The latest news on

Restructuring, recovery and insolvency

Newsletter Issue Number 33 February 2010

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Editorial

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Restructuring, recovery and insolvency

As I write this, the UK has just emerged from recession – just, marking the end of the lengthiest downturn for the country since the Second World War.

So, for the restructuring professional, time to put your feet up and relax? Nothing of the sort; we will be busy for some while yet. It's generally accepted that insolvency appointments tend to increase once recession ends as lenders are more prepared to crystallise losses in the knowledge that purchasers of assets are more plentiful as, at least in theory, will be the supply of credit.

This recession has been unlike any other before it with a slashing of interest rates keeping consumer spending from decimation and a reluctance by secured lenders to make formal appointments. They have been keen to ensure that the publicity surrounding alleged over-eager enforcement of the early 90s recession is not repeated. Instead, the hate figure this time has been the pre-pack, which despite valiant efforts by R3, other stakeholders and the Insolvency Service to prove its virtue, the perception is that no matter how much justification there is for the system, it will never be acceptable to the wider public. Will a new Government – of whatever colour – bow to the clamour for reform? We will have to wait to see.

New Real Estate Restructuring partner appointed....

Iain Thomas joined LG at the beginning of the year after 16 years with Mayer Brown (and predecessor firm Rowe & Maw) where he was head of real estate finance.

Iain qualified as a lawyer during the last property recession in the early 1990s when he was part of the team that advised SE Banken on the enforcement and restructuring of the Gamlestaden portfolio and also represented lenders (particularly RBS) and insolvency appointees in connection with anything to do with distressed real estate.

During his time at Mayer Brown, Iain was part of the highly regarded Real Estate Finance team representing lenders (including Nationwide Building Society, RBS, Aareal, Dekabank, Fortis, JP Morgan, Merrill Lynch, AIB and Bank of Ireland) in connection with many high value and landmark real estate financings (including the Citibank Tower and the Shard of Glass).

With the onset of the most recent recession, Iain's practice has turned full circle and he has recently been working with lenders in conducting reviews of their loan portfolios, advising on enforcement options and implementing restructurings (both consensual and non-consensual). We are delighted to welcome Iain to the team.

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Tour of duty

Tallyia-Marie Charalambous & others v B&C Associates & another

[2009] EWHC 2601 (Ch)

An administrator, Ms Filippa Connor, and B&C Associates, the partnership in which she was a partner, applied to strike out claims issued by Mrs Martha Charalambous and her two children, Bradley and Tallyia-Marie, alleging Ms Connor's negligence or misfeasance in the conduct of a company's administration.

Bradley and Tallyia-Marie were the beneficiaries of a trust fund which owned Hickory Holdings Limited. Hickory had made a secured loan to Henry Charles Limited, the company in administration, of which Mrs Charalambous' husband was managing director. Henry Charles went into administration and Mrs Charalambous subsequently petitioned for divorce. Following ancillary relief proceedings, Mrs Charalambous received no financial provision from her husband as he had no assets. It was the court's intention that Mr and Mrs Charalambous' children would obtain the benefit of the disposal of Henry Charles' assets, via repayment of the secured loan to Hickory, and thereby to the trust of which the children were beneficiaries.

However, nothing was realised for Henry Charles' creditors and Mrs Charalambous and her children issued proceedings seeking damages for the administrator's negligence or wrongful misappropriation in her conduct of the administration. Ms Connor and her partnership applied to strike out the claim on the basis that it disclosed no cause of action or had no reasonable prospect of success. It was contended that Mrs Charalambous was an unsecured creditor, and the general rule is that no duty of care in tort was owed by an administrator to an unsecured creditor unless a special relationship existed between them. It was further argued that the children were not creditors, merely the beneficiaries of a trust which owned a company which was itself a creditor, so that the necessary special relationship did not exist.

The judge found that there was no evidence of a special relationship between the administrator and Mrs Charalambous or her children and therefore no duty of care was owed. The fact that the administrator knew Mrs Charalambous and her children needed (and were relying on receiving) the proceeds of realisation was not sufficient to create a special relationship. The whole point of the administration had been to realise cash for payment to the trust and there was no suggestion that the sale proceeds of Henry Charles' assets would be enough to pay off the administration costs and capital and interest owing under Hickory's secured loan and leave a surplus for unsecured creditors.

Comment

This is an important case for administrators as it clarifies the position in relation to their duties in an administration. This case makes it clear that, save where there is some other form of special relationship, an administrator owes no general common law duty of care to unsecured creditors in relation to the conduct of the administration.

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Not all creditors are created equal

Re Zegna III Holdings Inc: BLV Realty Organization Limited and another v Batten and others

[2009] **EWHC 2994 (Ch)**

In Re Zegna III Holdings Inc, the High Court ruled that an administrator did not have to treat all creditors in an identical way in order to satisfy his duty to act in the interests of creditors as a whole, providing the administrator had sound, commercial reasons to justify the unequal treatment.

Zegna III Holdings Inc ("Zegna") was a BVI incorporated special purpose vehicle set up to carry out a property development project. Zegna subsequently entered into an agreement with BLV Realty Organisation Limited ("BLV") whereby BLV would provide management and co-ordination services in relation to the property. The project overran and overspent. Zegna defaulted under its loan facility with the Royal Bank of Scotland plc ("the Bank"), which was secured by fixed and floating charges. Zegna also failed to settle BLV's invoices. The Bank applied to court to have administrators appointed over Zegna and the court agreed to make the order.

On receipt of evidence from sub-contractors, the administrators decided that BLV lacked the competence to complete its obligations under the agreement and concluded that another contractor would be able to do the job at a lower cost. Having been advised by their lawyers (who, together with the administrators, had previously advised the Bank) that Zegna had good grounds for terminating the contract for breach of duty on BLV's part, the administrators accordingly gave notice that they wished to terminate the agreement.

BLV took issue with the termination and applied to court to have the administrators removed under paragraphs 74 and 88 of Schedule B1 of the Insolvency Act 1986 ("the Act"), arguing that the administrators had failed in their statutory duty to act in the best interests of creditors as a whole or, alternatively, that BLV had suffered unfair harm by the administrators' decision to terminate the agreement. BLV asked the court to make an order that would provide, amongst other things, for the administrators to settle BLV's outstanding pre-administration invoices and retain BLV as development manager on the terms provided for in the agreement. It also suggested that the administrators and their lawyers were conflicted because of their previous relationship with the Bank.

On hearing the application Mr Justice Norris expressed serious reservations as to whether it was possible at such a hearing for the court to determine whether the administrators had been wrong to terminate the agreement. The judge considered that such a judgment could only be made following a full trial on the issues.

The judge rejected BLV's suggestion that the administrators were conflicted and so should be removed from office on the basis that both their firm and their lawyers had previously advised the Bank. The judge found that there was no evidence that the administrators' objectivity in deciding to terminate the agreement had been compromised by their relationship with the Bank.

The judge also noted that administration is a class remedy and the duty to treat creditors fairly did not necessarily mean treating all creditors equally and in an identical way. Indeed there may be cases where it is in the interests of creditors as a whole to terminate a particular contract with a particular creditor. Moreover, the court in this case did not accept that BLV's interests as a *creditor* had been harmed; rather its interests as a *contractor* were affected as its agreement had been terminated while other contractors were retained. The application appeared to the judge to be an attempt to enforce the agreement, cloaked in an application concerned with whether the administrators were best placed to conduct the administration. In the circumstances, the court refused to grant the order sought.

Comment

The judge in this case was keen to stress that unequal treatment of creditors will not necessarily result in "unfair harm" within the meaning of paragraph 74 of Schedule B1 of the Act. The decision will be welcomed by practitioners as another example of the court deferring to the commercial judgment of officeholders. The court made it clear that, providing such a judgment is not taken in breach of any law and is not clearly unfair, the court will be loathe to interfere with an administrator's commercial decision.

