement Limited (TPL), which were applied by BOSI on TPL's behalf and therefore unfairly received by Ebert Construction in preference to other creditors.

The court agreed with the liquidators and declared the payments voidable under section 293 of the Companies Act 1993. The result of this judgment is that contractors who negotiate and enter into direct deeds are unlikely to get the protection that they will have expected. Despite this, the decision of the court does appear to be correct.

See Court decision here.

No evidence of agency relationship between administrator and secured party

Mr Pala and Mr Luthera were directors of Shanton, a large retailer of women's clothing in New Zealand. BTC Group Limited (BTC) was in the business of supplying clothing to Shanton in accordance with Shanton's stock orders. BTC had obtained guarantees from Shanton's directors, pursuant to which each director guaranteed the obligations of Shanton to BTC. Earlier this year, Shanton was unable to pay its debts as they fell due and was placed into voluntary administration owing creditors over $7m.

When Shanton was unable to make payment under BTC's invoices as these payments fell due, BTC brought a claim for summary judgment in the High Court against the directors under their guarantees. It was successful in the High Court.

In *Pala & Anor v BTC Group Limited* [2015] NZCA 487, Mr Pala and Mr Luthera appealed the High Court judgment. BTC had a perfected security interest over the garments it had supplied to Shanton, and therefore had the right to repossess its stock. However, it opted not to do so, given that it was based in Hong Kong (and the stock was spread amongst the various stores throughout New Zealand). One of the directors' arguments was that BTC took possession (although not physically) of certain garments and appointed the administrator to sell them as BTC's agent. The pair claimed the administrator had failed to get the best price possible for the clothes and that BTC was liable for this failure because the administrator was acting as BTC's agent.

The Court held that there was no evidence that the administrator was acting as BTC's agent. However, the Court reduced the amount for which the directors were found liable under their guarantee on another point concerning when the invoices for supply of the goods were payable.

See Court decision here.

Indemnity for receiver's costs and the operation of penalty clauses

Torchlight Fund No 1 (Torchlight) contracted with Wilaci Pty Ltd (Wilaci) for a $37m loan. The terms included the payment of a 'late fee' of $500,000 per week. Following default, Torchlight applied for a declaration that the fee was a penalty, and therefore unenforceable. Torchlight also applied for directions as to the payment of the costs of the receivers appointed by Wilaci, arguing that a clause indemnifying Wilaci in respect of a default did not apply to such costs.

The Court confirmed that a clause stipulating for an additional payment upon default will be unenforceable if it is extravagant, and therefore disproportionate, to the loss likely caused by the breach.

However, the indemnity clause in respect of a default was held to cover receivers' costs as a direct cost of Wilaci attempting to remedy the default of Torchlight. The Court considered there was no jurisdiction to review costs without an application under section 34 of the Receiverships Act 1993.

See Court decision here.

Liquidator personally liable for costs

In *Stojkov v Kamal* [2015] NZHC 2513 a creditor, Mr Stokjov, gave notice to the appointed liquidator, Mr Kamal, for a meeting of creditors to be called. Mr Kamal did not call the meeting and maintained that the notice was given out of time. Mr Stokjov reasonably pointed out that this was plainly incorrect. Mr Kamal, despite clearly being in breach of his duty, still refused to call the meeting and later claimed (quite irrelevantly) that the cost of the meeting was not justified.

The Court held that, in breaching his duty under section 245(1)(b)(iii) of the Companies Act 1993, Mr Kamal's conduct was so unreasonable and out of the ordinary that he was required to pay the order for costs personally. He could not claim that it was a simple error of judgment on his part.

See Court decision here.

Company in liquidation to provide security for costs

A bank recently obtained an order for security for costs against a company in liquidation. This case provides a useful summary of when security for costs may have to be paid by a company in liquidation.

Traditionally, there has been an aversion to requiring security for costs where proceedings are brought by a company in liquidation. However, more recently there has been a trend to order security in appropriate circumstances. The courts are now more inclined to order security against a plaintiff in liquidation, because the defendant does not have the protection of a liquidator's personal liability. The usual discretionary factors will be relevant in any such application for security.

See Court decision here.

Bank not liable for alleged breaches of duty

Recently, a bank successfully obtained an order to summarily dismiss a claim against it. The claim arose out of a loan advanced by the bank to purchase farm land. Almost six years after the land was purchased, the borrowers alleged that they had paid too much for the land. The borrowers brought a claim against the bank, alleging that the bank had advised them that they should purchase the property and that it was worth what they paid for it. The causes of action were based on breach of contract, negligence, breach of fiduciary duty and breach of the Fair Trading Act.

