BUDDLE FINDLAY

Legal update on insolvency law - June 2017

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29 June 2017

Direct agreements can protect builders from insolvent developers

Ebert Construction Limited v Sanson concerned the question of whether payments made by a third party under a 'direct agreement' to finance construction are payments made by the company in liquidation for the purposes of the insolvent transaction regime. Direct agreements are an agreement between the developer, builder and financier of a construction project. The agreement in this case obliged the financier to make progress payments directly to the builder throughout the duration of the project. However, the financier continued to make payments to the builder after the developer had fallen into default under the facility agreement. The question was whether those payments were made by the insolvent developer and therefore recoverable by the liquidators.

In the High Court, Associate Judge Doogue held that the payments were recoverable by the liquidator because the payments made by the financier were payments by the insolvent developer. On appeal, this result was overturned.

The Court of Appeal held that the agreement created contractual privity between the financier and the builder. The financier was obliged to make payments to the builder, which depended on the builder not being in default under the agreement. It was not dependent on whether the developer was in default under the facility agreement with the financier. The financier's discrete obligation to the builder was as a principal rather than an agent of the developer. The financier was obliged to make payments upon the direction of the builder, not the developer. Accordingly, the payments were not made by the insolvent developer and could not be set aside by the liquidators of the developer.

It is worth noting that the direct agreement in question was reasonably contractor friendly. Relatively few direct agreements would allow payment to be made to the contractor once the developer was in default. The outcome may have been different had the drafting been more favourable towards the financier.

There may be a further appeal to the Supreme Court on this matter.

See the full case here.

Distribution of assets upon the liquidation of a Ponzi scheme

Arena Capital Limited (Arena) was a Ponzi scheme. Arena's liquidators applied under s284(1)(a) of the Companies Act 1993 for directions regarding the distribution of assets under liquidation.

The Court held that dividing the assets into trust assets and general assets was inefficient in the circumstances and ordered a "common pool approach." The Court ordered distribution on a pro rata, pari passu basis. The investors had borne the same degree of risk and it was not cost-effective to trace the numerous small contributions.

The liquidators proposed a "net contribution" basis for calculating distributions - the amount paid by an investor less the amount they received from Arena, calculated at the date of liquidation. One investor demonstrated that this approach favoured investors who received pre-liquidation payments from Arena, and proposed that those sums be voided within the distribution calculations.

The Court rejected this, noting that the 124 investors who had recovered their deposits could not lawfully be required to account for those sums. The alternative approach required different treatment of pre-liquidation returns across categories of investors. Furthermore, the alternative approach would circumvent the voidable transactions regime in the Companies Act 1993, and the fraudulent dispositions regime in the Property Law Act 2007.

See the Court's full decision here.

Final word on Ponzi scheme clawback

The Supreme Court in *McIntosh v Fisk* upheld the Court of Appeal decision permitting the liquidators of Ross Asset Management Ltd (RAM) to claw back the fictitious profits paid out to Mr McIntosh. However the claw back did not apply to the original investment of $500,000.

The majority found that McIntosh had a defence for the $500,000 as he had provided "real and substantial valuable consideration". Once RAM misappropriated the $500,000 it became indebted to McIntosh for that amount, this equated to the provision of valuable consideration.

As in the lower courts, the Supreme Court had no issue with bifurcating the $954,047 payment made by RAM into the $500,000 original investment and the $454,047 fictitious profits. McIntosh could not prove that he had given valuable consideration for the fictitious profits or that he had changed his position in reliance of obtaining them. The liquidator was therefore entitled to claw back the $454,047.

Glazebrook J disagreed with the majority and stated that the full $945,047 should be clawed back. McIntosh had not given value for the $500,000 either at time of payment or when the funds were misappropriated due to the existing trust relationship between the parties. The funds were only misappropriated by RAM to perpetuate a fraud that was of no real value to RAM.

See the Court decision here.

Security for costs against liquidator

The UK case of *Cherkasov & Ors v Olegovich, the Official Receiver of Dalnyaya Step* concerns an application for security for costs against a liquidator.

A Russian court appointed a liquidator to the Russian subsidiary of a Guernsey unit trust. The liquidator applied for recognition of the liquidation proceeding as a foreign proceeding in the UK under the Cross-Border Insolvency Regulations 2006. The application for a recognition order was granted.