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Expensive rent

Goldacre (Offices) Limited v Nortel Networks UK Limited (in administration)

[2009] EWHC 3389 (Ch)

In *Goldacre (Offices) Limited v Nortel Networks UK Limited (in administration)* the High Court ruled that rent for premises that continue to be used for the beneficial outcome of an administration must be paid in full in accordance with the terms of the lease as an expense of the administration.

This case concerned Nortel Networks UK Limited (in administration) ("Nortel") who occupied leasehold property under two long leases, both pre-dating the date of the administration, between itself and its landlord, Goldacre (Offices) Limited ("Goldacre"). The administrators of Nortel considered that Nortel needed to occupy a small proportion of the total premises for the purposes of the administration. The administrators continued to pay the rent, albeit late in relation to the most recent quarter. It was accepted by the administrators that interest in respect of that late payment would be paid. There were sub-tenants of other parts of the premises and notices were served that had the effect of transferring Nortel's right to receive the rent to Goldacre. Goldacre applied to the High Court for an order directing that the administrators pay the full rent due in relation to the whole property as an expense of Nortel's administration.

Where possible, it has been the custom and practice for administrators to be appointed shortly before the rent quarter date to ensure that the moratorium is in place to prevent a landlord taking enforcement action for non-payment of rent. If the company required use of the premises, the administrators would pay an apportionment of the rent for the duration of occupation. As and when the company stopped using the premises, the administrators would stop paying the rent on that apportioned basis.

However, Goldacre argued that, under established case law, once the administrators decided that the company was to continue to use *any* part of the premises for the beneficial outcome of the administration the administrators became liable to pay the rent as it fell due, in full, as an expense of the administration. Goldacre contended that this followed from the Insolvency Rules 1986 as amended following the enactment of the Enterprise Act 2000. The judge agreed that the matter should be considered exclusively by reference to the rules and that if the rental liability falls within the rules, then that is payable as a matter of mandatory obligation, not as a matter of discretion, either on the part of the administrators or on the part of the court.

The relevant rule in respect of administration is rule 2.67(1), which contains a list of expenses payable in the following order of priority: (a) refers to "expenses properly incurred by the administrator in performing his functions in the administration of the company"; (f) refers to "any necessary disbursements by the administrator in the course of administration…".

The judge found that if rent does not fall within (a) then it falls within (f) – the disbursement was a necessary one because the application of the *Lundy Granite* principle requires rent to be paid. Under this, liquidators were held liable to pay rent as a liquidation expense where the liquidators made use of or retained, for the benefit of the liquidation, possession of leasehold premises. The same principle applies in an administration.

The administrators argued that a disbursement could only be regarded as necessary if the administrators chose to make it or if the court, founding itself upon some proper jurisdictional basis, ordered it. They also submitted that there was a distinction between the rules applying to liquidations and those applying to administrations and that they should only pay a proportionate amount of the rent attributable to the floor space that the company occupied.

However, the court ruled that the quarter's rent became payable in full from the quarter date as one of the costs and expenses of the administration and would not be apportioned should the administrators vacate the premises during that quarter. In other words, where administrators make use of, or decide to retain the property, the rent payable in accordance with the terms of the lease ranks as an expense of the administration. This decision confirms that the court has no discretion in these circumstances and that it does not matter if only *part* of the premises are being used. Although the case establishes the priority of the liability of a company in administration to pay rent, it does not oblige the administrator to pay the rent immediately upon it falling due, if the administrator does not have sufficient funds to do so.

Comment

This case has not been appealed and the time limit for doing so has now expired. As a result, further guidance on this decision may not be obtained until the same point arises in another case which either distinguishes this decision or reaches the Court of Appeal. This case has potentially wide-reaching implications and may well result in a very different way of dealing with administrations.

The case has a number of important practical consequences for IPs and the way in which administrations are conducted, for example:

1. It is now clear that if a company in administration is in occupation of property under a lease on a particular quarter day, a full quarter's rent will become due in accordance with the terms of the lease, notwithstanding that the company may only occupy part of the premises and even though that the company may vacate the premises at some time during the quarter.
2. It is clear from the judgment that it is not actually necessary to pay the rent on the quarter day but it is necessary to accrue for it as a liability and ultimately pay it given that the rent liability will enjoy the benefit of the statutory charge as an administration expense.
3. It is always open, of course, for an administrator to seek to agree a variation to the terms of the lease with a landlord. The ability to do so will depend upon the strength of both parties' negotiating position and the landlord's desire to recover possession of the property.
4. The case has important consequences for the granting of licences to occupy to purchasers as part of business and asset sales. Whether or not a licence is intended as a short term arrangement to allow assets to be removed or with a view to the purchaser obtaining an assignment of the lease, it is important to tie in the end of the licence with the end of rent quarter periods. For example, if a licence were to end on 1 April, as a result of this case, the whole of the March quarter will fall due by virtue of the property being occupied for the benefit of the administration as at the March quarter day. Protection under licences can be achieved either by ensuring that payment is received in advance on shorter licences or, for example on longer licences, including a requirement to make payment of licence fees ahead of the quarter day and, if payment is not received, terminating the licence ahead of that quarter day.
5. The case also potentially presents some of the difficulties caused in the past by cases such as Paramount and Spectrum Plus in that it amounts to a statement of the law as it always has been, ie it will have retrospective effect. Landlords may seek to re-open existing or closed cases where an administrator has vacated the property part way through a quarter and paid rent corresponding to the period of occupation only. The landlord may now seek to recover the full quarter's rent for the quarter during which the administrator vacates. It will therefore be important, where a licensee has occupied under a licence, to check the terms of that licence to see whether the indemnities provided are sufficiently widely drawn to give the administrator a claim.
6. There is an element of positive news for administrators in the case. This stems from the timing of the obligation to pay rent. Whereas in most leases, tenant's covenants are framed in terms of continuing obligations (for example, to maintain the property, not to part with possession etc), the covenant to pay rent is a covenant to pay rent on the quarter day. This case does not therefore mean that if the administrator is not in occupation and is not benefiting from the property on the quarter day, the administrator has to pay rent as an administration expense for that period. In other words, if the administration commences on the day after the quarter day, there is no liability to pay rent as an administration expense as a result of this case.

However, there is a very important limitation to this piece of positive news: the landlord will be in a position to apply for leave to forfeit the lease already as a result of the administration and will have a further ground for forfeiture for non payment of rent, usually within 14 days of the quarter day. The only ground upon which an administrator will be successful in obtaining relief from forfeiture will be on the basis the rent is paid up to date. This apparent loophole, therefore, is only likely to be of benefit where the property is needed for a short period and there is no prospect of a purchaser seeking an assignment of the lease.

In summary, the case means:

- Greater analysis will be needed in relation to the timing of the commencement of administration;
- More analysis will be needed early as to whether a property is needed in the short, medium or long term and, in particular, whether a purchaser will want to take an assignment of the lease;
- The case stresses the importance of occupation on the quarter day and potentially the need to vacate prior to those days;
- The drafting of licences to purchasers will need careful attention, and in particular, their duration, termination provisions and the timing of the payment of licence fees.

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Sign away

Carson Country Homes Limited (in administration)

[2009] EWHC 1143 (Ch)

In previous years we have looked at a number of contested administration applications. However, what happens on an out of court appointment of an administrator by a qualifying floating charge holder where it subsequently turns out that the debenture under which the appointment was made contained a forged signature? This was the issue in the case of Carson Country Homes Limited (in administration).

Carson Country Homes Limited ("CCH") was a property development company which owned commercial and residential property in Oxfordshire. At the relevant times, CCH had two directors; Mr Andrew Jewson and Mr Edward Carter. Mr Jewson was also the company secretary. CCH had three shareholders; a company called SGJ Limited ("SGJ") which owned 100 ordinary shares, Mr Jewson, who owned 32 ordinary shares, and Mr Carter, who owned 68 ordinary shares and an "A" share. SGJ was a company owned by the Jewson family. SGJ itself had varying substantial commercial interests including property holdings and developments. Both CCH and SGJ banked with the same bank ("the Bank").

