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CORPORATE RECOVERY AND INSOLVENCY BULLETIN

CHARLES RUSSELL OBTAINS FIRST ADMINISTRATION ORDER UNDER NEW INSURANCE REGULATIONS

Charles Russell has successfully obtained the first UK administration order under the Insurers (Reorganisation and Winding Up) Regulations 2004 ("The Regulations"), for client AA Mutual International Insurance Company Limited ("AAMIICL").
At the hearing, on 23 July 2004, Mr Justice Lewison appointed Dan Schwarzmann and Nigel Rackham of PricewaterhouseCoopers LLP as administrators of AAMIICL, which has been in run-off since 1987. It is believed to be the first appointment of UK administrators to an insurer since the regulations came into force on 3 March 2004.

Stephen Carter, who led the team at Charles Russell, said, "This appointment offers a moratorium against proceedings and will enable AAMIICL to save ongoing run-off costs, potentially leading to a better result for creditors."

The Regulations are intended to simplify and provide a consistent approach to the winding-up or restructuring of insurance undertakings. They enable directors to achieve a better result for creditors than if they waited until the company became insolvent.

Charles Russell acted for AAMIICL and the insurance team was lead by Stephen Carter assisted by Tobey Butcher. James Hyne advised on the corporate recovery/restructuring issues.

SIMON THOMAS OF TENON RECOVERY GROUP MAKES SOME POST ENTERPRISE ACT 2002 OBSERVATIONS

A cursory look at current insolvency appointment statistics shows that the Enterprise Act 2002 ("EA 2002") has achieved the effect it was designed to have, namely increasing the use of administrations as the preferred procedure to deal with situations where businesses can be preserved. If you were to look at administrative receivership and administration appointments prior to the introduction of the EA 2002, you will see that typically 60% to 75% of the appointments were administrative receiverships. This has now been reversed and in the first 6 months of 2004, 63% of the appointments have been administrations.

It has been surprising to see that much of new lending post the introduction of the EA 2002 has not involved an assignment of any existing pre-EA 2002 security. This was something which was anticipated prior to EA 2002 coming

into force. It is possible for a new lender to take an assignment of pre-EA 2002 security and preserve the new lenders' right to appoint administrative receivers and avoid having to make any payment to the preferential creditors or contribute the prescribed part to the unsecured creditors ahead of the floating charge. In addition, any capital gains charge arising as a result of the administrative receiver releasing assets is an unsecured claim against the company whereas in the new administration procedure, the tax liability is treated as a cost of the administration. It seems odd that many lenders are not taking an assignment, perhaps they feel that this is contrary to the spirit of the EA 2002?

With reference to the capital gains tax issue, it is expected that more companies will be formed specifically to hold assets which will create capital gains tax liabilities on realisation, so that secured lenders can realise these properties either as mortgagee or by using a receiver appointed under The Law of Property Act with the tax liability remaining as an unsecured claim.

Creditors' Voluntary Liquidations are nearly 20% down on the comparable period last year, and it is interesting to consider whether part of the reason for this is the Leyland Daf case (digested in the Summer 2004 Bulletin) which has changed the priority of expenses so that now a liquidator's costs rank behind a floating charge holder. This is not the case in an administration where Rule 2.67 of the Insolvency Rules 1986 puts the administrator's costs ahead of the floating charge holder. There is a suggestion that imaginative insolvency practitioners are finding reasons to justify administration whereas pre-Leyland DAF, they would have been happy to wind the company up voluntarily.

On a different note, I recently came across an insolvency where there was a significant amount of partly-paid share capital which had a devastating impact on the shareholder who had already invested all available spare cash into the company. The director shareholder was unaware that the uncalled element would have to be called up. I wonder how many partly-paid shares exist and whether the shareholders are aware of their obligations, i.e. to pay up the unpaid element, in an insolvency?

On a closing note, I have always thought that a significant number of directors give personal guarantees to lenders and do not bother to get them released when the companies cease to be borrowers. I recently asked a bank manager whether their branch held many personal guarantees from directors where the company bank account was in fact in credit. The response was that approximately 50% of the guarantees held were in respect to

companies where the account was in credit. It goes without saying that any guarantor should demand a release as soon as they cease to be a borrower and this should be easily achieved with a threat to move the account. If it is necessary to borrow subsequently, the guarantee issue can then be reconsidered.

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RECENT CASE LAW DEVELOPMENTS

Winding Up In The Public Interest

In The Matter Of Drivertime Recruitment Limited/ DST Limited [2004] EWHC 1637; 2004 WL 1640185

The Secretary of State for Trade and Industry presented two Public Interest company winding up petitions pursuant to s124A of the Insolvency Act 1986 ("IA 1986"). The companies, "Drivertime" and "DST", operated a franchise business in the temporary driver recruitment industry. The individuals in charge of the companies, Antoni and Andrei Wilk ("the Wilks"), were neither registered as directors or employees of either company. They described themselves as "consultants" and went to great lengths to conceal their control over the companies by having as shareholders and/or directors of both companies, their mother and one of their wives (using their maiden names). However, the court was satisfied that they were the driving force behind the companies.

