RPC

Restructuring and insolvency roundup

January 2018

In this roundup, we consider four cases with implications for all those involved in the restructuring and insolvency sector. This edition includes an article on crowdfunding, a sector which continues to be of interest to practitioners giving the changing regulatory landscape and the risk to investors. Other cases include two Court of Appeal decisions and cover privilege in bankruptcy, the adequacy of ATE policies, and the requirement for boards to be quorate when directors appoint administrators.

Cases

Any comments or queries?

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Cases

Crowdfunding: rewards, risks and regulation

BBH Property 1 Ltd and 12 Others[1]

Following the appointment of the Official Receiver as provisional liquidator of thirteen companies involved in crowdfunding schemes earlier in the year, we consider the rise in the popularity of crowdfunding and the increasing scrutiny they have attracted to ensure investors are protected.

Crowdfunding

The last 20 years have seen crowdfunding platforms surge in popularity and become an increasingly sophisticated source of fund raising for a range of organisations, including companies. By 2016, crowdfunding had overtaken venture capitalism in terms of funding for smaller companies and the FCA reported in its 2017/2018 Business Plan that at the time of publication there was £7.2bn worth of cumulative lending on peer-to-peer platforms (Source: peer2peer Finance Association).

Whilst crowdfunding is often thought of as a modern invention, actually it is said to trace its roots back to the 1700s. Put simply, it is a way in which people, organisations and businesses, including business start-ups, can raise money to finance or re-finance their activities. In the internet age, this has been done through online portals or "platforms".

There are four main types of crowd-funding proposition.

- **Investment-based crowdfunding** – where consumers invest directly or indirectly in new or established businesses by buying investments such as shares or debentures
- **Loan-based crowd-funding or "peer-to-peer lending"** – where consumers lend money in return for interest payments and a repayment of capital over time
- **Donation-based crowdfunding** – where people give money to enterprises or organisations they want to support), and
- **Pre-payment** or **rewards-based crowdfunding** – where people give money in return for a reward, service or product; for example concert tickets, an innovative product, or a computer game.

BBH property

Provisional liquidators were appointed over the thirteen BBH companies, following an investigation by the Insolvency Service and the presentation of a public interest winding up petition by the Secretary of State for Business, Energy and Industrial Strategy. The two schemes involved were set up to purchase and develop property in the UK and Norway, and used a form of investment-based crowdfunding.

The BBH schemes had assured investors – who paid £5.8m into the schemes – that:

- their funds would be invested in the companies purchasing the properties
- they would receive shares, and
- the companies were fully asset-backed by various properties and free from debt.

In fact, none of the companies had legal ownership of securities over any properties and some of the investment funds went to companies connected with the bankruptcy of the couple behind the schemes. The court found that the companies had not kept proper records, lacked transparency and had misapplied investment funds.

1. [2017] EWHC 2584 (Ch).

Regulation of crowdfunding

Whilst there is some data to suggest that crowdfunding failures may be reducing, the BBH Property example serves as a reminder that there will inevitably be crowdfunding schemes which fail, which makes the regulation of the sector and the limitations on safeguards for investors relevant to consider.

Two types of crowdfunding are regulated by the Financial Conduct Authority (FCA):

- investment-based crowdfunding has always fallen within the FCA's mandate where this involves the regulated activity of arranging deals in investments, or the communication of a financial promotion in relation to securities.
- loan-based/peer-to-peer crowdfunding became subject to FCA oversight in 2014 when the regulation of the consumer credit market gave the FCA responsibility for regulating firms lending by way of business through loan-based crowdfunding platforms, and also the platforms themselves.

The other types of crowdfunding – donation-based and rewards-based crowdfunding are not regulated by the FCA.

In addition, regulators and commentators have long highlighted the increased risks of crowdfunding generally compared with traditional means of investment. The FCA has flagged that investors will not have access to the Financial Services Compensation Scheme (FSCS) if a platform fails and becomes insolvent. Investors also bear the risk of platforms operating without the necessary regulatory approvals; for example, the FCA notes that if firms handle clients' money without its permission or authorisation, there will be no protection in place for investors.

Our last piece looked at the regulation of blockchain technology, an area much newer to regulators making this balancing act even greater. It is notable that as yet, there have not been any public sanctions by the FCA against crowdfunding platforms.

Yet the FCA is nonetheless concerned that its current regulatory regime may not be providing sufficient protection for investors, noting in particular the tendency for young crowdfunding platforms to run into difficulties. The FCA has therefore proposed a series of rule changes, which it has been consulting on – for example to impose more prescriptive requirements on the content and timing of disclosures by both loan-based and investment-based crowdfunding platforms, and a proposal to make clear that the auditor of a firm operating a loan-based crowdfunding platform must submit a client assets report.