There were other connected companies, in particular, a company called Carson International Limited ("Carson International") which was involved with property development in Turkey, and Jewson Europe Limited ("Jewson Europe") which was involved with property development in Ibiza.

Mr Jewson was entrusted with the handling of all administrative and financial matters relating to CCH and was styled its financial director. Mr Carter concerned himself more with the practicalities and operational aspects of the property developments themselves and with the operations in Turkey of Carson International. Indeed, Mr Carter at no stage during CCH's operations had any meeting, even though on occasion invited, with anyone from the Bank, which thus, in effect, only knew him as a name. Mr Carter was, throughout, content to leave all dealings on behalf of CCH with the Bank to Mr Jewson.

Very unusually, Mr Carter allowed Mr Jewson to sign documentation with Mr Carter's name, as long as Mr Carter knew in general terms what was happening. This meant that third parties dealing with CCH would be given documents which appeared to have been signed by both Mr Jewson and Mr Carter whereas in reality, Mr Jewson had signed his own signature and reproduced Mr Carter's signature.

The Bank became concerned about the group position. By April 2008, the Bank had lent some £8.7 million to SGJ and £300,000 to CCH. The Bank was particularly concerned to learn that, out of the funding provided by the Bank to SGJ, some £1.9 million had at that time been lent on by SGJ without any security to CCH, which in turn had lent on significant sums, again on an unsecured basis, to Carson International and Jewson Europe.

In June 2008, the Bank demanded a cross guarantee and debenture from CCH in return for its continued support of SGJ. Mr Jewson signed the documents with his signature and with Mr Carter's signature and returned them to the Bank. He did not tell Mr Carter that he had counterfeited his signature in this way, or even that CCH had given the Bank a cross guarantee and debenture because Mr Jewson wanted to placate the Bank and avoid a possible dispute with Mr Carter.

At this time, Mr Jewson and Mr Carter had been in discussions about splitting up CCH and dividing the assets or proceeds of the assets between the shareholders.

The relationship between Mr Jewson and Mr Carter then deteriorated and the Bank became increasingly concerned about CCH's ability to recover the inter-company loans which it had made to Carson International and Jewson Europe. On 21 January 2009, the Bank appointed administrators over CCH using the out of court route under paragraph 14 of Schedule B1 of the Insolvency Act 1986. The appointment therefore relied on the validity of the debenture. Following the appointment, the administrators learnt from Mr Jewson that he may have reproduced Mr Carter's signature on the debenture and Mr Carter then challenged the appointment claiming that the debenture was a forgery and that he knew nothing about the debenture. The administrators subsequently applied for directions as to the validity of their appointment.

The formalities of execution of deeds by a company are well known; the common seal must be affixed, or the document must be signed by two "authorised signatories" (ie. directors and a company secretary) or a director in the presence of a witness (section 44(2) Companies Act 2006 ("CA 2006")). The guarantee and debenture had clearly not been executed in accordance with these rules. However, section 44(5) CA 2006 provides that: "In favour of a purchaser a document is deemed to have been duly executed by a company if it purports to be signed in accordance with sub-section (2) … A "purchaser" means a purchaser in good faith for valuable consideration and includes a lessee, mortgagee or other person who for valuable consideration acquires an interest in property". The Bank had acted in good faith, and the court concluded that it gave valuable consideration by its continued support of the group of companies to which CCH belonged. The main issue for the court was whether section 44(5) CA 2006 could validate documents which are forgeries.

Mr Justice Davis decided that, on the facts, Mr Jewson had ostensible authority on behalf of CCH to warrant to the Bank that all formalities relating to the execution of the guarantee and the debenture had been complied with and that the signatures were genuine. This was based on the longstanding practice of Mr Carter allowing Mr Jewson to handle all of CCH's dealings with the Bank and to counterfeit his signature on other documents. Having reached this conclusion, it was unnecessary to decide whether section 44(5) CA 2006 would validate a document with a counterfeit signature in a case where the person delivering the document to the Bank had no actual or ostensible authority to warrant that the signature was genuine.

Comment

The facts of this case were very unusual. Even in the most informally run companies, directors do not regularly counterfeit signatures of other officers of the company who are not there to sign in person. It remains to be seen how section 44(5) CA 2006 will work where the person delivering the document had no actual or ostensible authority to warrant that the signature was genuine. In the meantime, lenders may now wish to consider whether it would be prudent in certain cases to arrange for security documentation to be signed in the presence of the borrower's solicitor, to ensure that the signatures really are genuine.

Creditors' rights

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Flipped away

Perpetual Trustee Company Limited and Another v BNY Corporate Trustee Services Limited and Another

Butters and Others (Joint Administrators of WW Realisation 8 Limited) and Another v BBC Worldwide Limited and Others

[2009] **EWCA Civ 1160**

This case involved conjoined appeals arising out of the Lehman and Woolworths insolvencies concerning the extent of the so-called anti-deprivation rule which invalidates a contract that has the effect of transferring a person's property to another and taking it away from his creditors on bankruptcy.

In the Lehman case, a Lehman sponsored SPV issued loan notes and used the proceeds to pay for government bonds and other investments (the collateral). The SPV also entered into a swap agreement with Lehman Brothers Special Financing Inc ("LBSF"). The collateral was charged by the SPV to a trust corporation as security for the noteholders and LBSF.

The trust deed, under which all the parties had set out the rules regulating their rights in the collateral, stated that if an event of default occurred under the swap agreement and LBSF was the defaulting party the noteholders were to have priority over LBSF. Otherwise LBSF was the party that had first priority to the collateral. When Lehman Brothers Holding Inc (which was a credit support provider for LBSF under the swap) filed for Chapter 11 protection, that constituted an event of default for the purposes of the swap. There were other events of default relied upon by the noteholders, including LBSF's own filing for bankruptcy protection in the US. The noteholders applied for a declaration as to their position.

At the first hearing the judge decided that the priorities of payment provided for by the contractual documentation were valid and enforceable. LBSF appealed the decision but the Court of Appeal upheld the decision of the lower court. The Court of Appeal emphasised a number of points which led to its conclusion:

1. the flip in priority did not divest LBSF of an asset that was vested in it. Any rights LBSF had to the proceeds of any realisation of the collateral were always contingent in the sense they were always subject to the reversal of priorities in favour of the noteholders if a Lehman entity defaulted;
2. the assets over which the parties argued were acquired with the noteholders' money. The Court of Appeal thought that the rule was not applicable where the person in whose favour the deprivation provision worked was the person who had provided the money to acquire the assets in the first place;
3. the flipping of priorities had many of the characteristics of termination provisions common in leases or licences that gave the grantor the right to determine the lease or licence on insolvency. There was a long line of cases which made it clear such provisions were effective and the priority agreement was similar to these forms of agreement;
4. the court felt it was highly desirable to respect party autonomy in this context. The Court of Appeal's view was that where complex arrangements of this type were concluded between sophisticated parties having the benefit of expert advice, they should be given effect to in the interests of market certainty – particularly where an insolvency had occurred; and

5. the court said that even if the flip provisions had engaged the rule the deprivation of assets of LBSF had been effected prior to the insolvency of LBSF. It was triggered by the earlier insolvency of Lehman Brothers Holdings Inc. The rule was clear – any deprivation of assets effected prior to the insolvency of LBSF was not caught by the rule.

