INTRODUCTION

In constrained times such as the present, with corporate and individual insolvencies running at high levels, a number of cases have fallen to be decided under the vulnerable transaction provisions of the Insolvency Act 1986 (‘IA 1986’). As we arguably teeter on the edge of a second recession, it is opportune at this juncture to reflect upon a couple of cases decided during the challenging period of the last few years.

The rationale of the preference provisions have been succinctly described by Adrian Walters in ‘Vulnerable Transactions in Corporate Insolvency’, as:

‘… seeking] to reverse transactions entered into by an insolvent company in the twilight period before formal administration or liquidation which have the effect of improving the position of one creditor in relation to other creditors possessing an equal-ranking claim to the company’s assets on liquidation.’

It is against this backdrop that Re Stealth Construction Ltd [2011] EWHC 1305 (Ch) (‘Re Stealth’) was decided earlier this year. This case is noteworthy for a number of reasons:

• it reaffirmed the significance of the timing at which a preference is given for the purpose of s 239 of the IA 1986;

• it confirmed the fact that s 239 focuses not on the conduct or state of mind of the creditor concerned, but on that of the directors or others acting for the debtor company; and

• it provided an example of an unsuccessful rebuttal of the presumption for connected persons in s 239(6).

THE FACTS

In October 2007, Mrs Ireland decided to lend £300,000 to her sister’s company, Stealth Construction Limited (‘S’). S’s directors and equal shareholders were Miss Gillis (Mrs Ireland’s sister) and Mr Costa. S purchased three properties in London between August 2007 and March 2008 with the intention of renovating and reselling them or renting them out.

Mrs Ireland was to receive 15 per cent interest on her year-long loan, with interest paid at six-monthly intervals. Her investment was to be secured by a second charge over one of the properties.

The project was ultimately unsuccessful and, in October 2008 (when Mrs Ireland was due to receive her money back), she was informed by her sister and Mr Costa that S was experiencing cash-flow problems and was unable to pay the sums due. Subsequently, Mrs Ireland discovered that a second charge had not been granted to her. She raised the issue with her sister, and consequently, a second charge was put in place on 9 December 2008.
S failed to repay loans to other lenders and on 16 June 2009, a petition was presented for it to be wound up.

The fact at issue in the case was whether anyone from S had instructed S’s solicitors to prepare the second charge in favour of Mrs Ireland in October 2007 or at any other time before October or November 2008. Mr Justice David Richards found that S’s solicitor had not received such instructions to prepare a second charge until late 2008.

THE LAW

‘Relevant time’ is defined, for the purposes of s 239, by s 240(1) as being, in the case of a preference given to a person who is connected with the company, any time in the period of two years ending with the onset of insolvency. A time is not ‘a relevant time’ unless the company was at that time unable to pay its debts within the meaning of s 123 or became so in consequence of the transaction. Persons ‘connected’ with a company are defined through a combination of the provisions under ss 249 and 435 and, of relevance to this case, include a sister of a director of the company.

The liquidator did not contend that the company was or became insolvent in October 2007. Equally, it was accepted on behalf of Mrs Ireland that the company was insolvent, as so defined in IA 1986, from October 2008. Therefore, of crucial importance was the ascertainment of the date at which the decision was made to grant the preference.

On the facts, it was found that no enforceable contract for the grant of a charge in favour of Mrs Ireland was made in October 2007 and that the time for judging whether S was influenced by a desire to improve her position was November 2008.

THE TIME AT WHICH THE PREFERENCE IS GIVEN

We will not dwell too much on the issue of the time at which the preference is given as this has been covered in detail recently in (2011) 4.3 CRI 75, except to note that Mr Justice David Richards confirmed that for the purposes of s 239, that ‘relevant time’ is the date of the decision, not the date of giving the preference. Furthermore, the question of when the decision is made is a question of fact to be determined in the particular circumstances of each case.

Such a finding by Mr Justice David Richards provides a common sense approach and builds upon existing case law. The distinction between the two timeframes is obvious and problems in the application of the law in this area are likely only to arise in great numbers where the time between the decision being made and the preference being given is lengthy. In such cases, it is likely that a ‘second’ decision would be deemed to have been taken at a time closer to when the preference is actually given, for it would appear to be illogical to claim that a decision made in the circumstances of 12 months ago is a valid decision to be applied today.

