waterline

waterstone INSOLVENCY

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INSIDE:

The value of sharing; The Part 14 Compromise

Learning to Compromise

Often forgotten, the Part 14 Compromise is a powerful tool for companies and their creditors to use when there is a desire to salvage a business. Typically reserved for smaller firms, it was used successfully by State Owned Enterprise Solid Energy last year and subject to a vigorous legal attack by the Bank of Tokyo (BoT). The judgement clarified some important issues.

The Numbers

Solid Energy was financially distressed and its creditors could be broken into three broad classes;

The Banks - Group A; ANZ, BNZ, Bank of Tokyo, Commonwealth, TSB and Westpac all had unsecured loans repayable on demand except for the TSB that held a long-term bond; total debts were $368m.

The Banks - Group B; Westpac and the Commonwealth Bank had contingency obligations that meant if Solid Energy failed these banks would be liable for covering the cost of the remediation of several Solid Energy sites. Total contingent claims were $58m.

Others; There were lease obligations to several parties, including KiwiRail, and these debts were considered partly secured, totalling about $131m and other trade creditors with $106m.

The Compromise

Part 1; All of the banks would be required to convert 20% of their core cash debt to equity.

Part 2; The balance of the remaining debt would be converted into a term loan, to be repaid over time and managed by the ANZ; with the exception of the TSB whose debt was already a long-term bond.

All other creditors would remain unaffected. There were therefore two classes of creditors. They held separate meetings one hour apart and in both cases the compromise passed with the required 75% supporting the deal but here is where it got interesting.

The Bank of Tokyo was opposed. So far as Part 1, swapping 20% of the debt for equity, this wasn't a problem because all other banks supported the agreement and together they held over 75% of the debt.

However, when it came to rescheduling the debt there was a problem because the TSB wasn't affected and therefore was not entitled to vote. If the TSB was excluded then the BoT held a blocking vote. However, if the contingent claim by the Commonwealth and Westpac banks were added in then the Bank of Tokyo would be out voted; and this is exactly what happened.

The Challenge

The Bank of Tokyo raised a number of legal challenges, a few being very fact specific to the case but others having more general interest; let's look at those specific challenges and the court's response.

Was Part 14 suitable for such a complex reorganization?

The BoT claimed that as the compromise included swapping debt for equity it was outside the scope of Part 14 and it relied on the existence of Part 15 of the Companies Act as evidence.

Part 15 allows the High Court to approve a number of arrangements by a company, including a compromise as envisioned in Part 14, as well as an amalgamation or some other re-organization. Part 14 is driven by the company and its creditors and requires no court supervision.

The BoT made the case that the Solid Energy compromise was so large and complex that it fell outside the limited scope of Part 14 and that Parliament intended that such reorganizations required the judicial oversight provided for in Part 15.

The High Court disagreed. A Part 14 Compromise is not limited to merely compromising debts and that a company and her creditors were entitled to enter into whatever deals that they wished to. There is nothing unusual or inappropriate that requires the court's supervision when it comes to swapping debt for equity.

Can a compromise compel a creditor to engage with a third party?

The BoT made the argument that because their debt obligation was now being managed by the ANZ they were being forced to contract with a third party, when the Part 14 compromise was only between the company and its creditors.

This argument wasn't without merit; the BoT was now confined in a syndicate with the other banks and bound by the terms of that syndication. Critically, this included arrangements that gave the manager of the syndication, the ANZ, an indemnity from the other banks for its role as manager.

This argument failed because the Court found that the obligations were ones that the bank would have had if they were dealing with Solid Energy directly. The court accepted that if the BoT were being forced into real and new obligations to third parties

	Cash Debt	Performance Bonds	Total
ANZ	40		40
BNZ	80		80
BoT	80		80
CBA	45	17	62
W'Pac	55	41	96
TSB	68		68
Total	**368**	**58**	**426**

The banks who were swapping debt for equity got to vote on their proposal

PART 1

Voting	Cash Debt	Yes	No	
ANZ	40	40		
BNZ	80	80		
BoT	80		80	
CBA	45	45		
W'Pac	55	55		
TSB	68	68		
Total	**368**	**288**	**80**	
		78%	***22%***	***100%***

The banks swapping the remaining current debt for long term debt got to vote; but the contingent debt for CBA and W'Pac were added. TSB excluded.