The other case considered by the Court of Appeal arose out of the termination of certain joint venture arrangements between the BBC and Woolworths group companies – the latter having gone into administration. The issue was whether a provision which allowed the BBC joint venturer to acquire the shares in a joint venture vehicle at “fair value” was void because it infringed the rule. This option to acquire shares was linked with a provision in a licence agreement by the BBC in favour of the joint venture company relating to the BBC’s extensive video and DVD catalogue. The terms of this licence allowed the BBC entity to terminate it on the insolvency of any Woolworths company. Termination of the licence would inevitably diminish the value of the shares in the joint venture company. Consequently, what amounted to “fair value” after the licence terminated would clearly be less than it would be prior to its termination. The administrators of Woolworths argued that the effect of the licence coupled with the option to acquire shares in the JV agreement was essentially to permit the BBC to forfeit valuable assets on the insolvency of the Woolworths companies. However, again, the Court of Appeal decided that the anti-deprivation rule did not apply:

1. the licence provision was clearly valid because of the long line of cases relating to leases and licences of land (in which a lessor or licensor is entitled to terminate if a lessee or licensee goes into insolvency process);

2. the option in the JV agreement did not offend the rule because it was clear fair value had to be paid to the seller of the shares. Had fair value not been payable then the rule would have been engaged and the option would have been invalid;

3. the fact the licence and option were part of the same suite of documents and linked in that both could be triggered by the same circumstances did not alter the fact that both were valid. The court reiterated its view that where parties enter into complex arrangements with the benefit of expert advice these should be upheld; and

4. as the relevant provisions were triggered before the onset of formal insolvency proceedings in relation to the relevant counterparties, the rule against forfeiture did not apply. Both provisions were triggered not by the administrations of the counterparty itself but by the parent company of the Woolworths group. The clear time limit on the operation of the rule was not one that the court felt it should extend to upset transactions prior to the insolvency of the relevant counterparty.

Comment

The anti-deprivation rule prevents debtors entering into transactions where the insolvent estate is “deprived” of an asset if a debtor enters an insolvency process. So, the transfer of an asset to a debtor “unless you become bankrupt, whereupon title to the asset reverts to me” is contrary to that rule and is not permitted. This case provides useful guidance on the rule in situations which are much more factually complex.

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Going Dutch

Michael Holland v The Commissioners for H M Revenue and Customs (Re. Paycheck Services 3 Limited)

[2009] EWCA Civ 625

Mr and Mrs Holland were directors of Paycheck (Directors' Services) Limited ("Paycheck") which in turn was the corporate director of 42 composite companies, structured to avoid liability for higher rate corporation tax. The composite companies traded between 1999 and 2004 and paid dividends on the basis that only small companies' rate corporation tax was due.

H M Revenue and Customs ("HMRC") claimed that the composite companies were not entitled to rely on the statutory concession. Mr and Mrs Holland sought legal advice on the issue and it was found that the scheme was flawed as the composite companies were in fact associated, with the consequence that each company was liable to pay tax at the higher rate. Mr and Mrs Holland had not made provision for this and had declared and paid dividends which should not have been paid, given that there were insufficient distributable reserves to permit this. The companies were therefore insolvent and were placed into administration on 19 October 2004, and creditors' voluntary liquidation in February 2005. The total deficiency in the insolvencies was some £3.5 million in respect of unpaid corporation tax.

Neither the administrators nor the liquidators brought any claims against Mr and Mrs Holland, but HMRC took a different view. While the only director of the composite companies was the corporate director, Paycheck, HMRC alleged that Mr and Mrs Holland were also de facto directors. HMRC further claimed that Mr and Mrs Holland were in breach of duty as de facto directors of the composite companies and brought claims against them for misfeasance under section 212 of the Insolvency Act 1986 ("the Act").

At the hearing of HMRC's claim on 4 July 2008, the case against Mrs Holland was dismissed. The court ruled that Mr Holland was a de facto director of the composite companies, and consequently liable to HMRC. Mr Holland was ordered to repay the dividends wrongly paid *after* the date on which he had received legal advice on the issue. The judge also limited Mr Holland's liability to the increased deficit in higher rate corporation tax accruing for the same period under the discretion afforded to him under section 212 of the Act. Mr Holland appealed the decision.

On appeal, the Court of Appeal overturned the earlier decision and found that Mr Holland was not a de facto director of the composite companies. On reaching its decision the court declined to follow the decision in *Secretary of State for Trade and Industry v Hall and Nuttall* (2006) EWHC 1995. Lord Justice Rimer applied the principles expressed by Mr Justice Millet in the context of shadow directorship in *Re. Hydrodam (Corby) Limited* (1994) 2 BCLC 180 and concluded that a director of a corporate director will only become director of the subject company if he steps outside the confines of his role as a member of the board of the corporate director and acts directly in relation to the affairs of the subject company. Lord Justice Rimer emphasised that he was not suggesting that there would *never* be circumstances in which a director of a corporate director will be regarded as a de facto director of the subject company, but that something more would be required other than the mere performance, by him, of his duties as an actual director of the corporate director. On the present facts, this was not the case, and Mr Holland was not liable to the creditors of the composite companies.

The Court of Appeal also considered what the liability of Mr Holland would have been *had* he been liable to the creditors concerned. Would his liability to repay the dividends lie in either damages for the breach of the common law duty to the companies or restitution of the unlawful dividends unlawfully paid? Lord Justice Rimer applied the case of *Bairstow and Others v Queens Moat Houses plc* (2001) 2 BCLC 531 and stated that directors have trustee-like responsibilities because of their duty to manage the company's business in the interests of all its members. Therefore, the remedy was one of restitution which would require the director to reinstate the amount of the unlawful payment rather than damages for loss suffered (which might be less).

Comment

This case brings some certainty to the issue concerning de facto directorship, supporting the principle that membership of the board of a corporate director will not, without more, make such member a de facto director of a company.

This case also provides clarity to the principle that the remedy for causing loss to a company for paying unlawful dividends is restitution rather than damages for loss.

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Man recognised

MK Investments and MK Aircraft Leasing

Unreported (22 August 2008)

In a case decided by the High Court of the Isle of Man, the appointment of administrators in the UK over an Isle of Man incorporated company whose COMI was held to be located in the UK has been recognised in the Isle of Man.

Article 16 of the EC Regulation states that any judgment opening insolvency proceedings handed down by a court of a Member State which has jurisdiction to open main proceedings shall be recognised in all other Member States from the time that it becomes effective in the jurisdiction of main proceedings. Article 19 provides that the authority of the officeholder shall be recognised upon production of a certified copy of the officeholder's appointment issued by the court which has jurisdiction. The well documented case of BRAC Rent-a-Car International Inc confirmed that the EC Regulation assigns jurisdiction to the courts of the UK to open insolvency proceedings in relation to a company incorporated outside the European Union where the company's COMI is located in the UK. In that case, the company was incorporated in the United States but conducted its operations almost exclusively from the UK. The decision in MK Investments and MK Aircraft Leasing has added to the body of case law in this area confirming that English insolvency procedures may apply to companies registered overseas.

MK Investments and MK Aircraft Leasing Limited ("the Companies") were incorporated and had assets in the Isle of Man. The assets were deposits in accounts held with Standard Bank Isle of Man Limited and Credit Suisse. However, the main business of the Companies was at all material times carried out in England. On 10 June 2008 the directors appointed administrators in the UK under paragraph 22 of Schedule B1 of the Insolvency Act 1986, and an order was subsequently sought from the High Court of Justice of the Isle of Man recognising their standing in that jurisdiction. The administrators also sought a declaration that they could realise all assets of the Companies located in the Isle of Man.

The court noted that there was ample legal authority to support the notion that it had jurisdiction to recognise and grant assistance to foreign officeholders under the principles of private international law. The court concluded that the administrators had been validly appointed under English law as the Companies Court had endorsed the notices of appointment and accordingly their appointment would be recognised within the jurisdiction of the Isle of Man. Reference was made to Lord Walker's judgment in *Walker v Lundborg* (6 March 2008) in which it was said that:

"Under general principles of private international law one country will usually recognise the status of a trustee in bankruptcy (or similar officer) appointed by another country, and will also recognise his title to moveable (but not immoveable) property situated in the recognising country".