Whether the length of time between the two dates is too long to claim that the original decision stands is one to be decided on the facts of each case. Some guidance can be gleaned from case law on the point. In Re MC Bacon Ltd [1990] BCC 78, the company reached the limit of its overdraft on 14 April and executed a debenture towards the end of May. Millet J found in that case, that the relevant time when the decision was made was probably sometime between 15 April and 20 May, thus, a month’s wait was considered acceptable. A similar delay was found acceptable in the case of Re Fairway Magazines Ltd [1992] BCC 924. However, it must be borne in mind that while these two cases are informative, each case will ultimately turn on its particular facts.
AN INNOCENT VICTIM

As noted above, Mrs Ireland agreed to lend money to S on the basis that she would become a secured creditor by means of a second charge. Due to ill health she had not checked to see whether such a charge had been duly registered. When the charge was finally registered in December 2008, S was in a position whereby it was unable to pay its debts, thus bringing the security granted for Mrs Ireland’s loan within the remit of s 239. Due to the charge, Mrs Ireland had become a secured creditor and consequently in December 2009 she was paid £130,414.09.

As a result of the decision in Re Stealth the charge has been set aside and Mrs Ireland has had to return the money she had received by way of her secured status. With the exception perhaps of not checking sooner that a charge had been put in place, Mrs Ireland would appear to be entirely blameless in losing her secured status, which, it must be remembered, is something that she was under the impression she had all along. Whilst the decision in this case is correct on the facts as presented, the result with regard to Mrs Ireland is arguably unjust.

Mr Justice David Richards took time to note that Mrs Ireland was an entirely innocent party in the events and that the result of the case implied no criticism of her. He also stated that s 239 focused not on the conduct or state of mind of the creditor concerned, but on that of the directors or others acting for the company.

Whilst, as noted by Mr Justice David Richards, in many cases the preferred creditor will share the desire to be so preferred, this need not be the case. Indeed when this is not the case, truly innocent parties can find themselves out of pocket through no fault of their own.

NON-REBUTTAL OF S 239(6)

Re Stealth has provided another example where the burden of proof under s 239(6) was not rebutted. Section 239(6) provides that:

’A company which has given a preference to a person connected with the company (otherwise than by reason only of being its employee) at the time the preference was given is presumed, unless the contrary is shown, to have been influenced in deciding to give it by such a desire.’

Whilst the point was not mentioned at length in the judgment, this case can be added to the long list of cases which have unsuccessfully tried to reverse the ‘connected persons’ presumption of a desire to prefer.

DELANEY V CHEN [2010] EWCA CIV 1455 (‘DELANEY’)

Section 423 of the IA 1986 contains provisions dealing with transactions defrauding creditors. These provisions make vulnerable those transactions at an undervalue entered into by a debtor for the purpose of putting assets beyond the reach of creditors or otherwise prejudicing creditors.

Section 423 applies equally to companies and individuals and does not have the time limits that are in place for the provisions dealing with transactions at an undervalue elsewhere in IA 1986.

The Court of Appeal decision in Delaney is of interest for the following reasons:

• it addresses the question of where the burden lies in proving that a transaction was at an undervalue;
• it contains a useful discussion of the valuation rules; and

• it highlights the fact that all of the requisite parts of s 423 must be met in order to bring a successful claim.

THE FACTS

Shortly before a charging order was to have been obtained, Mrs Chiu and Mr Ding (the ‘Debtors’) entered into a sale and leaseback of their home. It is this sale and leaseback transaction which was the subject of challenge in this case.

Under the terms of the agreement, the freehold of the Debtors’ home was sold to a Mr Delaney for £210,000 who then granted the Debtors a lease of 21 years at a fixed rent of £500 per month. The lease was absolutely unassignable.

The valuation evidence showed that the value of the freehold with the benefit of full vacant possession was £275,000, whereas the value of the property with the tenancy in place was £115,000.