PART 2

Debt Rescheduled into time payment

Voting	Total Debt	Yes	No	
ANZ	40	40		
BNZ	80	80		
BoT	80		80	
CBA	62	62		
W'Pac	96	96		
TSB	*68*			*68*
Total	**358**	**278**	**80**	
		77%	***23%***	

then these obligations then this would have been fatal to the compromise.

Can a compromise be used to bolster the balance sheet of a cash-flow solvent company?

A compromise is only available for companies that "...is or will be unable to pay its debts...". (s 228).

The claim here was that this restructure was about getting a better gearing for Solid Energy to maximize profitability, an argument that the court rejected on the facts. Although the company was able to pay its bills its balance sheet was in such a poor state that unless it was addressed the company, in the view of its board, would become unable to pay its bills.

Should the contingent creditors have been in a separate class?

From the perspective of the BoT it appeared as if Solid Energy and the banks supporting the compromise gerrymandered the creditors vote by including Westpac and the Commonwealth's contingent bonds even through their debt wasn't the same type as the other bank creditors.

There are no definitions of a creditor class in the Act but over a century of case law has distilled the issue.

The subject was first canvassed seriously in 1892 in Sovereign Life v Dodd. Here the failed insurance company proposed a deal with it policy holders that they accept new policies at a lower value. Policy holders with matured policies were grouped into the same class as those whose policies were still running.

Those with matured policies challenged and were successful. The English Court ruled that classes:

> "...must be confined to those persons whose rights are not so similar as to make it impossible for them to consult together with a view to their common interest."

Subsequent judgements have reinterpreted the final word *interest* as being analogous in this case to *rights*. A class was defined as a group of creditors who had common *rights* against the company. Although it clearly looked to the BoT as if Solid Energy were gerrymandering the different classes of creditors pool they failed to convince the High Court.

Does it matter that some creditors were left out?

No. The court declared plainly:

> "A company is free to select the creditors it wishes to compromise. A company does not have to compromise all of its debts nor all of it debts within a class"

This was caveated with a warning that the court would consider any such exclusion to see if there was any oppressive activity but found that Solid Energy could compromise its bank debts even though their rights against the company were identical to those of its trade creditors. The banks were large, sophisticated lenders and there was a valid reason for compromising them and not the trade creditors.

Had, however, there been no valid reason for selecting some creditors or not others, or had the court found that the selection of classes had been decided for the purpose of rigging the vote, then the Solid Energy compromise would have been struck down.

In Summary

A company has a very wide scope when embarking on a Part 14 compromise. It can be creative in selecting different classes of creditors and in compromising some creditors but not others, but there must be valid commercial reasons for doing so.

PART XIV COMPROMISE

If 75% of an insolvent company's creditors by dollar value, representing over half of the total actual number of creditors, agree to a deal then this deal is binding on all creditors.

Only applies to creditors of equal class. So, unsecured creditors can pass a compromise but it will not be binding on preferential or secured creditors.

How Voidable is Voidable?

Parliament, like Jesus, sometimes speaks in riddles. It tinkered with the voidable transaction regime in 2008 and there has been a predictable spike in litigation as the Priests of the High Court interpret the meaning of the sacred scrolls.

The Priests cannot agree with each other, and sometimes even themselves but a consensus of sorts has emerged.

The 2008 change introduced the concept of looking at the entire commercial relationship between the company and its creditor. Unhelpfully, parliament did not define what was meant by a continuing business relationship. Claw-backs are restricted to the specified period, being the last two years prior to the company's liquidation.

In response, two schools of thought have emerged from the Courts.

The first; that the liquidator can 'cherry pick' the start of that relationship to maximise the level of claw-back. This is the *Point of Peak Indebtedness* rule but appears to have been abandoned.