The applicants for costs in *Cherkasov* were involved in the management of both the Russian subsidiary (in liquidation) and companies advising or managing the Guernsey unit trust. The applicants alleged that the liquidation of the Russian subsidiary was unlawful and part of an abusive campaign by the Russian Government against them. They applied to set aside the recognition order on public policy grounds and sought security for costs.

The Court held that when applying to set aside the recognition order, the applicants should be treated as effectively the defendants to the application for the recognition order. They were entitled to apply for security for costs. The liquidator was ordered to provide security for costs of £1m.

See the full judgment here.

Composing scheme classes

The New South Wales Court of Appeal recently handed down an important judgment relating to the composition of classes in a creditors' scheme of arrangement. In *First Pacific Advisors LLC v Boart Longyear Limited*, the Court of Appeal unanimously dismissed an appeal brought by First Pacific Advisors LLC (FPA). The appeal was against an order made under s 411 of the Corporations Act 2011 convening meetings of creditors of Boart Longyear Limited (BLL) and several associated companies, to consider and if it saw fit, agree to two schemes of arrangements (one relating to unsecured creditors, the other relating to secured creditors).

In an earlier landmark decision, the New South Wales Supreme Court had rejected FPA's contentions that aspects of the secured creditors' scheme amounted to differences in the treatment of the secured notes debt and the term loan debt. FPA had also unsuccessfully argued that several associated transactions made it impossible for the parties to consult as one class. The primary judge held that, on balance, although there were differences in rights between the two groups, they were not such that the creditors could not consult together with a view to their common interests. This included the very substantial common interest that they have in addressing the risks of BLL's insolvency and how those risks are increased by the fact that they share security in respect of the same assets.

On appeal, the Court of Appeal:

- Affirmed the long established test arising from Sovereign Life - creditors in a single class should only be those 'whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest'. The Court held that in considering whether any difference in rights or different treatment of rights would make it impossible for creditors to consult together, the context in which the scheme is propounded is of importance. The Court held that the relevant rights to be compared against the terms of the scheme are those that arise in an insolvent liquidation

- Held that in the context of the case, and taking into account the company's financial position, the rights provided for by the scheme (including additional equity conferred on some, but not all, creditors in the class; the differential effect of the waiver of change of control rights; and different changes to interest regimes in relation to the secured note holders and term loan holder) were not so dissimilar as to require separate meetings
- Held that the primary judge did not err in holding that the rights conferred by associated transactions were relevant to the question of class composition. This aspect of the appeal was not of particular significance given that the waiver of the change of control clause formed part of the scheme and the purpose of the waiver was to give effect to the associated transactions.

The Court of Appeal's decision, like the Supreme Court's earlier decision, has been viewed as potentially extending and somewhat blurring the boundaries of the differential rights that may be conferred on different creditors without causing the need for separate classes to be ordered. The court still retains the ability to consider the overall fairness of the schemes in determining whether to give its sanction at the final court hearing and expressly noted that a number of the matters raised will be relevant to that assessment.

In a New Zealand context, the decision will be of potential relevance to schemes of arrangement under Part 15 of the Companies Act 1993. However, it will be of limited relevance to the composition of classes in creditors' compromises under Part 14 following the High Court's 2016 decision in *Advicewise People Ltd & Ors v Trends Publishing International Limited* [2016] NZHC 2119 (currently awaiting a decision from the Court of Appeal).

See the full New South Wales Court of Appeal judgment here.

The insolvency waterfall and Lehman Brothers

In a comprehensive judgment arising out of the collapse of Lehman Brothers, the UK Supreme Court recently determined the ranking of creditors.

Principally, the Court held that Lehman Brothers International (Europe)'s subordinated debt holders were "at the bottom of the waterfall", behind statutory interest and non-provable debt claimants.

In addition, the Court, by a majority, overturned the Court of Appeal in holding that foreign-currency creditors cannot claim as a non-provable debt the difference in value between the sterling value of the debt at the administration date and the sterling value at the date the debt was paid.

The Court further held that the rights of those creditors are restricted to the rights provided comprehensively under the statutory scheme. The Court favoured a strict application of the Insolvency Act 1986 (Act) and Rules. For example, the Court highlighted a gap in the legislation in confirming that statutory interest that accrues during an administration cannot be recovered in a later liquidation.

The Court also found that:

- A claim under section 74 of the Act for contribution from shareholders does not include a liability to meet statutory interest
- A section 74 claim is provable only by a liquidator
- Section 74 liabilities may not be set off against proofs filed by shareholders as creditors in an administration.