The court therefore made the order sought, while being careful to point out that the court has a discretion to refuse recognition and assistance if the interests of justice so require.

Comment

This decision is interesting because there has always been doubt as to whether the out of court appointment of an administrator will be recognised under the EC Regulation. The reason for this is that the wording of article 16(1) regarding the recognition of insolvency proceedings refers to "any judgment opening insolvency proceedings **handed down by a court of a Member State**" (emphasis added). An out of court appointment becomes effective upon the court sealing the notice of appointment and it has not been clear whether article 16 therefore required a court order or whether the court clerk simply stamping the notice with the court seal would suffice. As a result, conventional practice has been to adopt a cautious approach whenever it may be necessary for other Member States to recognise insolvency proceedings as main proceedings and apply to court for an order appointing administrators.

This decision of the High Court of the Isle of Man appears to confirm that the court seal will qualify as a judgment "handed down by a court". Notwithstanding this decision, whenever there is doubt surrounding a debtor's COMI it is still advisable to obtain a court order approving the appointment as there is no guarantee that other Member States will adopt the same interpretation of article 16 as the Isle of Man.

Liquidation

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There's no one home

In the matter of Teeside Operating 2 Limited

In the matter of Flotilla Power (UK) Limited

[2009] EHWC 2544 (Ch)

Teeside Operating 2 Limited and Flotilla Power (UK) Limited were both restored to the Register of Companies as they owed monies to their parent; Enron (Europe) Limited.

Following the restoration to the register both companies nominated a liquidator and summoned a meeting of their respective creditors within 14 days. When the liquidator attended the meetings there were no creditors present and no creditors gave a proxy.

Section 165 of the Insolvency Act 1986 ("the Act") confers extensive powers upon a liquidator following a meeting of the creditors. Section 166 of the Act states that the powers conferred under section 165 may only be exercised before the holding of a creditors' meeting if the sanction of the court has been granted. Similarly, if a creditors' meeting was not held the sanction of the court would be needed to enable the liquidator to exercise his powers.

Rule 12.4A of the Insolvency Rules 1986 governs the procedure of a creditors' meeting; it states that a quorum for such a meeting is at least one creditor entitled to vote (a creditor may also be present by virtue of a proxy vote). If a quorum is not present then the meeting is not competent. However, does this mean that no meeting is held? The judge opined that it was difficult as a matter of ordinary English to assert that a meeting has been held if no relevant person was in attendance.

He emphasised that the Act requires a meeting of creditors, not a meeting of the liquidator, who was required to be in attendance owing to the provisions of the Act, and others. The judge concluded that if no creditor was present in person, or in proxy, then the meeting could not have been held.

The judge supported this conclusion by providing rule 4.108(6) of the Insolvency Rules 1986 as an example. This concerns the resignation of a liquidator. Rule 4.108(6) requires a meeting of the creditors and expressly provides that if there is no quorum at the meeting of the creditors then the meeting will still be deemed to be held. The presence of such a deeming provision supports the view that, in other cases where quorum is not achieved, the meeting will not have been held.

A failure to hold a creditors' meeting is not an absolute bar on a liquidator exercising its powers. Section 166 of the Act allows for the sanction of the court to be sought to allow the liquidator to use its statutory powers as set out in section 165.

Comment

A meeting with creditors will not be deemed to have been held if no creditors are in attendance at the meeting or have given a proxy. However, a liquidator should be granted the sanction of the court to exercise his powers under section 165 of the Act if he has attempted to hold a meeting but a quorum was not present at the meeting.

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All gone

Internet Investment Corporation Limited

(2009) EWHC 2744 (Ch)

In this case, the court discussed the merits of compulsory liquidation over creditors' voluntary liquidation and commented on section 116 of the Insolvency Act 1986. This provides that the voluntary winding up of a company does not bar the right of any creditor or shareholder to have it wound up by the court, but in the case of an application by a shareholder the court must be satisfied that the rights of the shareholders will be prejudiced by a voluntary winding up.

Internet Investment Corporation Limited ("IIC") had been incorporated to manage fund-raising to further the development and exploitation of an invention pending patent devised by Mr Scott, who was both the majority shareholder in IIC and its only director. In 1999, Mr Goldsmith contributed payments totalling £100,000 to IIC under two written agreements dated 1 September 1999 and 19 October 1999. In return, he became the holder of a minority of the ordinary voting shares in IIC and the only holder of a block of non-voting preference shares.

Mr Goldsmith subsequently attempted to discover what had been done with his investment but claimed that he was consistently refused any information and that his reasonable inquiries were met with nothing but aggression and abuse by Mr Scott.

After an unsuccessful attempt to persuade the Companies Investigation Branch of the Insolvency Service to investigate the affairs of IIC, Mr Goldsmith petitioned the court for the compulsory winding up of the company in August 2008. Mr Scott's response was to call an extraordinary general meeting of IIC in which, in Mr Goldsmith's absence, he and his son (a minority shareholder of the company), voted in favour of the voluntary liquidation of IIC.

In evidence, Mr Scott admitted that he had paid Mr Goldsmith's investment monies into his personal account. He accepted that, contrary to the clear impression to be derived from its accounts, IIC had never opened a bank account or held any money in its own name. He also accepted that the money invested by Mr Goldsmith had not been dealt with in accordance with the agreements between himself and Mr Goldsmith. However, he argued that a voluntary liquidation would be less likely to threaten a beneficial outcome to the project than a compulsory liquidation.

Mr Goldsmith, on the other hand, argued that in view of the fact that he had been refused any information as to the use and deployment of his investment, nothing short of the compulsory liquidation of IIC would give him any prospect of having Mr Scott's custodianship of IIC's business and assets properly investigated or any prospect of him ever obtaining any return on his investment.

The court ruled that in considering whether it should order a compulsory winding up in preference to a voluntary winding up, a reasonable requirement that the company's affairs should be scrutinised by the process that followed a compulsory order could weigh strongly in favour of a compulsory liquidation. This principle was equally applicable to a shareholders' petition, subject to the requirement that the shareholders demonstrate to the court's satisfaction that the shareholders' rights would be prejudiced by a voluntary winding up as stated in section 116 of the Insolvency Act 1986.

On the evidence, the court was satisfied that it was proper to order the compulsory winding up of IIC. This took into account the fact that Mr Scott had deliberately obstructed the reasonable inquiries of Mr Goldsmith, falsified IIC's accounts and dealt with Mr Goldsmith's investment in a way which breached the agreements under which the money was given, therefore breaching his fiduciary duties to IIC. The court felt that Mr Scott's custodianship of IIC's affairs required a thorough investigation.

The court was also of the view that the continuation of a voluntary liquidation pursuant to the resolution passed by Mr Scott and his son, by which it was likely that as majority shareholders they would have control, for example, in the choice of liquidator, would be prejudicial to the rights of the shareholders as a whole. Mr Scott's argument that a voluntary liquidation would be less likely to threaten a beneficial outcome was deemed 'speculative'. The court felt that in reality, IIC's claims consisted of claims against Mr Scott for breach of fiduciary duty or for breach of contract rather than in any real expectation of deriving a possible return from a project which had not advanced for ten years.

Comment

We are often asked to advise on the view the courts take if a petition is presented when a company is already in creditors' voluntary liquidation. Generally, a creditor seeking a compulsory order will usually get his wish. Where a petition is presented by a contributory – in other words a shareholder – a different test applies, recognising that in an insolvent company a shareholder's economic interest in the company will probably be worthless. Given that, the court will need to be persuaded that the shareholders' rights are likely to be prejudiced before it will permit the increased costs of a compulsory liquidation to be incurred.

Here, the behaviour of the director and his son gave rise to considerable concern by the court; the facts here meant that the shareholder got his way and a compulsory order was made.