It will be interesting to see how the regulator and other agencies try to strike the right balance in this sector in the coming years between the need for stringent investor/creditor protection on the one hand, and the opportunities for innovation and competition in the sector.

Rachael Ellis and Amy Gallimore

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Does ATE insurance without an anti-avoidance clause constitute adequate security for costs?

***Premier Motorauctions Ltd (in liquidation) and anor v Pricewaterhousecoopers LLP and anor*[2]**

Premier Motorauctions Ltd and Premier Motorauctions had run car auction and number plate sales businesses in Leeds until 2008 when they went into administration. In 2014 the companies (the Claimants), then acting by subsequently appointed liquidators (from a different firm) asserted claims against the former administrators and the companies' bank, Lloyds (together the Defendants), alleging among other things that the Claimants' assets had been sold by the administrators at an undervalue for the benefit of the bank, in breach of duty. The Defendants denied the claims, contending that in fact the companies had been run into the ground by poor management prior to their administration.

In response to a letter before claim, the bank said it would be seeking security for costs. It claimed to fulfil the jurisdictional requirement under CPR 25.13(c)) on the basis that the Claimants were companies in liquidation and the Defendants had reason to believe the Claimants would be unable to pay the Defendants' costs if ordered to do so. In response, the Claimants provided redacted copies of the after-the-event (ATE) policies which the liquidators had arranged. The Defendants asserted that the policies were not adequate security because they could be avoided in certain circumstances by the insurers, whereas the Claimants argued that the risks of avoidance were contingent and no more than theoretical.

Consequently, the Defendants issued applications for security for costs totalling around £7.2m.

First instance decision

The High Court's decision at first instance appears here.

Mr Justice Snowden held that where a claimant has obtained an ATE policy specifically to cover the bringing of a claim, the question is whether, having regard to the terms of the ATE policy, the nature of the allegations in the case and all the other circumstances, there is reason to believe that the ATE policy will not respond so as to enable the defendant's costs to be paid. The judge agreed that the instances in which an insurer could avoid an ATE policy were theoretical and the Defendants did not do enough to satisfy the court that there was reason to believe the Claimants would be unable to pay the Defendant's costs. As such, the jurisdictional conditions under CPR 25.13(c) were not met and consequently the Defendants' applications for security for costs were rejected.

Decision on appeal

The Defendants appealed to the Court of Appeal, whose decision appears here. The issue before the court concerned whether ATE insurance with no anti-avoidance provisions constituted adequate security for costs in a case requiring such security.

The Defendants submitted that in the absence of ATE insurance, it was obvious the Claimants would not be able to meet an adverse order for costs and as such the jurisdictional threshold would be crossed. The Claimants repeated their earlier submissions that the ATE insurance was only a contingent asset and consequently could not be considered in determining whether the Claimants would be unable to meet an adverse order for costs.

Lord Justice Longmore gave the leading judgment, finding that, if an ATE policy gave the Defendants "sufficient protection", there will not be "reason to believe" that the Claimants would be unable to meet an adverse order for costs and the Court would have no jurisdiction

2. [2017] EWCA Civ 1872.

to make such an order. However, neither the Defendants nor the court had any information with which to assess the likelihood of any avoidance of the ATE policies by the insurers. The Defendants must be entitled to an assurance that the policy was not liable to be avoided due to misrepresentation or non-disclosure. In the absence of such assurance – such as an anti-avoidance clause in the policy confirming that the policy could not be avoided due to misrepresentation or non-disclosure – it follows that there would be reason to believe that the Claimants would be unable to pay the Defendants' costs if ordered and therefore the jurisdictional requirement under CPR 25.13 was satisfied.

The Court of Appeal was also of the opinion that ordering security would not stifle the claim and consequently saw no reason not to order security. The Court held that ordering security would level the playing field as the Claimants had no reason to suppose they would not be able to recover costs if they won. Security was awarded in favour of both the Defendants costs at £2m each, totalling £4m.

Key points for practitioners

For insolvency practitioners contemplating litigation of any kind, the risk of potential adverse costs orders and the means by which these could be met will be a key consideration. The latest judicial decision as to the adequacy of ATE policies to cover this risk means that prudent IPs will need to scrutinise the terms of the policy to ensure that it will respond when needed, and to minimise the risk of defendants applying for security for costs.