A winding-up petition can be presented under s124A IA 1986 where it appears to the Secretary of State that it is expedient in the public interest that a company should be wound up. If the Court thinks it just and equitable for the company to be wound up, it may do so under s122(1)(g) IA 1986. The Court of Appeal authority of ***Re Walter L Jacob & Co [1989] BCLC 345*** set out the approach which requires the Court to weigh up factors for and against placing the company into liquidation in similar circumstances to the Drivertime case. It must form a view for itself and be able to identify what aspects of the public interest would be promoted by the making of the winding up order, and base this view on evidence in the way of submissions before the court. The Court relied on the affidavit evidence of, amongst others, an investigator appointed under s447 of the Companies Act 1985 and former franchise and franchisee operators. All of the franchisees who gave evidence had serious criticisms of the Wilks and their methods. Some had invested and lost their life savings and many have disputes with the companies and were seeking damages for misrepresentation. The franchisees were led to believe that they were buying into a very successful franchise business, which was not the case. Whilst they were under

investigation the Wilks lied to the investigator in the hope that the very high failure rate of its franchisees would not be discovered. They presented prospective franchisees with false marketing material which claimed that they had regional networks and established blue chip clients both of which proved not to be true. They provided none of the promised support or advertising to franchisees and the sample sales and gross profit figures were fabricated by the brothers for the sole reason of selling these franchises.

The Wilks gave evidence in person and were described as being unsatisfactory witnesses whose evidence under cross-examination was “at best peripheral and at worst irrelevant”.

HELD

In all of the circumstances the Court found that it was just and equitable to order the winding up of Drivertime and DST.

COMMENT

This case serves as a timely reminder of the basis upon which a company may be wound-up if in the public interest to do so. It is worth noting that proceedings under s124A 1A 1986 do not fall within the EC Regulation, even if the company is insolvent.

Subordination Of Debt

SSSL Realisations (2002) Limited (Formerly Save Service Stations Limited (In Liquidation) And In The Matter Of Save Group Plc (In Liquidation) [2004] EWHC 1760(Ch)

Save Group plc (“Group”) was the parent of the Group and primarily a retailer of petrol. Group purchased petrol and petrol related products, selling them on to Save Service Stations Limited (“Stations”) who sold it on to retail customers. Group was in charge of borrowing for the whole Save Group and lent funds on to subsidiaries as necessary to enable them to carry out their trading functions. This therefore gave rise to substantial inter-company debts, in particular funds owed by Stations to Group for petrol and petrol products bought by Group and sold on to Stations. Stations owned the retail premises and other fixed assets. The supply of petrol to Group gave rise to liabilities for Customs and Excise (“C&E”) duty. Payment for this duty can be deferred by providing a bond to C&E. AIG Europe (UK) Limited (“AIG”) entered into a bond with C&E on behalf of the Save Group on the condition that members of the Save Group (including Group and Stations) entered into a Deed of Indemnity (“the Deed”). In this case, Lloyd J was asked to consider the Deed and its legal effect.

Administration orders were made in relation to Group and each of its subsidiaries in February 2001.

Stations went into Creditors' Voluntary Liquidation in May 2002. Group was wound-up compulsorily in May 2002. The entire assets of the Save Group were sold by administrators for £54.5m, with the sizeable portion (£53.5m) of this representing the property of Stations. Group's main asset was the inter-company debt of £127m owed to it by Stations. Stations also owed other subsidiaries around £38M; AIG was owed almost £10m. Under the Deed, AIG is a creditor for the same amount in respect of each of Stations, Group and several other subsidiaries. Stations had other creditors including banks and trade creditors AIG contended that by virtue of the Deed, Station's debt to Group (and any other relevant subsidiary) was subordinated to that owed to AIG so that no inter-company debt could be paid until AIG is paid in full. If AIG was correct, then the competition for assets will be between AIG, banks and Station's creditors, who would all do much better from the exclusion of the inter company debts. Two applications were put before the court, one from the liquidator of Stations and the other by the liquidators of Group.

AIG had included a clause in the Deed to ensure that AIG's debt ranked in priority to debts owed by any of the indemnitors to any other. This case raised the issue of the proper treatment of subordinated debts. The underlying principle was expressed in ***Re Maxwell Communications Corporation Plc [1993] 1 WLR 1402*** where it was held that a contract between a company and a creditor, providing for the debt due to the creditor to be subordinated on the winding-up of the company to other secured debt, is not rendered void by insolvency legislation and that such agreements could be valid.