The second; that there are two running accounts. One from either the start of the specified period or at the point at which the company became insolvent within the specified period and the end of the trading relationship. The second; from then to the date of liquidation.

Initially the courts favoured the date of peak indebtedness.

Blanchett and Hollis v McEntee Hire (Christiansen) August 2010

In his original ruling back in 2010, much loved by liquidators, Christiansen declared that the date of peak indebtedness could be used by the liquidators. This allowed liquidators to choose the point at which the debt between the company, now in liquidation, and the creditor was at its peak and the difference between that and the closing balance was voidable.

However, judicial thinking evolved.

Shephard and Croad v Steel Building Products (Abbott) February 2013

Abbott rejected the point of peak indebtedness and instead looked at the entire trading relationship. He makes no mention of the specified period as in this case the entire commercial relationship was inside it. He made the very specific comment that "I... accept...that the Court should look at the whole course of trading under the continuing relationship."

He accepted that payments made after the date of the last invoice could be part of the on-going business relationship but only voided one final payment made on the cusp of liquidation because this was made outside the trading relationship. He stated that there was no evidence the trading relationship was deemed to be over, something that appears to have influenced Christiansen in the decision he gives the following year.

Levin and Madsen-Reis v Timberworld (Abbott) November 2013

In the Timberworld judgement Abbott refined his position. Here was a case where there were transactions that went back before the specified period. Abbott drew a line here; actually, he drew two lines.

First, he articulated that the continuing business relationship extended from the start of the specified period to the end of the trading relationship which he considers to have been the date of the last invoice. The decline in indebtedness from the start of the specified period and the end of the relationship was considered void.

Further, Abbott also looked at the payments made after the last invoice and declared that these payments were not part of the continuing business relationships and voided these payments as well.

Grant and Khov v Nauhria Precast (Christiansen)

In revisiting the voidable issue several years after McEntee Christiansen adopted and extended Abbott's interperation. In this case the trading relationship started and ended in the specified period yet there had been a series of payments after the final invoice. However the liquidators could point to no evidence that the trading relationship had actually ended and this featured heavily in the judge's decision to reject the application.

A Consensus of Sorts

The Court of Appeal is hearing Timberworld on the 8th of August; the liquidators, Deloitte, are challenging the rejection of the date of peak indebtedness . Until then there appears to be a High Court consensus on how to treat voidable.

Period One: All transactions from the start of the specified period until the end of the trading relationship.

Period Two: All transactions from the end of the specified period until liquidation.

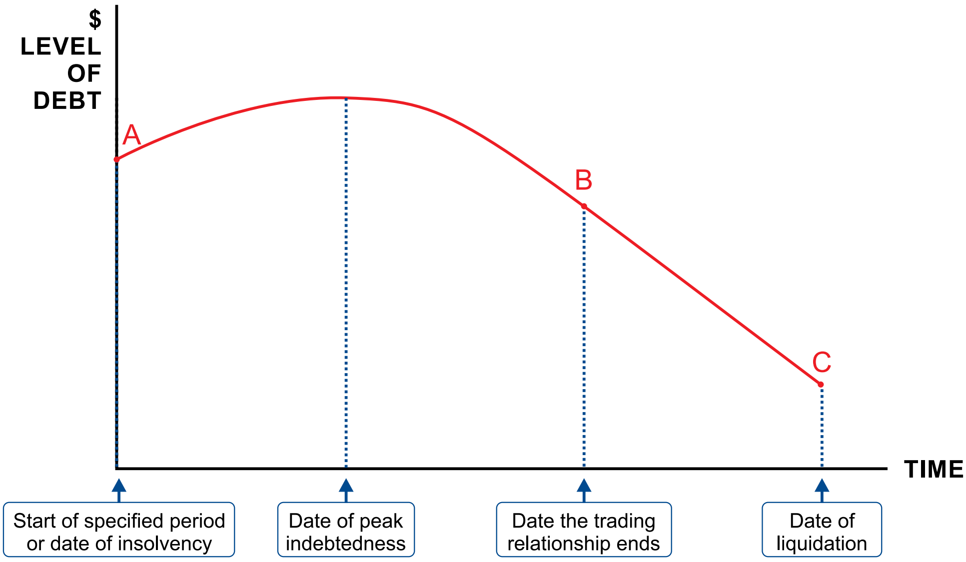
What constitutes an end of the trading relationship is a little opaque but in the Timberworld case the trading relationship was deemed to have ended when the last invoice was raised, but in the Nauhria case the Court found that the liquidator must provide evidence that the relationship had in fact ended. It was not enough to point to a cessation of invoices as evidence that the relationship had ended.

