Briefing

BURGES SALMON

Corporate Turnaround and Insolvency

Pre-insolvency transfers of company assets and director misconduct – two contrasting decisions

The question of appropriate action in the face of directors' duties to creditors in the pre-insolvency "twilight zone" is a perennial one. In particular, the question of preservation of asset value (given all the hoo-ha about pre-packs), and whether to transfer out assets before insolvency has an impact on value, is fraught with difficulty. Two recent cases offer contrasting versions of how to go about it.

Background – Re Finch UK plc

In *Re Finch UK plc (in liquidation) [2015] EWHC 2430*, the company involved was a property development vehicle, run by a husband and wife (Mr and Mrs Finch). They were also settlors of a family trust (owning property) and settlors of a bare trust, under which certain of the family trust properties were transferred to the company.

The husband had received 870,000 redeemable preference shares, paid for out of his director's loan account, the agreement being that the shares would not be redeemed for at least two years. Prior to the company entering liquidation, however, the shares were redeemed, and the director's loan account credited with the redemption value. The bare trust properties were also returned to the husband, the value of such properties being debited to the loan account, but with a credit for the value of the mortgages on the properties being applied. The liquidators alleged that this amounted to misfeasance and a preference.

Background – Hedger v Adams

In *John David Hedger (Liquidator of Pro4Sport Ltd) v David Adams [2015] EWHC 2540*, some quite different considerations applied. After having been advised by insolvency practitioners that an insolvency process was inevitable for his company, Mr Adams obtained valuations for his company's assets, which concluded that its open market value was £37,000 plus £15,000 for goodwill. However this was impacted by the viability of its business model and questionable future profitability. Mr Adams investigated whether the creditors of an associated company (of which he was also director) would continue to support it, which they indicated they would do. Adams then arranged for the transfer of the whole of the company's assets to the associated entity, for a price of £56,400, entirely deferred and with the only security being retention of title. The liquidator adopted this contract.

Whilst the schedule of payments was initially kept, the transferee company itself ran into difficulties and eventually went into liquidation. The liquidator of Pro4Sport claimed against Mr Adams for breach of his directors' duties under the Companies Act 2006.

What were the issues

In Finch, the questions were: (i) whether the issue and redemption of the shares (and re-transfer of the properties) constituted misfeasance; and (ii) whether the crediting of the director's loan account with £875,000 for the redemption constituted a preference under s.239 IA 1986.

In Pro4Sport, the issues were whether the transactions constituted a breach of the following sections of CA 2006: (i) s.172 (failure to promote the success of the company) as he had failed to sell assets for the best price and had done so on a risky deferred consideration basis; (ii) s.174 (failure to exercise reasonable care, skill and diligence) as he had failed to secure or guarantee the liability; and (iii) 190 – 195, for failure to seek approval of substantial property transactions.

What did the court decide? Finch

In Finch, the misfeasance point was cured by the fact that the directors were shareholders of the companies, and under the "*Duomatic* principle" had endorsed the allotment of the shares. This principle did not apply to the redemption of the shares, however, as shares could only be redeemed out of profits available for distribution. The redemption was therefore made in breach of duty and could not be cured as the *Duomatic* principle did not apply in insolvency situations.

Turning to the redemption of the shares however, once Mr Finch had issued notice to redeem the shares, this constituted him as a creditor of the company. The adjustments made to his director's loan account and the return of the trust property had put him in a better position than he otherwise would have been on liquidation (as the properties formed part of his estate and not that of the company). The transaction occurred within the six months prior to liquidation, and the husband was aware of the company's financial straits.

What did the court decide? Pro4Sport

In *Pro4Sport*, the court did not consider that Mr Adams had acted in breach of his duties. At all times he had considered the creditors' interests, And had acted as he did to avoid the costs (and diminution in values) caused by an open market sale. He had sought professional advice, on which he was entitled to rely, and had applied the maximum value obtained from each valuation to the sale. Deferred consideration was the only basis of the terms offered, and Adams had checked serviceability of the debt by checking with the creditors of the intended transferee.

The liquidator had adopted the contract and had not sought to challenge it prior to default. Nor had he sought a personal guarantee when agreeing the payment schedule under the contract, so the issue of a guarantee was irrelevant. It could not be said that – given all this – the director had not exercise due care and skill. Even if he had breached his duties, he had acted honestly, reasonably and on the basis of advice (and to the knowledge of the liquidator) – any breach would have been excused under s.1157 CA 2006.

What can practitioners learn from these cases?

It is useful to contrast these two decisions. The *Finch* case is a typical situations where – faced with imminent insolvency – directors decide to take action to salvage what they can for themselves personally and attempt financial obfuscation in an attempt to justify what has been done.

Pro4Sport, on the other hand, shows a director taking measured steps, with the benefit of independent advice (not obtained in *Finch*), in order to maximise the benefit to creditors and is not a million miles from what might be considered as a "good" pre-pack.

As ever in these situations, the key for directors and practitioners alike is record keeping and obtaining professional advice. This will set out a clear evidence trail for those acting honourably in the event that – as sometimes happen – this do not subsequently go accordingly to plan.

Some of the comments in the judgment in *Finch* make for stomach-churning reading. Perhaps the difference between the two cases is best summed up in the following extract from Finch (para 24): "I fear that I cannot accept any of this evidence. … I am satisfied … that … Mr Finch appreciated that the company was at serious risk of insolvency and he was determined to extricate from the company the properties which were the subject of the commercial arrangements, and which he had carefully built up with his wife over the previous ten or more years, in order to preserve them for the benefit of his family. I find that Mr Finch has sought to mislead the court to achieve that end."

Ouch.

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