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Rolling stone

Re Stone & Rolls Limited (in liquidation)

[2009] UKHL 39

Mr Stojevic was the sole director and the beneficial owner of Stone & Rolls Limited ("the Company"), which was used solely by Mr Stojevic as a vehicle for defrauding banks. The fraud involved the Company obtaining payments under letters of credit by presenting to various banks false documents in relation to fictitious commodity trading. The fraud gave rise to liabilities by the Company to the banks, in particular to a Czech bank, which sued the Company and Mr Stojevic in deceit and was awarded substantial damages against both. The Company could not pay the damages to the bank and went into liquidation. The Company, through its liquidators, brought an action for negligence against its former auditors, claiming that they had negligently failed to detect the fraud. The liquidators argued that had the auditors not been negligent, the Company would not have been able to perpetrate its fraud and incur liability to the bank.

The auditors applied to strike out the Company's claim, contending that the Company was seeking an indemnity against liabilities it had incurred by its own fraud. Such a claim was barred by the principle of public policy expressed *in the maxim ex turpi causa non oritur* action (a claimant is unable to pursue a cause of action if it arises in connection with the claimant's own illegal act). The Company submitted that (1) the ex turpi causa maxim did not prevent it from suing for recovery in respect of its own losses caused by Mr Stojevic as the Company's directing mind (the Company itself was a victim of the fraud and should not have any knowledge of the fraud attributed to it); and (2) the ex turpi causa maxim did not provide a defence to the auditors, who were retained to detect dishonesty in the Company's offices. The judge declined to strike out the claim.

The auditors appealed. The Court of Appeal ruled that the claim should be struck out, reasoning that the Company was a fraudster under the total control of another fraudster. Accordingly, the Company was party to, and not itself a victim of, the fraud. The auditors, therefore, owed no duty of care to the Company to take reasonable care to detect its fraud.

The Company appealed. The House of Lords held that the auditors' application to strike out the claim should succeed. As a "one-man" company with no legitimate activity, and no innocent shareholders, the Company was to be treated as guilty of the fraud. As Mr Stojevic was the owner of the Company, as well as its directing mind, his fraudulent conduct was to be treated as the conduct of the Company and the doctrine of ex turpi causa defeats the claim against the auditors.

In reaching this decision, the House of Lords considered the law of agency under *Re: Hampshire Land Co*, [1896] 2 Ch 743, which provides an exception to the normal rule that an agent's knowledge is imputed to his principal in the event of the agent's own breach of duty to the principal. In the context of a director of a company using it as a vehicle for fraud, which would involve a breach of the director's duty as the company's agent, the company would not be deemed automatically to be aware of the fraud. However, the Hampshire Land principle did not apply in this case because the Company, as a "one-man" outfit, was held to be a direct participant in the fraud, and not a secondary victim. This case differs from the situation in which a dishonest employee of a large plc commits a fraud for his own benefit using the company name. Further, the House of Lords contended that auditors owe no duty of care either to individual shareholders or to creditors, individually or as a class. There was no reason, therefore, to allow the Company's claim for compensation for its own fraud to succeed.

Comment

The decision of the House of Lords makes it clear that auditors are unlikely to have liability where a one-man company is used for a fraud. However, the extent, if any, of an auditor's liability in cases where the fraudster's actions cannot be so clearly attributed to the company has not been clarified by the House of Lords. It must also be noted that the decision does not affect those rare cases where the claim against the auditors is based on fraud rather than negligence, including cases where the auditors are knowingly a party to the fraudulent business of the company within the meaning of section 213 of the Insolvency Act 1986.

Section 423

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Caught in the act

4ENG Limited v Roger Harper & others

[2009] EWHC 2633 (Ch)

In 2001 4ENG Limited ("4ENG") agreed to purchase from Roger Harper and Barry Simpson all the shares of an engineering company. As a result of a fraud uncovered following the acquisition of the company, 4ENG successfully claimed for fraudulent misrepresentation against the vendors in relation to false warranties they had given. 4ENG then applied to set aside certain transactions entered into by Mr Harper and Mr Simpson in order to realise assets to meet an award of damages in its favour. Mr Harper settled, but the case continued against Mr Simpson. 4ENG applied under section 423 of the Insolvency Act 1986 ("the Act") (transactions defrauding creditors) for orders requiring Mrs Joyce Simpson, Mr Simpson's wife, to pay monies and restore property to Mr Simpson and to assist in the realisation of the assets to meet the award of damages in favour of 4ENG. It was argued by 4ENG that Mr Simpson had transferred significant assets into Mrs Simpson's sole name, including their matrimonial home and funds from a joint bank account. 4ENG alleged that the purpose of these transfers was to shield Mr Simpson's assts from 4ENG.

Mrs Simpson argued that the transfers were not at an undervalue as they merely reflected the wife's entitlement to matrimonial assets arising out of their long marriage. Further, the transfers should be protected in the same way as the transfer of a matrimonial home as part of ancillary proceedings following divorce (*Haines v Hill* [2007] EWCA Civ 1284). In *Haines v Hill* the court made a property adjustment order requiring the husband to transfer his 50% interest in the matrimonial home to his wife, notwithstanding the warning signs that the husband was subsequently going to become bankrupt. This transfer was upheld by the Court of Appeal when the husband's trustee in bankruptcy sought to secure the value of the husband's half share of the property. The judge rejected Mrs Simpson's arguments.

The judge reiterated that a section 423 claim will only be successful if the transferor was substantially motivated by one of the aims set out in section 423(3)(a) or (b) of the Act. However, the transfer does not have to be for the sole or dominant purpose of putting assets beyond the reach of the claimant or otherwise prejudicing their interests. Instead, it is sufficient to show that this was the *substantial purpose* of the transfer. The judge stated that when determining the purpose of a transfer, the transferee's mental state at the time of the transfer and his degree of involvement in the transfer should be considered. He ruled that Mr Simpson had formed the intention that the most valuable elements of his family's wealth should be protected as far as possible in May 2003, when he sought legal advice in relation to putting the matrimonial home into Mrs Simpson's sole name.

However, following the transfer of the matrimonial property in 2003 into Mrs Simpson's sole name, Mrs Simpson had made a declaration of trust, stating that she and her husband owned the matrimonial home in equal shares. This declaration was made in an attempt to protect the property from possible seizure as proceeds of crime in entirely separate proceedings, and was only disclosed in July 2009. However, in August 2008, Mr and Mrs Simpson had sworn affidavits stating that the property was owned entirely by Mrs Simpson.

As a result of Mrs Simpson's misrepresentation, 4ENG were prevented from seeking a charging order over the property in 2008. It also meant that it could be argued that 4ENG did not need the order it sought. But 4ENG still asked the court to restore the position to what it would have been had the transfer of the property into Mrs Simpson's name not been made. 4ENG believed that the property had fallen in value since she had alleged she owned the entirety of the beneficial interest and so required Mrs Simpson to pay an amount equal to any decrease in the value of Mr Simpson's share of the property from August 2008, the date of Mrs Simpson's misrepresentation. The judge agreed to make this order as he considered the loss to 4ENG sufficiently linked to the original transfer of the property in 2003. The judge reasoned that 4ENG had a good case in the tort of deceit against Mrs Simpson.

Comment

Here, the fact that Mrs Simpson had lied clearly impacted on the judge's unusual decision to grant, under the remit of a section 423 claim, damages to 4ENG in relation to Mrs Simpson's misrepresentation. It should also be noted that if Mrs Simpson had divorced her husband rather than standing by him once the fraud had been discovered, it is possible that she might well have done better financially – as the principle in *Haines v Hill* may have allowed her to keep the property.

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That's my cash

Re: Equilift Limited

[2009] EWHC 3104 (Ch)

Equilift Limited supplied and installed stair-lifts, but was put into administration on 12 December 2008, and subsequently went into voluntary liquidation. It operated four bank accounts and attempted to hold customer deposits and other payments in reserve until work had been completed. However, these arrangements were operated rather loosely ...