There are two periods, as in the diagram overleaf.

Period One: The specified period to the end of the trading relationship. In the Timberworld case the creditor improved its position by $29k and this was considered voidable. However, it is possible that the creditor's position could have worsened in that period, in which case there would be no voidable amount.

Period Two: From the end of the trading relationship until liquidation. What is critical here is how the end of the trading relationship is defined. Abbott appears to define it as merely when the last invoice was issued; Christiansen was looking for some definitive evidence that the relationship had come to an end.


Debates about voidable transactions can be intense.



The amount voidable is (A-B) + (B-C), but if either (A-B) or (B-C) is less than zero, there is no net-off. Therefore if the level of debt between A and B increased, the creditor would be ordered to re-pay the balance between B and C.

It would be possible for the end of the trading relationship to be the date of liquidation and in many cases this will be the case.

In-Specie Distributions in Solvent Liquidations

By Prashika Chand, Insolvency Officer

In-specie distributions are also known as distributions "in kind". These distributions are made in solvent liquidations where the assets of the company can be distributed to the shareholders according to their shareholding. In order for the company to be able to make in-specie distributions the directors of the company must initially make and file a resolution as to the solvency of the company in the twenty days preceding the appointment of a liquidator.

The solvency test is found in section 4 of the Companies Act 1993 and specifies a company to be solvent if:

(a) a company is able to pay its due debts as they fall due in the normal course of business; and

(b) the value of the company's assets are greater than the value of the company's liabilities, including contingent liabilities.

The liquidator then collects the assets and distributes the proceeds to any creditors. The remaining assets are then distributed to the shareholders in accordance with their share rights and values.

There are three reasons why companies engage in a solvent liquidation;

Reason 1: Tax

The advantage of an in-specie distribution to the shareholders is that unlike a dividend it is not treated as income and tax is not payable at the company rate or the individual shareholder income tax rate. Instead an in-specie distribution is treated as a capital gain to shareholders.

This is because what is being distributed is the equity remaining on the balance sheet after all taxes have been paid. The initial shareholders put in the capital to start the business, profits are made, taxed and the balance goes onto the balance sheet as equity. That equity is owned by the shareholders and can be distributed to them without the IRD taking a second bite of the cherry.

However, if the distribution is made to a related entity taxes may apply. It is the passing of property from one entity to the other for the purpose of generating future taxable income from the same or similar taxable activity that may attract the attention of the IRD. There is then a capital gains portion in the sale and the distribution is taxable. Transferring the asset to related parties winding up the company whilst the company may not be solvent or for the purposes of generating income, classifying this as a distribution is deemed to be tax avoidance and illustrates characteristics of a phoenix company, or a transaction at undervalue. This can open up many areas of investigation by the liquidator, creditors and IRD.

Reason 2: Contingent Creditors

The advantage to the company of distributing these assets in-specie are that there are no further assets or values held by the company and can then be wound up and struck off the Companies Register. There is no legal impediment to the shareholders using the business assets to continue trading and so long as the tax affairs of the business are treated correctly closing down one business and transferring the assets to a new trading entity is common practice, especially in the building industry.

Reason 3: Completion of the business

Many companies are special-purpose vehicles established to complete a defined project. Once again, such structures are very common in the building industry where companies are often established for each development. However, it is also common for other industries to also establish limited liability companies for a set project and once that project has come to an end a solvent liquidation is a perfect and tax efficient way to bring the company to an end.