See the Court's full decision here.

Security for costs ordered against liquidator with litigation funder

The liquidators of a group of companies related to property investor, David Henderson, have recently been ordered to pay a substantial sum for security for costs to the former directors and auditors of the group. In *Walker & Ors v Forbes & Ors* the plaintiffs sue the former directors and auditors of the group for alleged breaches of duties. The proceedings have been allocated a trial of 12 weeks commencing in February 2018. We reported on disputes over the litigation funding arrangement in this proceeding in an earlier update.

The defendants sought additional security for costs to cover the stages up to and including the trial. In total the defendants sought security of approximately $3.642m.

The liquidators acknowledged that the proceeding was funded with the assistance of a litigation funder. The Court held that the existence of a litigation funder was an important factor that influenced the exercise of the discretion to grant security. Overall, the

Court assessed the merits of the claims against the defendants as largely neutral although made a small adjustment to reflect the merits in some areas. In total the Court ordered that the plaintiffs are to provide security for the costs and expert witnesses of the defendants (excluding Mr Henderson) in the global sum of $2.63m together with security for Mr Henderson's costs in the sum of $150,000.

See the Court's full decision here.

The Courts' limited jurisdiction to approve payment proposals

The Commissioner of Inland Revenue (Commissioner) appealed a decision of Associate Judge Christiansen to approve a payment proposal by Mr Wilson to discharge a debt he owed the Commissioner and thereby avoid a declaration of bankruptcy.

The Court of Appeal considered whether the High Court had jurisdiction, either inherent or under section 29 of the Insolvency Act 2006, to approve a debtor's payment proposal when that proposal had not been accepted by the creditor. Associate Judge Christiansen had cited the Court's inherent jurisdiction in approving the payment proposal, despite opposition from the Commissioner.

Applying a purposive approach to interpretation of section 29, the Court of Appeal held that this provision did not grant the High Court the power to approve a compromise proposed by a debtor unless the creditor had accepted the proposal. The Court held that while a creditor and a debtor could compromise a debt outside the comprehensive statutory regime, the Court had no inherent jurisdiction to do so. Furthermore, when the creditor is the Commissioner, the debtor may only seek to compromise a debt by applying for financial relief under sections 177 to 177B of the Tax Administration Act 1994.

See the full judgment here.

Insolvent gifts to trustees

In *Official Assignee v Carrim* the High Court considered the concept of a "gift" in the Insolvency Act 2006.

The Official Assignee sought to cancel insolvent gifts made by the bankrupt to complete a property purchase by a family trust settled by the bankrupt and Ms Carrim, the bankrupt's partner (as trustees). The High Court considered:

- The appropriate calculation for the sum gifted by deed to fund the property purchase to be ordered to be paid to the Official Assignee
- Whether a second sum was a gift.

In terms of the appropriate calculation, the High Court disagreed with the argument for Ms Carrim that it should deduct the full value of the original loan, or offset the payment of household costs by Ms Carrim.

While, on the evidence, the Official Assignee did not establish the second sum was a gift, the decision provides guidance on concept of "gift" in the Act and evidential requirements.

See the full decision here.

Trustee company property not subject to preferential treatment

The Supreme Court of Victoria has recently considered whether trust property is subject to the priority regime provided for in section 556 of the Corporations Act 2001 (Cth) (the Australian equivalent of New Zealand's Schedule 7 of the Companies Act 1993). It also considered whether a trustee's right of indemnity is subject to the obligations of receivers under section 433 of that Act, to pay employee entitlements in priority out of assets subject to a circulating security interest.

Amerind Pty Ltd was the trustee company of a trading trust that was in the business of manufacturing and distributing decorative and architectural finishes. Administrators were appointed by Amerind's director and its principal financier, Adelaide Bank, appointed receivers. Subsequent to their appointment, the receivers continued trading and a surplus existed once Adelaide Bank had been repaid.

The three primary issues for determination by the Court were whether:

- The receivership surplus was trust property or company property
- The priority regime set out in section 556 required the receivers to pay preferential debts from the surplus instead of paying it into Court pending determination of competing claims
- The trustees' right of indemnity was subject to section 433.

In relation to the first issue, the Court held that as Amerind had operated as a corporate trustee, the surplus constituted trust property. As to the second and third issues, the Court held that both sections 433 and 556 only apply to property of the company and do not include trust assets (nor the trustees' right of indemnity). Accordingly, the surplus and the right of indemnity were not subject to the preferential claims in either section.