The High Court confirmed the well-established principles in relation to a bank's liability for negligence and breach of fiduciary duty. Essentially, if a bank chooses to give advice to its customer about the quality of an investment, the bank may assume a duty to give sound advice. The focus is on whether any advice given by the bank might have resulted in the bank "crossing the line" between a normal business relationship and one in which the bank had a dominating influence.

In the circumstances, the High Court held that no aspects of the borrowers' claim could succeed. Accordingly, the claim was dismissed.

See Court decision here.

Limiting voting power of shares in order to prevent a takeover is not a proper purpose

Eclairs Group Ltd v JFX Oil & Gas Plc [2015] UKSC 71concerned a company with a constitution that allowed the directors to restrict the voting rights attached to the company's shares. The directors exercised their power to restrict those rights in order to pass a resolution at the company's AGM to issue shares to the public without a pre-emptive offer to existing shareholders. This was to prevent a takeover of the company by the plaintiff shareholders. The issue was whether that power had been exercised for a proper purpose.

The Court confirmed that even if powers are conferred by the constitution of a company, they still must be exercised for a proper purpose. The defendant directors had relied on an assumed failure by the plaintiff shareholders to properly disclose the nature of their shareholdings as the grounds for the restriction. However, any failure on the part of the plaintiffs to provide information did not justify restricting voting rights. Therefore, the power was not exercised for a proper purpose, despite the directors' belief that the power was exercised for the benefit of the company. The decision to restrict voting rights was set aside. Section 133 of the New Zealand Companies Act 1993 contains a similar provision requiring a director to exercise powers for a proper purpose and this decision should be kept in mind when considering that obligation.

See Court decision here.

Classification of receipts as principal or interest

The recent decision in *CBRE Loan Servicing Limited v Gemini* involved the classification, as either principal or interest, of rental payments, sale proceeds and surrender of lease premia received by a Master Servicer under a Cash Management Agreement. The agreement formed part of a complex securitisation structure and the classification affected how the funds were to be applied under the payment waterfall in that agreement, and therefore the economic interests of the varying classes of noteholders.

The Court looked at the agreement in the overall context of the securitisation and loan documentation and looked to characterise

the receipts in the hands of the Master Servicer (rather than the noteholders).

The Court took the view that the classification should be determined using commercial common sense and the common law principles applicable to distinguishing capital receipts and income receipts in a business context, rather than to apply the common law rules on appropriation of payments made by a debtor to his creditor, as contended for by the junior noteholders.

On that basis, the Court characterised the rental payments as interest. Conversely, the proceeds of sale of the properties and the premia received on the surrender of leases represented the underlying capital value of the security for the loan and so were characterised as principal.

See Court decision here.

Duties owed by receivers to bankrupt mortgagors

In *Purewal v Countrywide Residential Lettings Ltd* [2015] EWCA Civ 1122, the receivers of a property did not make an insurance claim in relation to damage to the property. The mortgagor of the property (a bankrupt) repaired the property himself. He brought an action against the receivers for breach of duty by failing to make an insurance claim, claiming damages for the cost of the repairs.

The UK Court of Appeal held that receivers owe a duty to a mortgagor if and to the extent that the mortgagor retains an interest in the equity of redemption (ie the right to redeem the property once the mortgage debt has been discharged). On bankruptcy, the mortgagor's liability under the mortgage is discharged and the equity of redemption is vested in the trustee-in-bankruptcy (the UK equivalent of the Official Assignee) for the benefit of the general body of creditors. Although the bankrupt will receive any surplus in the bankruptcy under section 330(5) of the Insolvency Act 1986 and therefore has an interest in the receivers exercising their duties with care, that interest will be protected by the receivers upholding their duty to the trustee. Therefore, the receivers do not owe a duty to the bankrupt mortgagor.

See Court decision here.

English Court grants relief to Argentina bondholders

The recent case of *Knighthead Master Fund* is another that arises out of payment defaults by the Republic of Argentina (see our June 2014 update for details of the US proceeding). This proceeding involved payments by the Republic to a bond trustee that were held on trust for bondholders in accordance with the terms of a trust indenture that was governed by English law.

An injunction had previously been granted by a New York court restraining the trustee from paying the bondholders. Bondholders applied to the English Court for a declaration that the funds transferred to the trustee's account were held on trust for the bondholders and that, because the trust was governed by English law, the trustee's obligations were unaffected by the New York court's injunction.