The Law, John Banks and Kim Dotcom

One of the great privileges of living in New Zealand is the independence and incorruptibility of our judiciary. We have been treated in recent months to the energetic antics of Mr Kim Dotcom but what is truly remarkable about this is case is here we have Mr Dotcom pitted against perhaps the most powerful nation that has ever existed. Yet when the issue of his extradition is finally determined the power and weight of the respective parties will count for nothing. A judge, (presumably followed by several more judges) will consider the issues without fear or favour.

There is no point in the US attempting to pressure our government on this issue because before the New Zealand courts even a powerful cabinet minister is equal to the must humblest of citizens. And as it happens, that most humble of citizens is Graeme McCready.

Mr Doctom may feel gratified at the guilty verdict in the Banks trial but what that trial demonstrated is that our judicial system and the judges who toil within it will not be swayed by pressure, convenience or the whim of public opinion. They are a grey and sometimes grim eminence of calm and reason in a turbulent and often superficial world.

Our Mascot Prudence, inspecting the Terracotta Warriors.

Regulation 22

By Alden Ho, In-House Counsel

In *Waipareira Investments Ltd v Grant* [2013] NZHC 3281, the High Court determined the circumstances in which a creditor will be deemed to have surrendered its security in a liquidation by voting at a creditors meeting.

Background

West Harbour Holdings Ltd (in liquidation) (West Harbour) was placed in liquidation in March 2013. Waterstone were its liquidators.

Waipareira Investments Ltd ("Waipareira") was a secured creditor and held a mortgage over several properties owned by West Harbour.

Under the Companies Act a secured creditor has three options:

305(1)

a) Realise the security (ie; selling, taking possession of it, etc)
b) Value the property and claim as an unsecured creditor for any balance
c) Surrender the security.

Waipareira completed a proof of debt form supplied by Waterstone, claiming to be a secured creditor. Critically, there are two specified forms in the Regulations, one for secured creditors and one for unsecured creditors. The regulations allows liquidators to modify their forms as required and Waterstone did so, resulting in a form bearing an uncanny similarity to that used by the Official Assignee!

Waipareira subsequently called a creditors meeting with the agenda of replacing the liquidators and at that meeting voted their entire debt but failed to install new liquidators. Some weeks later the liquidators challenged Waipareira's security on the basis of Regulation 22.

Regulation 22

The Insolvency Regulations are often overlooked, even by liquidators, but they contain some tricky clauses; none more so than Regulation 22. The critical wording is:

> *(2) Subject to the Act, if a secured creditor votes in respect of the creditor's whole debt, the creditor shall be taken to have surrendered his or her charge.*

At Court, the liquidators submitted that Waipareria duly made an election pursuant to s 305(1)(b) to rely on its security but to prove in the liquidation for the shortfall. Thereafter, it was a secured creditor until the creditors' meeting when it voted. By doing so, Waipareira was deemed to have surrendered its security by virtue of the operation of regulation 22(2)

Conversely Waipareira submitted that it did not qualify as a creditor for the purposes of the creditors' meeting as it was not caught by the definition of creditor under s 240 of the Act. Accordingly, Waipareira was not a creditor and was unable to vote at the creditors' meeting.

The Decision

The Court held that regulation 22 can apply only to a creditor who is caught by s 240 of the Act which defines a creditor as:

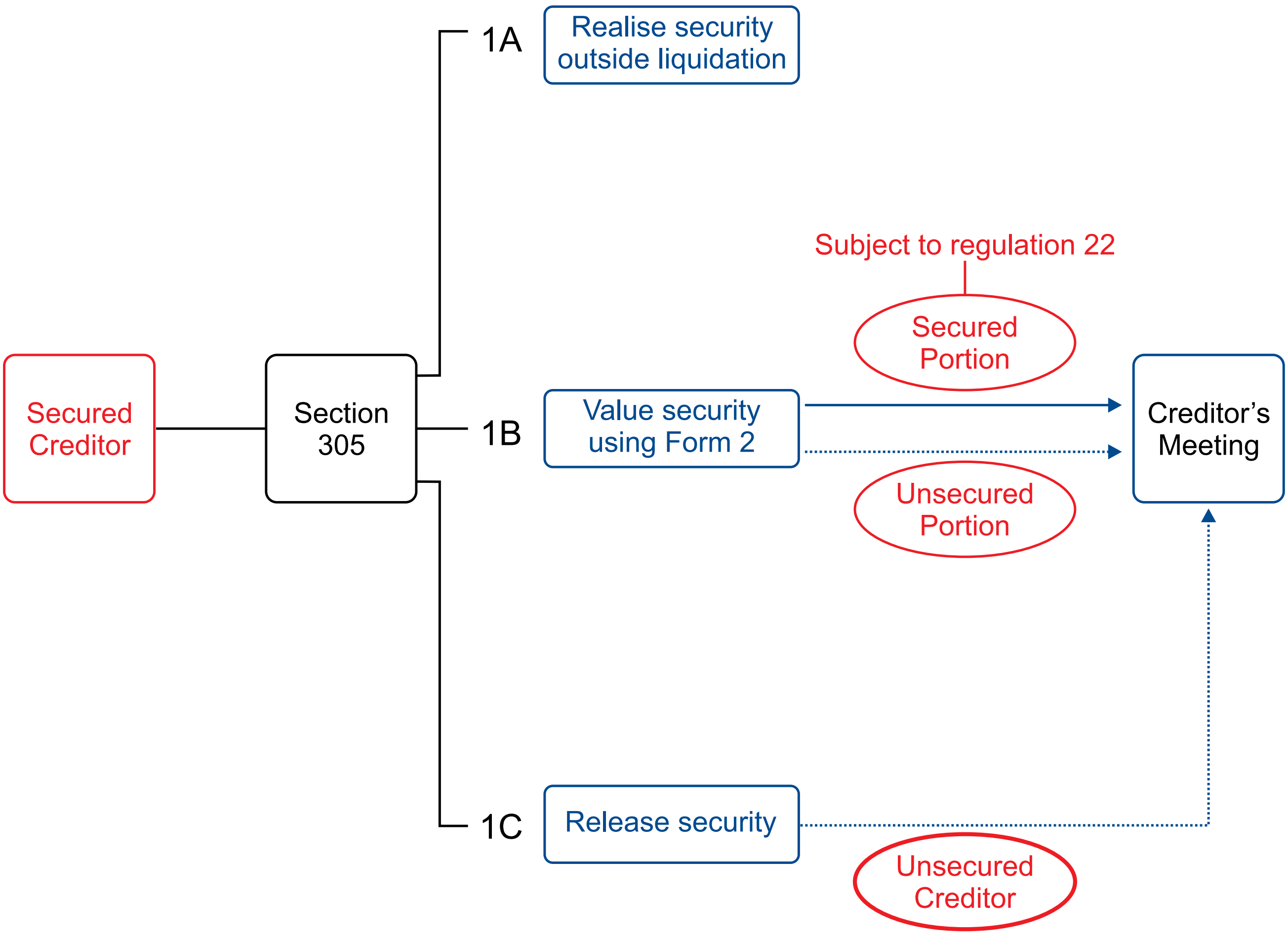
> *... a person who, in a liquidation, would be entitled to claim in accordance with section 303 of this Act that a debt is owing to that person by the company; and includes a secured creditor only -*
> *(a) For the purposes of sections 241(2)(c), 247, 250 and 289 of this Act; or*
> *(b) To the extent of the amount of any debt owing to the secured creditor in respect of which the secured creditor claims under section 305 of this Act as an unsecured creditor.*

In light of the above, the Court held that:

> *"the scheme of the Act requires that a secured creditor consciously and voluntarily take steps to bring itself within the definition of the term "creditor" under the Act, and so be entitled to participate in the liquidation."*

Accordingly, regulation 22 was found to be inconsistent with the Act.