It will be interesting to see how the insurance market responds to this decision: although the Court of Appeal determined that ATE policies without anti-avoidance provisions were not sufficient security for costs, the court did not confirm that an anti-avoidance provision would itself be sufficient. If insurers are called upon to include anti-avoidance clauses (or additional means of assurance) in policies, we can expect the additional risk to insurers to be priced into those policies. In a post-Jackson world where ATE policy premiums are not recoverable from Defendants, any additional insurance premium will effectively be passed on to creditors as it will further reduce recoveries.

Harry Collins and Amy Gallimore

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Can a trustee in bankruptcy deploy privileged documents in proceedings against the bankrupt's wishes?

***Leeds v Lemos*[3]**

The first respondent, Mr Lemos, was made bankrupt in March 2015 and was discharged from bankruptcy in March 2017. One of his sisters, a major creditor in his bankruptcy, had issued proceedings under s423 of the Insolvency Act 1984 (IA 1986) alleging that the valuable London home Mr Lemos occupied with his wife (the second respondent) had been transferred to an offshore trust in an attempt to defraud creditors.

Mr Lemos' trustees in bankruptcy (the Trustees) sought directions regarding certain potentially privileged documents that they had obtained from his former solicitors under s311 IA 1986, a provision which enables a trustee to gain control of (among other things) records relating to the bankrupt's estate or affairs. They intended to use those documents for the purposes of the s423 proceedings. Mr Lemos and his wife objected to their use and asserted privilege.

3. [2017] EWHC 1825 (Ch).

Issues

The issues for the court to decide were as follows:

- the true meaning and effect of the recent Court of Appeal judgment in *Avonwick Holdings Limited v Shlosberg*[4], that privilege was not property of a bankrupt which vested in the trustee in bankruptcy
- whether the principle formulated by Goff J (as he then was) in *Crescent Farm (Sidcup) Sports v Sterling Offices*[5], that the right to assert legal professional privilege could pass to a successor in title, applied in bankruptcy, and
- whether ss333 and 363 of IA 1986 could be used to compel Mr Lemos to waive his privilege in any documents released to the Trustees. Section 333 requires a bankrupt to cooperate with his or her trustees, even after discharge. Under section 363, a bankrupt or a discharged bankrupt whose estate is still being administered is subject to the general control of the court.

Decision

HHJ Hodge QC found for Mr Lemos and his wife, permitting them to assert privilege over the documents.

In *Avonwick*, the Court of Appeal held that privilege did not constitute property of a bankrupt which was capable of vesting in the trustee in bankruptcy, and was therefore personal to the bankrupt. It followed the House of Lord's decisions in *Derby Magistrates*[6], *Simms*[7] and *Morgan Grenfell*[8] in finding that privilege is a fundamental human right and basic tenet of the common law. A bankrupt could be deprived of privilege only if IA 1986 so provided or if it was a necessary implication of the express language of its provisions.

All the relevant provisions were set out in general terms and did not specify that privilege was property of the bankrupt which automatically transferred from the bankrupt to the trustee, nor was that a necessary implication of the provisions. In particular, section 311 IA 1986 merely provides that a trustee in bankruptcy can take possession of documents with the overriding function of getting in, realising and distributing the bankrupt's estate. The public interest in carrying out this function, however great that may be, does not justify even a limited exception to the absolute nature of privilege.

The judge found that the *Crescent Farm* principle has no application in bankruptcy. In any event, all that had been decided in *Crescent Farm* was that the right to assert privilege could voluntarily pass to a successor in title, not that a successor in title could waive privilege.

Insofar as Peter Gibson J held in *Konigsberg (A Bankrupt), Re*[9] that the *Crescent Farm* principle did apply in the case of the passing of property to a trustee in bankruptcy, his decision was wrong.

Neither s333 nor s363 IA 1986 assisted the Trustees, since they do not include an express power to waive the bankrupt's privilege.

Key points for practitioners

This is an important decision for insolvency practitioners and trustees in bankruptcy in particular. Until *Avonwick* it had generally been assumed that trustees in bankruptcy simply stepped into the shoes of the bankrupt and acquired the benefit of any privilege exercisable by them. This decision confirms that, following *Avonwick*, trustees can only make limited use of documents subject to legal professional privilege in favour of a bankrupt. Whilst trustees are entitled to look at privileged documents to obtain information, they cannot waive privilege without the bankrupt's consent.

4. [2016] EWCA Civ 1138.
5. [1972] Ch 553.
6. [1996] AC 487.
7. [2000] 2 AC 115.
8. [2002] UKHL 21.
9. [1989] 1 WLR 1257.

It should be noted that this case does not apply to the issue of privilege in liquidation where privilege remains with the company (of which the liquidator is an agent).

