BUDDLE FINDLAY

Legal update on insolvency law - August 2017

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28 August 2017

The Court of Appeal has recently dismissed an appeal from the High Court's judgment (discussed in our September 2016 update) setting aside a compromise under Part 14 of the Companies Act 1993 after finding that the challenging creditors, who had voted against the compromise, had been unfairly prejudiced by the decision to call only one meeting of creditors.

In a unanimous judgment in *Trends Publishing International Ltd v Advicewise People Ltd & Ors* [2017] NZCA 365, the Court of Appeal has reinforced the importance of properly constituted voting classes for the purpose of Part 14, and provides useful guidance for those involved in creditor compromises, particularly where insider creditors are involved.

The fundamental issue was whether the High Court erred by taking into account creditors' economic interests for the purpose of class formation, rather than focusing solely on strict legal rights. There was also a jurisdictional issue as to the basis on which the Court could intervene – were Trends' various failings a material irregularity in the obtaining of a compromise, or were they better considered as causing unfair prejudice to the objecting creditors?

The Court of Appeal upheld Justice Heath's finding that a non-prescriptive, flexible approach to class composition is appropriate in the context of Part 14. It would be inconsistent with the broad discretion of the court under s 232(3)(c), where it may intervene if a compromise is unfairly prejudicial to a person or group, to have a rigid rule limiting separate classes on the basis only of different legal rights. The Court dismissed concerns that such an approach could cause fragmentation of the vote and that unworkable minorities could prevent legitimate compromises, noting they would be met by genuine compromises in the interests of creditors and the company. While a test focused solely on legal rights would be easier to administer, it carries significant risk, exemplified by the facts of this case. Insider creditors, who are likely to have a stake in the company not going into liquidation will be in a conflict position with third party trade creditors, even if the same legal rights are shared. It is unjust and impractical that they should be in the same voting class. The Court held that it will be left to the good sense of the proponents of a compromise and, if they do not show good sense, the courts, to decide when a difference in legal rights or economic interests between creditors is of sufficient gravity to warrant the creation of a class.

The Court noted the unusual features of the debt owed to insider creditors. One had obtained security from Trends only two months prior to the proposal. Then it abandoned most of that security so it could vote in favor of the compromise, despite it being clear that it would not participate in any distributions under the compromise. One obvious consequence was that the insider creditors achieved a position where they could dominate the voting. The Court concluded there could be no reason for abandoning the significant commercial advantage of security for voting power other than not wanting Trends to go into liquidation (which could have seriously adverse consequences for the directors or shareholders). As a result, the insider creditors are likely to have had a diametrically opposed interest in voting for a compromise than the other creditors.

Jurisdictionally, if classes have been incorrectly defined in the compromise, the court may intervene either on the basis of a material irregularity (s 232(3)(b)) or because the compromise is unfairly prejudicial to the objecting creditor (s 232(3)(c)). The Court does not necessarily have to analyse the correct definition of classes exclusively in terms of either ground, as both grounds may apply if there is an incorrect division of classes.

The Court of Appeal differed from the High Court in two respects. Unlike the High Court, the Court of Appeal considered that there had been a material irregularity as a result of Trends' failure to provide adequate information about its financial position to creditors, as required by s 229(2) of the Act. The provision of sufficient information for an informed assessment of the proposal is a key feature of the Part 14 regime, to ensure that a genuine majority is achieved. The Court also held that a creditor with a contingent claim should have been placed into a separate class to the other creditors (given that the debt to the creditor was disputed, it had different legal rights than those creditors whose right to repayment was uncontroversial). Concerns that the creditor could vote down the compromise could have been avoided by not including it in the compromise in the first place. A company can select the creditors with whom it wishes to compromise. Trends' desire to include that creditor in the compromise was not surprising: unless it was included, Trends would be at risk of liquidation (with an inevitable investigation into the affairs of the company and the actions of the directors), and the compromise with other creditors would be futile. However, the circumstances of Trends' dispute of the debt strongly suggested that the compromise was being used at least in part as a device to defeat the creditor's substantive claim.

Ultimately, the court concluded that the compromise was unfairly prejudicial to the challenging creditors because:

- Insider creditors should have been separated into separate classes, but were not
- The compromise process involving the insider creditors indicates a wish to keep control of the company and avoid liquidation
- Insider creditors had much to lose from a liquidation, and the challenging creditors much to gain
- Some of the actions of the insider creditors indicate commercial manipulation in order to control voting
- Insufficient information was provided, so that creditors could not properly assess the proposal
- One of the challenging creditors, with a contingent claim, ought to have been placed into a separate class or excluded entirely, but was not.

Seb Bisley (partner), Ollie Gascoigne (senior associate) and Jane Maltby (senior solicitor) of Buddle Findlay represented the challenging creditors in this matter.

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