In addition, the Court found that Water stone's proof of debt form was sufficiently distinct from the Secured Creditor's form specified by the regulations that Waipareira cannot have been considered to have been a s 305(1)(b) creditor. Waipareira did not, therefore, value their security and were outside the liquidation.



The above diagram demonstrates the Court's thinking. For a secured creditor to participate in a creditor's meeting they can only do so by valuing their security using Form 2. However the form used in this case wasn't compliant so its completion by the secured creditor was of no effect. A secured creditor who turns up to a creditor's meeting without completing the required form is not, for the purposes of the Act, actually present and their actions are of no effect.

To understand the decision it is important to draw a distinction between the legislation and the regulations. The Court felt that because s 240 defined a creditor as being someone who could claim under s 303 as a creditor and Regulation 22 allowed that creditor to participate in the meeting, there was an inconsistency between the legislation and the regulations and in that event the legislation must prevail.

Waterstone's Opinion

Whilst Waipareira did not fall within the definition of a creditor under s 240, this does not render regulation 22 inconsistent so as to subordinate regulation 22 to the Act. Regulation 22 acts concurrently with s 305 and provides for the treatment of secured creditors in circumstances where their security has been surrendered. To the contrary, Regulation 22 reaffirms a well-established position in Australia. The sister provision to our regulation 22 is regulation 5.6.24 of the Corporations Regulations 2001 (Cth). It provides that:

> *"If a secured creditor votes in respect of his or her whole debt or claim, the creditor must be taken to have surrendered his or her security unless the Court on application is satisfied that the omission to value the security has arisen from inadvertence."*

This was affirmed in *Young v ACN 081 162 512* (2005) 52 ACSR 629, where the Supreme Court of New South Wales held that the mandatory terms of Corporations Regulations 2001 operated to cause a security to be lost by voting on any poll, whether on a substantive issue relating to the rights of a creditor, or a non-substantive issue such as adjournment of the meeting. It is highlighted that the Court in Young went further by finding that in the absence of:

(1) an estimate of the value of a secured creditor's security in the proof of debt;
(2) evidence of an estimate of value in her proof of debt; and
(3) evidence of discussion of the value of her security at the meeting,

The only inference to be drawn was that the secured creditor voted in respect of the whole of its debt on the poll.

Therefore, the case of *Young* posits that if, at a meeting in a winding up, a secured creditor votes in respect of the creditor's whole debt or claim this is taken as an implied surrender of the security unless otherwise ordered by the court.

The Court's findings in *Waipareira Investments Ltd v Grant* are being appealed.

Marshalling

Competing claims amongst secured creditors can sometimes be settled by resorting to Marshalling. The idea is that if the primary secured creditor has a claim over several assets they should not be able to defeat the interests of a subordinate creditor as a result of the order of realisation.

A simple example might be a bank that has a security over two properties and a second tier lender with a second security over one of them.