The case continues the recent trend in the law that where a company operates as a trustee, preferential creditors do not enjoy the statutory priority to which they otherwise would be entitled.

See the full judgment here.

Is disclaimer effective to rid a company of its environmental obligations?

This question arose in Queensland recently in *Linc Energy Ltd (in liq): Longley & Ors v Chief Executive Dept of Environment & Heritage Protection*. The Supreme Court of Queensland found that the liquidators of Linc Energy were not justified in causing the company not to comply with an environmental protection order that required the company to maintain equipment that the liquidators had disclaimed.

Linc Energy had a pilot underground coal gasification plant in Chinchilla, Queensland. After Linc Energy was put into administration, the Queensland environmental authority issued an environmental protection order (EPO) requiring the company to keep on the land and maintain the equipment that was necessary to comply with the EPO. Linc Energy's creditors then put it into liquidation and its liquidators disclaimed the land and equipment associated with the pilot project. That disclaimer extended to any liabilities "in respect of" the disclaimed property. The liquidators sought the Court's guidance as to whether they were justified in causing the company not to comply with the EPO. The Court found that the EPO obligations were liabilities in respect of disclaimed property and as such there was a direct conflict between the disclaimer provisions in the Corporations Act 2001 (Cth) and the EPO provisions in the Environmental Protection Act 1994 (Qld). Based on the application of statutory priority provision, the Court held that the EPO provisions of the Environmental Protection Act 1994 (Qld) overrode the disclaimer provisions in the Corporations Act 2001 (Cth). As such, the liquidators were not justified in causing the company not to comply with the EPO. The judge was at pains to point out, however, that he had confined his analysis and directions to the specific set of facts.

There is no direct authority on this point in New Zealand. It is unclear whether a similar finding would be made here as there are pertinent differences between the environmental and insolvency regimes in Queensland and New Zealand. The timing and content of any enforcement order or abatement notice issued against the company under the Resource Management Act 1991, along with the scope of any applicable resource consent condition or rule will be relevant to whether a disclaimer would be held to be effective in ridding the company of its environmental obligations. However, there is New Zealand case law suggesting that the Courts do not view favourably the use of disclaimer to avoid environmental obligations when the liquidators have funds available to fulfil those obligations. In *Tubbs v Futurity Investments Ltd and Buchanans Foundry Ltd* [1998] 1 NZLR 471 (HC), the liquidators' application to disclaim capacitors containing hazardous substances was declined on the basis that disclaimer should not be used to transfer environmental obligations onto the Crown simply to increase the payout to unsecured creditors. In this case, the company in liquidation had sufficient funds to cover the disposal of the hazardous substances, even though it would not be able to satisfy its unsecured debts in full. *Tubbs* was decided under the previous disclaimer regime, which required liquidators to apply for leave to disclaim onerous property. Nonetheless, while liquidators no longer have to apply to the Court to disclaim onerous property, *Tubbs* is likely to be relevant if a creditor applies to the Court to reverse a disclaimer decision of a liquidator under section 284 of the Companies Act 1993.

It seems that the Crown is more likely to allow disclaimer of property burdened with onerous environmental obligations when there are no funds available in the company to discharge those obligations. In *Timaru District Council v R* [2016] NZHC 2170, there were no funds in the relevant company to remediate contaminated land that it owned. Various Crown agencies took a pragmatic approach to the disclaimer of contaminated land, so as to allow it to be remediated using Crown funds set aside for that purpose.

It is also important to note the judge's finding that the liquidators were 'executive officers' of the company for the purpose of s 493 of the Environmental Protection Act 1994 (Qld), which provides that executive officers commit an offence under the EPA if the company does. Section 340 of New Zealand's Resource Management Act 1991 similarly provides that if a company is convicted of an offence under the Act, "a person involved in the management of the defendant" is guilty of the same offence if it is proved that:

- The act or omission that constituted the offence took place with his or her authority, permission, or consent
- That he or she knew, or could reasonably be expected to have known, that the offence was to be or was being committed and failed to take all reasonable steps to prevent or stop it.

However, while liquidators would likely fall into the category of "a person involved in the management of the defendant", they could only be liable under that provision for breaches that occurred after the company came under their control and only if the enforcement authority had first been able to secure a conviction against the company. The enforcement authority would have had to have been given leave by the Court to pursue any such enforcement action against the company in liquidation.