Eliot Henderson and Amy Gallimore

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Duomatic and the dissolved corporate member

***BW Estates Ltd: Randhawa and another v Turpin and another*[10]**

This case concerns the contested appointment of administrators in complex circumstances, which included the company's corporate member having been dissolved and the involvement of a disqualified director.

The respondents, Andrew Turpin and Matthew Hardy (the Respondents), had been appointed as joint administrators of BW Estates Limited (the Company). Mr Gursharan Randhawa and Mr Sukhinder Randhawa (the Appellants) were creditors of the Company challenging the Respondents' appointment on the basis that the appointment had been approved at an inquorate board meeting.

Issues

At the time of the appointment, the Company had two shareholders: the sole director David Williams (DW), who held 75% of the Company's shares on trust for his father, Robert Williams (RW), and the remaining 25% held by another company, Belvedere (described by the High Court as an "alter ego" for RW). Belvedere had been dissolved in 1996 but remained on the Company's register of members.

The Company's articles provided that the quorum for board meetings and shareholders' meeting was two. The appointment of the Respondents was made by DW acting under guidance from RW, who was a disqualified former director of the Company.

Among the issues for the court to decide were whether:

- under the *Duomatic* principle (which provides that where all members who have a right to attend and vote at a general meeting unanimously consent to a decision, that consent is as effective as a formal resolution), the articles had been amended such that that quorum for board meetings was reduced to one
- a dissolved corporate member which remains on a company's register of members retains its status as member despite its dissolution, and
- paragraph 22(2) of Schedule B1 Insolvency Act (IA) 1986 empowers a company's directors to appoint an administrator regardless of quorum provisions set out in its articles.

First instance decision

The High Court's decision at first instance appears here.

His Honour Judge Purle, QC (sitting as a Judge of the High Court) upheld the validity of the Respondents' appointment on the basis that that the *Duomatic* principle applied. Since RW (who was likely the beneficial owner of both DW and Belvedere's shares) and DW had consented to DW's appointment of the Respondents, such consent could be interpreted to have altered the articles' quorum requirements to allow the sole director to make decisions, and therefore allow DW to appoint the Respondents.

10. [2017] EWCA Civ 1201.

The court held in the alternative that upon dissolution Belvedere had ceased to be a member, so that the Company became a single member company and DW's unilateral acts as sole member and director were valid under *Duomatic*.

Decision on appeal
The Appellants appealed to the Court of Appeal, which overturned the High Court's decision. The Court of Appeal's decision appears here.

Sir Geoffrey Vos, Chancellor of the High Court gave the leading judgment, and on the above issues found as follows:

- upon dissolution of Belvedere, the principle of bona vacantia applied, and the shares held by Belvedere had passed to the Crown. The legal owner of the shares (the Crown) had clearly not consented (actually or putatively) to the appointment or to a change of the articles' quorum requirements, so *Duomatic* could not apply. Belvedere's assent to the proposal to appoint administrators could not be inferred by looking at what RW, as someone who might previously have had an interest in Belvedere, might have thought. a "member" as referred to in the articles and the Companies Act 2006 includes any member on the register of members, whether alive or dead, or dissolved. The Company was therefore not a single member company (and so the articles' quorum requirement of two members still applied), so again, *Duomatic* could not apply.
- paragraph 22(2) of Schedule B1 Insolvency Act 1986 does not override the quorum provisions in a company's articles of association.

Comment
The Court of Appeal criticised the Respondents' failure to inspect the articles of association of the Company prior to the appointment. The decision is a clear reminder that the onus is on prospective administrators to ensure that their appointment is conducted in accordance with the Company's articles of association. Administrators will not be able to rely on paragraph 22(2) of Schedule B1 IA 1986 to validate the appointment.

Although the case considered the status of dissolved members still on the register in the context of the application of the *Duomatic* principle, it follows that dissolved or deceased members that remain on the register of members still constitute members for the purposes of the Companies Act 2006. This presents an interesting but practical dilemma for those companies that are seeking to pass shareholder resolutions, but have a dissolved or deceased member that holds more than 25% of the shares. Until the register of members is updated, the mere "paper presence" of these members may block the ability of the company to form quorate shareholder meetings or pass resolutions. In light of this decision, companies may need to review their articles to expressly disenfranchise shares held by a deceased or dissolved member until such time as those shares are registered in the name of the successor.

For the principle of *Duomatic*, the Court of Appeal has clearly adopted a rigid interpretation: even where a member is physically incapable of voting, the consent of that member would still be required for *Duomatic* to apply.

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