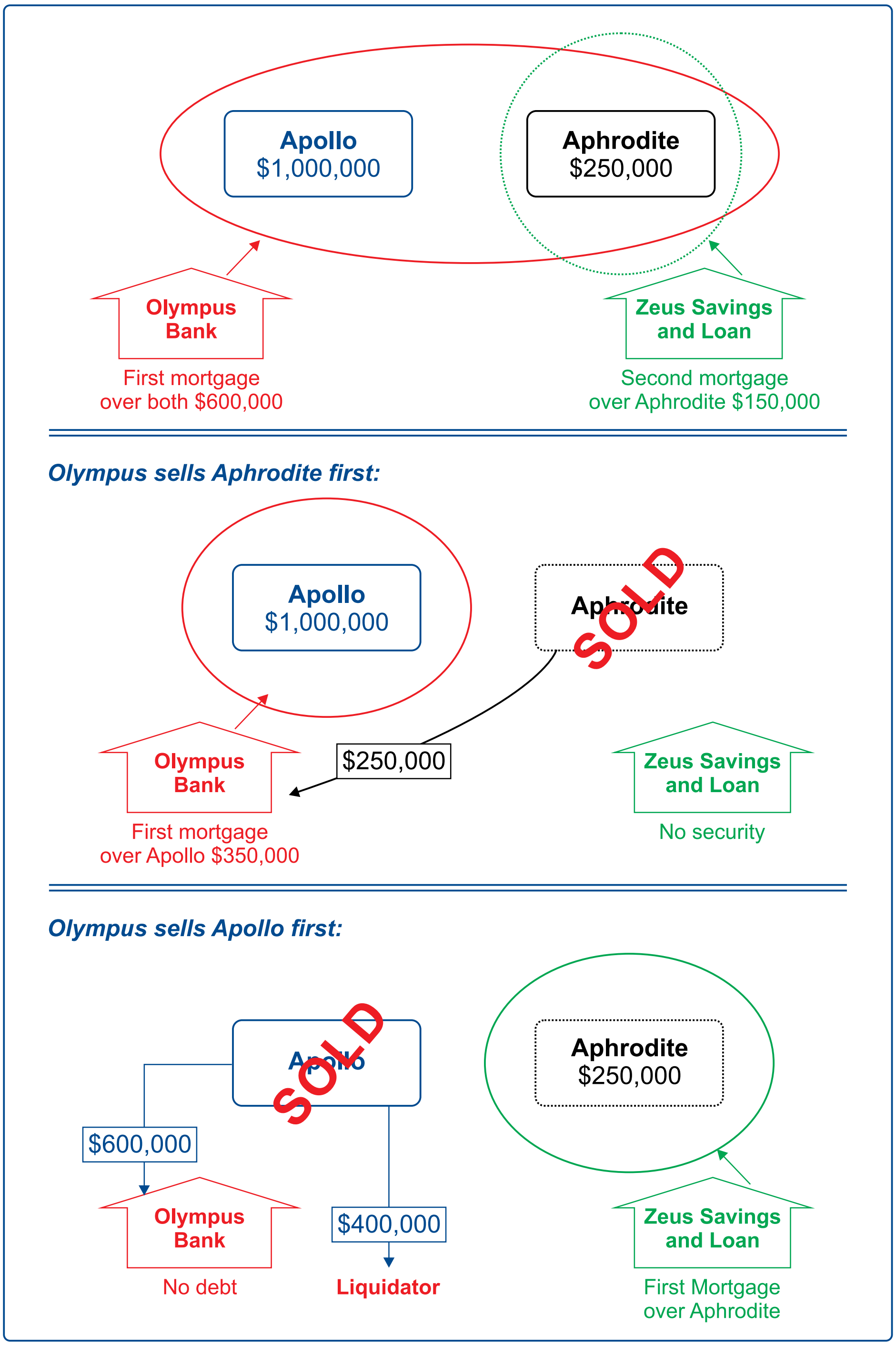
Athena Property Limited (in liquidation) is the debtor and they own two properties; The Apollo Theatre, worth $1,000,000 and the Aphrodite Spa valued at $250,000.

Athena Property has two secured lenders; Olympus Bank which has a first mortgage over both properties and is owed $600,000, and Zeus Savings and Loan which has a debt of $150,000 but only against the Aphrodite Spa.

Because Athena Property is now in default, Olympus moves to sell the Spa by mortgagee sale first, reducing its debt by $250,000. Only then does it sell the Athena Hotel, leaving Zeus to claim as an unsecured creditor. The order matters, because if it occurred the other way around and the Apollo was sold first Zeus would still have a security over the Aphrodite.

The Marshalling doctrine allows Zeus to compel Athena and Olympus to treat the sale of both units as a single transaction, resulting in Zeus getting paid.

There isn't a large body of case law on Marshalling but what there is makes it clear that a first secured party cannot be disadvantaged by Marshalling. They are entitled to move against one asset in preference to another even if it disadvantages subordinated creditors if to do otherwise would cause an economic harm, including delay or uncertainty, to the first charge holder.



Under Marshalling, it matters who goes first.