Read the full Supreme Court of Queensland decision here.

Two halves make a whole in bankruptcy

In 2013, Mrs Hanara was adjudicated bankrupt. The Assignee subsequently disclaimed Mrs Hanara's half-interest in a Hastings property (the Interest), in which Mrs Hanara had very little equity. In 2016, the owner of the other half-share in the property, Mr Hanara, was also adjudicated bankrupt. The Assignee, acting in respect of both bankrupt estates, looked again at the likely equity that might be available in the property. The Assignee considered that, on its own, Mr Hanara's one half- share in the property would be unsaleable and therefore applied under s 119 of the Insolvency Act 2006 for an order vesting the Interest in herself, either as Assignee of the property of Mrs Hanara or Mr Hanara.

The Court found that while the Assignee had the requisite standing to apply under s 119, Mrs Hanara's estate did not suffer loss as a result of the disclaimer. The increase in equity only occurred due to the passage of time and because Mr Hanara had continued to make payments on the house to avoid a mortgagee sale. There must be more than a post-sale increase in value before loss or damage is proved.

On the other hand, Mr Hanara's creditors would suffer a loss as a result of the disclaimer as his one-half share in the property would not be readily saleable. The property would be sold as a mortgagee sale and the creditors would likely lose out on any dividends. The Court therefore considered it was fair to vest the Interest in the Assignee, in her capacity as Assignee of the estate of Mr Hanara.

See the Court decision here.

Media update

Last month the Insolvency Working Group released its second and final report, dealing with voidable transactions and Ponzi schemes. The Group's first report was released in July 2016 and dealt with regulation of insolvency practitioners and voluntary liquidations. In the second report, the Working Group make a number of recommendations on the voidable transaction regime and regarding protection from Ponzi schemes. In relation to voidable transactions, the primary recommendations were repealing the "gave value" part of the defence available to creditors with a view to increasing the protection available to creditors, and the reducing the period of vulnerability for voidable transactions from 2 years to 6 months where the debtor company and the creditor are not related. In reaction to Ponzi schemes, the report addresses potential ways that insolvency law and the Property Law Act might better protect the interests of investors in Ponzi schemes and speed up recovery processes. The Working Group suggested that Government consider whether there may be scope to amend the Property Law Act 2007 to aid the recovery of funds for creditors after the release of the Supreme Court's decision in *McIntosh v Fisk*.

The Ministry of Business, Innovation and Employment sought public submissions in response to the report, which were due on 23 June 2017. With the decision in *Fisk v McIntosh* now released, no doubt there will be further consideration of how investors in Ponzi schemes could be further protected. Read the full Working Group report here.

We reported the attempts to save flailing listed Australian law firm Slater & Gordon in our March update. Since then it has been reported that the firm has secured extra funding to keep the business going. A recent announcement by the firm reports that the agreement will provide up to $40m of working capital and discussions continue regarding recapitalisation. However the firm has also reported that it has received notice of an impending claim by shareholders alleging misrepresentations in the firm's financial statements. This is the third such claim to emerge and will no doubt represent an unwelcome distraction from the restructuring attempts.

Meanwhile, creditors of two failed UK firms have been told to expect minimal dividends from the firms' administrations. Cost of administering the closure of Liverpool firm First Stop Legal Services Limited (trading as GT Law) have increased, as have claims from unsecured creditors, resulting in a revision of the expected divided to creditors from 12p in the pound to 6.47p in the pound. Creditors of personal injury firm Prolegal have been told to expect a dividend of just 1.9 p in the pound.

Permission has been granted to Guardians of New Zealand Superannuation Fund to appeal to the UK Supreme Court against a Court of Appeal decision that comes out of the collapse of Portuguese Bank Banco Espirito Santo and concerns the transfer of most of BES's assets to a new institution, Novo Banco. The issue on appeal relates to the jurisdiction of the UK courts to determine issues consequent upon the reorganisation.

The President of the UK Supreme Court, Lord Neuberger, recently delivered the keynote speech at the International Insolvency Institute Annual Conference in London. Lord Neuberger focused issues of cross-border insolvency and the challenges facing the courts and the insolvency profession that arise in cross-border situations. He recognised some shortcomings in the common law in adapting to increased globalisation, but affirmed the judiciary's commitment to remaining attuned to the needs and realities of the commercial world.

Read the full speech here.

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