The High Court held that on the plain construction of the trust indenture and terms and conditions of the bonds, the payments made to the trustee were held on trust for the bondholders. The Court emphasised that it was "*very concerned not to intrude improperly into matters which are before the United States' Courts*" but concluded that its decision did not do so because it related to the status of the funds as a matter of English law and issues of English law had not been raised before in the New York court.

See Court decision here.

A brave new world for financial disputes

The United Kingdom recently established a new, specialist, financial disputes list under Part 63A of its Civil Procedure Rules. The financial list is a single, specialist court list, which will hear complex financial litigation. The object of the financial list is to provide a faster, more efficient and economical forum for resolving financial disputes.

In order to bring a claim in the financial list, a litigant must show that the claim:

- Relates to one of the listed financial products (such as a loan, derivative, debt security, bond or sovereign debt) and has a value in excess of £50 million
- Is a claim which requires a particular expertise in financial markets, or
- Raises issues of general importance to financial markets.

Subject to the Civil Procedure Rules on establishing jurisdiction, the financial list would be available to international litigants who

satisfy the above criteria.

See article here.

Bankruptcy now available in Russia

On October 1 2015, for the first time in the nation's history, Russian individuals gained the ability to file for bankruptcy. While an insolvency process was previously available to legal entities, the need for individuals to do the same arose from the economic recession currently plaguing the country.

The legislation allows for those with 500,000 rubles (NZ$11,600) of debt or greater to file for bankruptcy, if they missed payments over a total of 90 days. Alternatively, if an individual can prove that they will not be able to repay a loan, they may also file for bankruptcy with a lesser debt.

Critics argue that the courts will become flooded with applications, which require management of a debtor's assets and the appointment of a court mediator. Those critiques are not without foundation: an estimated 580,000 Russians qualified instantly, with a further estimated four million cases of bankruptcy expected within the next year.

See article here.

International (legal) misfortune

We have been following the fate of the now defunct international firm Dewey & LeBoeuf (see our previous updates on this topic: April 2013, December 2013 and June 2014). Most recently, three former executives (including Steve DiCarmine, whose cousin Vinny is reputedly the former head of the Basciano crime family) have been acquitted by a US Court of numerous charges of falsifying business accounts. They had been accused of defrauding and stealing from the firm's lenders, investors and others by adjusting the firm's accounts to mask its poor finances before the firm went bankrupt in 2012 (as summarised here).

Simmons & Simmons' managing partner will be hoping for a similar result following a letter from German Lawyers threatening him with imprisonment after the firm failed to pay off disgruntled ex-employees (see here).

Another UK legal practice has succumbed to an unmanageable debt burden. Parabis Group had debts of about £70m Having just recently confirmed the sale of its defendant personal injury arm, Plexus Law, the legal and professional services provider is to be broken up and sold in a seven-part pre-pack administration process. This is expected to realise approximately £50m.

One of the first firms to benefit from sweeping liberalisation of the legal services market in 2012, Parabis has been placed into a pre-pack administration handled by AlixPartners, in a move that is expected to save 'all but a handful' of the 2,000 jobs at the company (see more here).

Meanwhile listed law firm, Slater and Gordon Ltd, has suffered a steep drop in its share price in recent weeks. This was the result of various factors; including its acquisition of Quindell earlier this year (at a cost of about AU$1.2b). Adding to its woes is a proposed change to personal injury laws in the UK that may impact on its business there (see more here).

Finally, in a cruel twist of fate, Quality Solicitors appears not to have been living up to its name. Quality Solicitors launched in May 2009 as an internet-based alliance of independent law firms. However, in the 15 month period ended 31 March 2015, the company posted an operating loss of £2.3m. In addition, the balance sheet as at March 2015 showed that the company's liabilities exceeded its assets by £15.9m. Nonetheless, its controlling party has indicated that it will support the company for the foreseeable future (see here).

Auckland

188 Quay Street
Auckland 1010

PO Box 1433
Auckland 1140
New Zealand

P: +64 9 358 2555
F: +64 9 358 2055

Wellington

Aon Centre
1 Willis Street
Wellington 6011

PO Box 2694
Wellington 6140
New Zealand

P: +64 4 499 4242
F: +64 4 499 4141

Christchurch

83 Victoria Street
Christchurch 8013

PO Box 322
Christchurch 8140
New Zealand

P: +64 3 379 1747
F: +64 3 379 5659