The liquidators faced complex issues as to how the (potential) trust monies should be distributed. There were different interested classes of beneficiaries, four separate bank accounts, and three classes of customer – all with arguments unique to themselves in respect of the monies. The monies had moved from one account to another regularly.

Usually, where there is genuine doubt as to whether a liquidator holds monies as liquidator or as trustee, all necessary parties are joined into court proceedings and the liquidator's costs are paid out of the monies in dispute, regardless of the outcome. The liquidators are potentially at risk, as if they distributed monies at variance with the beneficiary's rights, they could be personally liable for breach of trust.

The funds in question totalled £171,000, and 484 customers were affected; consumer customers, trade customers and those who paid for service contracts. Many were disabled and could not afford to lose their deposits, let alone the costs of litigation. Feelings were running high…

It seemed certain that the litigation would exhaust the funds available. However, the judge was quite innovative. He ordered the liquidators to obtain leading counsel's opinion, in order to consider the competing arguments. An opinion was obtained. It concluded that the accounting arrangements probably did not create an effective trust in favour of any customers.

The court did not endorse the opinion, as to do so would require expensive litigation, and the court was trying to avoid this. The judge did, however, find that the opinion was fair, balanced and well reasoned, recognising that there were arguments both ways. Whilst these matters were usually settled by litigation, here it would be disproportionate given the relatively modest fund. The reasonable and proportionate course was for the liquidators to follow the opinion and distribute the monies amongst the creditors, on the premise that the trust was ineffective.

The court accepted that the liquidators were theoretically at risk of a breach of trust claim. However, the courts can relieve trustees of personal liability under section 61 of the Trustee Act 1925. The judge thought that liquidators, acting under leading counsel's opinion in cases where the funds in dispute are modest, would undoubtedly be acting honestly and reasonably. They were seeking court directions – a sensible safeguard – and it was inconceivable that they would not be excused personal liability from any breach of trust.

The court also thought it was reasonable for the customers to accept the opinion as further debate would be an unreasonable and disproportionate waste of money. The liquidator was ordered to write to all customers and make available the opinion, application and court judgment. The customers would be given two months to apply to court for the cash sums to be distributed in some other way. If none applied, the liquidators could distribute the cash in the liquidation.

Finally, the liquidator's costs would be payable from the £171,000 as an expense in the liquidation.

Comment

This case is not an authority on circumstances when a trust can be ineffective. Neither is it "carte blanche" for liquidators to replace an application for directions with a counsel's opinion. It does, however, show that the courts can take a pragmatic approach to solving difficult legal questions quickly, cheaply and fairly. Counsel's opinion accepted that there were arguments for and against the existence of a trust, but rather than provide a definitive answer and use up most of the funds, the court ordered the liquidator to follow counsel's opinion thus significantly increasing the return to unsecured creditors.

Whilst potentially the liquidator could be at risk of a breach of trust, this was effectively eliminated because the court felt that the liquidator had acted honestly and reasonably and had sanctioned the proposed solution. In fact, no creditors objected within the two month period, resolving the matter.

Routes out of trouble for law firms

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A significant number of professional partnerships are currently facing financial pressures, including legal firms of all sizes.

The level of transactional and advisory work has dropped significantly and a competitive market means that a large number of law practices are struggling to attract new clients. The conveyancing practices of many have been severely affected by the downturn in the property market. Firms specialising in personal injury which may have expanded rapidly over the last ten years have suffered with the failure of two of the largest claims providers (Claims Direct and The Accident Group) leading to a significant tail off in new instructions. Criminal and family practices continue to have cash flow problems owing to the Legal Services Commission's delayed payment system. Already this year lenders are reporting a 63% increase in firms seeking to borrow to fund the 31 January tax payment.

Law firms are increasingly likely to seek advice as they struggle to deal with their liabilities. Advising an insolvent professional partnership gives rise to numerous challenges. Here are just a few of the issues to consider.

The Partners and the Partnership

It is clearly important to establish quickly the identity and status of each of the partners within the partnership. Identifying the partners ought to be straightforward, but sometimes is not so; individuals, particularly those recently appointed, may seek to refute their status if it transpires that the partnership is burdened with debt.

Not all partners are equal, at least internally. Equity partners will be those who share the profits, whilst fixed share and salaried partners will generally earn a fixed sum paid ahead of the equity partners. Non equity partners may have very limited financial information concerning the practice. In some instances they may have none at all. This is despite the fact that in a traditional unlimited liability partnership each partner is personally liable for the debts of the business, irrespective as to their partnership status within it.

It is fair to say that dealing with the restructuring of an insolvent law firm partnership can be one of the most taxing burdens placed on insolvency practitioners, banks and other creditors. By definition, a partnership is a collection of individuals, each of whom may well have very different views as to their capabilities, contribution to the practice, responsibility for its difficulties – and of each other. Any restructuring is likely to mean exits for certain partners and staff – and it is essential that this is accepted by both those staying and departing. Both advisers' and lenders' tact and diplomacy skills may be tested to the limit, for it is essential that a stronger business emerges from the restructuring. The skill will be to ensure that the most able and dynamic partners remain with the business and not be tempted away elsewhere. In the unlimited liability partnership, the driver for this will usually be the fact that the partner departing for a more profitable firm cannot leave their share of the old partnership debts behind them and so there is significant pressure on them to remain. However, each partner may have his or her own agenda – and the skill for the stakeholder will be to identify what that is, and how to deal with it.

There may well be a different dynamic in a limited liability partnership, where the individual partner's liability for the debts of the business will be capped at the level of their capital contribution to it. In that instance, the successful partner may be more tempted to "cut and run" – on the assumption that he has not guaranteed any part of the LLP's debt.

Managing the partners and ensuring that they all pull together in the same direction is therefore crucial to ensuring the best outcome for the firm's creditors and the partnership as a whole. "Lock ins", whereby each of the key partners agree not to leave the partnership may be desirable, although the mere act of asking for one may precipitate a crisis in itself.

Assets and Liabilities

As with any service provider, the major assets of a law firm partnership will be its debts and work in progress. Many, however, do not have effective systems in place to manage those assets. Valuation of work in progress may frequently be an art, not a science. When advising such a firm, it is therefore crucial to establish an approximation of the value of these assets. Often, work in progress figures will be good for only a fraction of book value and many debtors will be months, or even years old. The size of these assets may

therefore be illusory, and care must be taken not to rely on over inflated valuations.

Insolvency Process

Partnership insolvency law has been significantly changed in the last decade. The insolvency processes now available to an unlimited liability partnership include a partnership voluntary arrangement (with or without interlocking individual voluntary arrangements for the partners); administration, and compulsory liquidation. Bankruptcy of the partners is obviously also possible.

For an LLP, the insolvency processes include a company voluntary arrangement, administration, compulsory liquidation and voluntary liquidation.

However, the commencement of an insolvency process in relation to a law firm partnership can potentially lead to a significant destruction of its value; indeed, it may render the business effectively worthless.

By definition, the work in progress relates to incomplete matters. Since a law firm cannot, in effect, trade in a formal insolvency process all its work must be passed on to other law firms. Almost by definition, this will cause very significant disruption to clients as well as increased cost, since the new lawyer will need to familiarise himself with the assignment. This is likely to damage the value of the insolvent firm's work in progress and may also render previous unpaid bills irrecoverable. Clients who are required to engage another firm to complete the work will usually claim against the professional partnership for their additional costs and expenses.

It follows that it is vital to ensure continuity in the provision of services to the law firm's clients. A voluntary arrangement or a pre-pack administration will both be very attractive options. A liquidation of the professional partnership is usually unlikely to realise any significant value from debts or work in progress. Generally, a formal insolvency process spells disaster for stakeholders.