HELD

There was an effective clause in the Deed which prohibited Group from proving its inter-company debts due from Stations and from receiving a dividend in respect of such debt in the liquidation of Stations (when the debt due to AIG remains unpaid and the Deed provides that AIG will receive sums to pay the debt in full). The creditors of Group were bound by the consequences of Group's agreement. AIG was held not to have any propriety right over any asset of Group because the charge was limited to amounts required to pay AIG and if it were not so limited, it would constitute a charge. The Deed was held to be detrimental to the creditors of Group, but it does not impose on Group continuing financial obligations and did not give rise to prospective liabilities. Whilst the Deed was disadvantageous to Group this was the price for the advantage secured by Group in obtaining the assistance of AIG to defer the duty owed to C&E. The Deed was not held to be an

unprofitable contract just because the consequences of it being implemented were disadvantageous to Group and its creditors. Lloyd J commented that this result was unfortunate for Group's other creditors but this was the intended result of the agreement which Group entered into freely in order to secure the advantage of deferment of duty, and therefore he found in favour of AIG and against Group.

COMMENT

This case is interesting insofar as it demonstrates that the Courts are unwilling to retrospectively interfere with set aside transactions entered into on good faith and with justifiable commercial reasons – even if the effect of upholding such transactions (in this case relating to subordination) has an arguably prejudicial effect on a group of creditors.

<u>Appointment Of Administrators</u>

Fliptex Limited v Lisa Hogg, David James Elliot, Stewart James Davies, Melvin Laughton <u>[2004] EWHC 1280</u>

The Claimant (F) applied for an injunction to restrain the Defendants (F's administrators) from accepting the surrender of two leases granted by F to its parent company.

Prior to administration, F had entered into a loan agreement with which provided that, if F became insolvent within the meaning of s123 IA 1986, the creditor could enforce its security as the holder of a Qualifying Floating Charge. The floating charge crystallised on 24 November 2003. Pursuant to Schedule B1 Part 3 paragraph 16 of IA 1986, an administrator may not be appointed until the floating charge on which the appointment relies becomes enforceable.

F contended that its administrators had not been validly appointed as their appointment took place on 20 November 2003, when the statutory declaration prescribed by Schedule B1 Part 3 paragraph 18 IA 1986 was sworn. This was four days before the charge crystallised.

HELD

Schedule B1 Part 3 paragraph 19 stipulates that the appointment of an administrator is only effective when all of the requirements of paragraph 18 are satisfied. Paragraph 18 requires that the person who appoints an administrator must file with the court the Notice of Appointment, including the statutory declaration. These documents were not filed until 24 November 2004, and it was only then that the appointment became effective. Consequently, the administrators had not been 'appointed' in advance of the floating charge becoming enforceable. Their appointments were valid and they could accept the surrender of the leases.

COMMENT

In the interests of certainty, the Court will only deem an appointment

to be effective when all of the conditions of Schedule B1 Part 3 paragraph 18 of IA 1986 are satisfied. The date of the statutory declaration is irrelevant.

<u>When Is Transaction "At An Undervalue"?</u>

In The Matter Of Thoars (Deceased) sub nom Reid V Ramlort Ltd [2004] EWCA Civ 800

The deceased, T, had owned two companies which between them owed £185,000 to the applicant, RL. In 1994 T had taken out a life assurance policy to pay out £180,000 on his death. In July 1996, following repeated pressing from RL, T had made a declaration of trust of the benefit of the life policies in favour of RL. As consideration ("the incoming value" to T's estate), RL made two separate payments: £1,100 via a third party company to T and £1,900 directly to T. For there to have been a transaction at an undervalue pursuant to s339(3)(c) IA 1986, the value of the policy at the date of the declaration ("the outgoing value" from T's estate) must have been significantly less than the incoming value. RL contended that the outgoing value was only the surrender value of the policy which its issuer was contractually obliged to pay as of July 1996: £71.

HELD

There is nothing in s339(3)(c) IA 1986 requiring a Court to ascribe a precise figure either to the incoming or outgoing values. The Court may take from a range of possible values those most favourable to the party seeking to uphold the transaction. If the incoming value is still significantly less than the outgoing value, there will have been a transaction at an undervalue. The outgoing value, from T's point of view, was at least £10,000. It was not simply the surrender value. The incoming value paid by RL, two payments totalling £3,000, was significantly less.

When applying a remedy there is no presumption in favour of monetary compensation as opposed to setting the transaction aside and revesting the asset transferred. In every case the court should fashion the most appropriate remedy to restore the pre-transaction position. Regard must be had to subsequent events and the current situation. This transaction could be reversed: accordingly the declaration of trust was set aside and the payments made by RL returned to it with interest.

COMMENT

This case points to a flexible judicial approach when considering the basis of valuation for transactions at an undervalue and furthermore, in the Court's application of its statutory remedies which are prescribed as "such order as it thinks fit for restoring the position" (s339(2)IA 1986).