At first instance it was found that such a sale did amount to a transaction at an undervalue with the requisite purpose, pursuant to s 423. This decision was overturned on appeal by the High Court in Birmingham. An appeal against the decision of the High Court was made to the Court of Appeal in November 2010; this was dismissed. Permission to appeal to the Supreme Court was refused in April of this year.

WHERE THE BURDEN LIES

The District Judge at first instance concluded that the tenancy only had a speculative value, thus meaning that the burden was on Mr Delaney, the buyer, to produce evidence establishing that the tenancy had a value to the Debtors of at least £65,000 (following the House of Lords decision in Phillips v Brewin Dolphin Bell Lawrie Ltd [2001] 1 WLR 143). Judge Purle on appeal did not find that a proper appreciation of Phillips v Brewin Dolphin Bell Lawrie Ltd justified this conclusion and it was therefore distinguished on its facts, for in the present case there was nothing that was precarious about the tenancy and therefore there was no justification for placing any burden of proof on Mr Delaney. He found that the burden of proving an undervalue under s 423 is on those who claim there has been a transaction at an undervalue.

Confirmation that the onus of proof is on the person bringing the action under s 423, except for those cases where the transaction is obviously at an undervalue or where consideration received is too speculative or precarious that the debtor must prove its worth, provides clarity and certainty. Whilst one can envisage cases which do not fall neatly into either camp at least the decision in Delaney demonstrates that where the consideration is real, the onus will be on those who commence proceedings.

VALUATION POINTS

The Court of Appeal decision reconfirms the position taken by Millett J in Re MC Bacon Limited [1991] ch 127, that for the purposes of s 423, one looks at the value received from the standpoint of the debtor. This provides a somewhat unsatisfactory outcome for the creditors in the case of Delaney, since as the value of the transaction has to be seen through the eyes of the Debtors, such considerations as the ‘value’ of keeping their family home were taken into account in deciding whether or not the transaction amounted to an undervalue.
The point advanced by counsel acting for the creditors, that the lease should not be accorded any value for the purposes of s 423(1)(c), since it could not be sold on the open market because it was unassignable, was considered incorrect by Lord Neuberger MR, since the lease had a surrender value. This point has previously been considered in Ramlort Ltd v Reid [2004] EWCA Civ 800, which dispensed with the assumption that because something could not be sold on the open market, it was rendered worthless.

Surely, this is the correct approach to be taken and as highlighted in Ramlort Ltd v Reid, very often valuations are undertaken for such things as shares in private companies, which in practice may be impossible to market, yet a value is obtained frequently for them in a number of contexts, for example for taxation reasons.

AN INTENTION TO PREJUDICE CREDITORS ON ITS OWN IS NOT ENOUGH

The Debtors had stated in evidence that the sale had been made to retain somewhere to live, and such a reference clearly recognised that in the absence of sale and leaseback, the property could have been sold to satisfy the demands of creditors. The effect of the sale and leaseback was to make the property immune from the claims of creditors. The Court of Appeal did not interfere with the finding of the two lower courts with regard to the motivation behind the transaction, i.e. the fact that the Debtors used this transaction as a means of prejudicing their creditors. However, this fact was only one element of the s 423 offence that needed to be satisfied.

The valuation evidence provided to the court clearly showed that, if anything, Mr Delaney had overpaid for the freehold of the property. The comparables given showed that the price paid was a fair one and in excess of an offer previously made to the Debtors; therefore the transaction was not at an undervalue.

As noted by James Ayliffe in ‘Transaction Avoidance in Insolvencies’, the court retains a discretion under s 423 as to whether an order should be made and also the form of any such order. If there were no requirement to establish that the relevant transaction was a transaction at an undervalue, the Court would simply be able to exercise its discretion to make an order in cases where assets had been put beyond the reach of creditors. However, Delaney provides a useful reminder that all elements of s 423 must be present in order for the court to find culpability and to exercise its discretion in relation to any order.

CONCLUSION

Both of the cases discussed provide valuable insight into current judicial thinking on the issue of vulnerable transactions. As we move forward into increasingly difficult times it would appear likely that issues around the actions of debtors will become more commonplace. The cases of Re Stealth and Delaney provide clear guidance on some critical issues which will no doubt be of use over the coming years for insolvency practitioners and creditors seeking to challenge transactions which may have depleted the insolvent’s estate.