Restructuring and Rescue

Given the potential financial implications for the professional partnership, a restructuring or rescue will always be the preferred route if there is any business at all to salvage. A restructuring may include additional capital injections from the partners' own resources. Depending on their individual resources, some partners may have to contribute a great deal more than others. These partners may have no option but to accept this situation given the alternative of potential bankruptcy.

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Timed out

Casson and Wales v Law Society

[2009] EWHC 1943 (Admin)

This case involved two bankrupt solicitors who, after being made bankrupt and subsequently discharged, were found to have provided inadequate professional services to their clients. As a result, they were ordered to pay compensation by the Legal Complaints Service. However, the bankrupts did not pay the compensation due and the matter was brought before the Solicitors' Disciplinary Tribunal. The Tribunal determined a preliminary issue raised by the bankrupts relating to whether the compensation awarded constituted a bankruptcy debt from which they would be discharged following their discharge from bankruptcy. The Tribunal concluded that the compensation did not constitute a bankruptcy debt and the bankrupts therefore remained liable for it. The bankrupts appealed this decision.

On appeal, the bankrupts argued that, as the complaints related to services provided by them prior to their bankruptcies, any debts or liabilities that arose in connection with those services should be considered as bankruptcy debts for the purposes of sections 281 and 382 of the Insolvency Act 1986. In such circumstances, they would not be liable to pay the compensation following their discharge.

The Law Society argued that the discretion to make the award was exercised by the legal adjudicator after the start of the bankruptcies. Further, the debt and liability only arose at the time that an award was actually made. The debt was not therefore a bankruptcy debt.

The court dismissed the appeal and considered that the Tribunal had ruled on the matter correctly. Having considered previous case law on this issue, a general principle appeared which held that where a court or tribunal had a discretion whether to make an award, any sum ultimately awarded did not exist as a debt until the award was actually made. The prospect of a complaint being made to the Legal Complaints Service created no more than a risk of liability and did not therefore create a liability or debt, even contingent, which could be considered to be a bankruptcy debt. The bankrupts had not therefore been released from their liability to pay the compensation.

Comment

This is yet another case that deals with the question of what qualifies as a bankruptcy debt. Although the fact that the bankrupts had been discharged from their bankruptcies meant that their former clients could not bring claims against them in either contract or tort, it did not stop the disciplinary remedy from surviving discharge. However, it is important to note that it is clear from the judgment in this case that, had the disciplinary award been made prior to the bankruptcies, the debts would have constituted bankruptcy debts which would have been discharged following the bankrupts' discharge from bankruptcy. The fact that the awards were made post bankruptcy and post discharge was simply an "accident of timing".

Official Receiver v McKay

[2009] EWCA Civ 467

Mrs McKay was involved in a road traffic accident and refused to pay the repair bills claimed by the other driver, Mrs Martin. A judgment was obtained by Mrs Martin against Mrs McKay and eventually a bankruptcy order was made. However, when it became clear that Mrs McKay had no assets, Mrs Martin (or her insurer) withdrew her proof of debt and agreed to pay the costs and expenses of the bankruptcy estate.

Following numerous applications and appeals in the course of the bankruptcy proceedings, the court finally annulled Mrs McKay's bankruptcy under section 281(1)(b) of the Insolvency Act 1986 ("the Act"), on the basis that the debts proved for had been discharged. Mrs McKay, however, was not satisfied with this and appealed the annulment, preferring a section 282(1)(a) annulment – that is an order that the bankruptcy should be annulled on the basis that it should never have been made (Mrs McKay claimed the original judgment against her had been obtained by fraud).

Under section 282(1)(b) of the Act, the court may annul a bankruptcy order if, "to the extent required by the rules, the bankruptcy debts and the expenses of the bankruptcy have all, since the making of the order, been paid or secured for to the satisfaction of the court". Rule 6.211 of the Insolvency Rules 1986 states; "all bankruptcy debts which have been proved must have been paid in full". Mrs McKay's appeal, therefore, was on the basis that an order under section 282(1)(b) was not permissible where the debt had not been paid at all, but had been released instead. Although there had been, at one time, a proof of debt in relation to the bankruptcy, that proof had been withdrawn by agreement between the creditor and the trustee. When the judge considered the application for annulment, there was no subsisting proved debt in the bankruptcy. In support of her case, Mrs McKay referred to a number of Court of Appeal authorities in relation to the annulment provisions of the Bankruptcy Act 1883 ("the 1883 Act"), in particular *Re Keet* [1905] 2KB 666.

The Court of Appeal dismissed the appeal, stating that the court need only take into account those liabilities that creditors were proving for at the date of the hearing when considering the annulment of a bankruptcy order under section 281(1)(b). Where a creditor had withdrawn its proof ahead of the hearing, the debt due to that creditor need not be discharged in order for the court to annul the bankruptcy.

Further, it was held that the Court of Appeal authorities referred to by Mrs McKay were of no assistance in interpreting the Act. Under the 1883 Act, the discharge of the bankrupt from bankruptcy (and with it his release from outstanding debts) and the annulment of the bankruptcy order took place together. In an application under the 1883 Act the court had to consider not only whether to annul the bankruptcy order, but also whether the bankrupt should be released from his outstanding debts. However, in the Act (in force today), the bankrupt's discharge and the annulment of the order are separate issues. The underlying policy considerations for decisions under the 1883 Act, therefore, differed from the present case.

Comment

The Court of Appeal's decision has clarified that there is no need to insist on actual payment in full of a withdrawn proof before making an order for annulment under section 281(1)(b) of the Act. Further, the decision reminds us that authority under previous bankruptcy regimes does not automatically apply to the present regime, as similarly worded sections often do not share the same underlying policy considerations.

Meet the team

Serena McAllister

The Angle introduces you to one of our newest team members, solicitor Serena McAllister who joined us in August 2009.

What's your most embarrassing nickname and why?
It's not that embarrassing but some of my friends call me Rena.

If you were an animal, what would you be?
My family cat, George – he is the most pampered animal I know.

Have you ever had a brush with fame?
I live in the same road as Paul Whitehouse and I seem to bump into him most mornings.

If you were a sitcom, what song would be your theme-tune and why?
Rabbit by Chas & Dave because apparently I talk a lot!

If you could create any new law, what would it be?
I would ban people wearing rucksacks on the tube in rush hour.

What is your favourite movie quote?
"Nobody puts Baby in a corner".

Do you have any phobias?
Heights.

If you could take one luxury item to a desert island what would it be?
A friend - for company.

What is your favourite dance move?
The locomotion.

What would you be if you were not a lawyer?
Probably a doctor or something in the medical field.

Beer or wine or cocktails?
Red wine.

If you had to live your life by one motto, what would it be?
Avoid answering Meet the Team questions if you can.

What was the theme at your best ever themed party?
A Halloween party.

What makes you angry?
People that jump the queue.

Complete the following: in my opinion, the 1980s…

… was all about Bros.

If your house was on fire, what would you save?
My photos and a painting my mother gave to me which is irreplaceable.

Make us your first choice

LG's Corporate Recovery and Restructuring Group is at the forefront of recovery, restructuring and turnaround. The Legal 500 – 2008/9 said "LG is one of the premier firms in the market" and a "dynamic force." Chambers Guide to the Legal Profession – 2009 agrees: Tom Withyman "has a great presence in the market", Nick Pike is "practical, technically strong, commercially aware and easy to get on with" and Steven Cottee is "very responsive to his clients' needs – he understands where we're trying to get to commercially, rather than just dispensing legal advice". All three are named as leaders in their field.

We have specialists dealing with every aspect of recovery and restructuring law. To learn why we are rated so highly, contact any of the team members listed below.

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the angle is designed to provide a summary of recent developments in corporate recovery and restructuring law. It does not purport to be comprehensive or a substitute for specialist legal advice in individual circumstances