

# legalupdate

YOUR UPDATE OF  
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COMMERCIAL LAW

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Gary Pryce

**In the present economic downturn one does not need to be the BBC Economics Editor to foresee that the volume of bankruptcy proceedings in England & Wales will increase in 2009 and 2010. Lawyers may be tempted to draw on their experience of the 1990s recession and use the lessons of that period as a guide. But they will not be able to do that for applications to realise a bankrupt's interest in his home. Here the rules changed on 1 April 2004.**

### Use it or lose it

In personal insolvency the largest potential asset in a bankrupt's estate is usually a beneficial interest in his home. This interest will, of course, vest in the bankrupt's trustee in bankruptcy. In the 1990s and into this decade, there were many cases in which a trustee in bankruptcy did not attempt to dispose of the bankrupt's interest in his home for many years because the property was in or near negative equity. When house prices increased, sometimes a decade or more after the bankruptcy order was made and the debtor was long since discharged, it was not uncommon for trustees to make an application for possession and sale. This was often to the surprise and anger of the bankrupt (and any other joint owner).

The rules changed with Part 10 of the Enterprise Act 2002, which introduced section 283A into the Insolvency Act 1986. That section applies where a bankruptcy order was made on or after 1 April 2004, and provides that trustees have three years to deal with a bankrupt's interest in his home from the date of the order. A trustee deals with a bankrupt's interest where he:

- > realises that interest;
- > applies to court for an order for possession or sale;
- > applies to court for a charging order; or

## Dealing with the estate's beneficial interest in a bankrupt's home: use it or lose it

> comes to an arrangement with the bankrupt that the bankrupt will incur a specified liability to the estate in return for which the beneficial interest in the home ceases to form part of the estate (a 'specified liability agreement').

Under section 335A of the 1986 Act, where a trustee in bankruptcy makes an application for an order for sale more than one year after the property first vests in the trustee, there is a presumption that the interests of the bankrupt's creditors outweigh all other considerations, unless the circumstances of the case are exceptional. *Nicholls v Lan* [2007] 1 FLR 744 held that the person opposing the sale of the property must demonstrate that exceptional circumstances exist. The ordinary incidents of bankruptcy will not meet this test. If the court finds exceptional circumstances, it must balance the interests of the creditors against those of any children, any present or former spouse (bearing in mind whether their conduct has contributed to the bankruptcy) and against all the circumstances of the case other than the needs of the bankrupt.

So the new regime gives a trustee three years in which to deal with a bankrupt's former interest in his home, and contains a statutory presumption that a sale will be ordered when an application is brought between the first and third anniversaries of the vesting of the property in the estate. If a trustee does not deal with the bankrupt's interest within the three-year period, that interest automatically re-vests in the bankrupt: see section 283A(2).

### Finer points

But those advising trustees and bankrupts should also be aware of some of the new regime's finer points.

#### (1) Commercial property and second homes

The new regime only applies to an "interest in a dwelling-house" which was, on the date of the bankruptcy order, the "sole or principal residence" of the bankrupt or a current or former spouse. So trustees will be able to deal with second homes and commercial properties in the same way as they did before the Enterprise Act 2002 came into force.

#### (2) Low value realisations

Section 313A of the 1986 Act provides that a court "shall" dismiss an application for possession, sale or a charging order if the value of the bankrupt's interest in his home (after deduction of the reasonable costs of sale) is less than the prescribed amount, currently £1,000 (see SI 2004/547). Moreover the dismissal of a trustee's application normally has the effect of re-vesting in the bankrupt his former interest in the property. So a trustee should be reasonably sure of his evidence of value before launching an application: if he gets it wrong, he will be unable to make a subsequent application even if there is a later rise in the value of the property.

#### (3) Late notification

Bankrupts are of course required to provide a statement of affairs to the Official Receiver and to provide details of their assets to their trustee. But some breach these obligations. Where a bankrupt fails to notify the Official Receiver or his trustee of his interest in his home within three months of bankruptcy, the legislation provides that the three-year 'use it or lose it' period will begin only on the date on which such notification is given.

#### (4) Substitution of an extended period

The court may vary the usual three year period "in prescribed circumstances" or "in such other circumstances as the court thinks appropriate". There are, at present, no "prescribed circumstances" and no guidance from the courts.

#### (5) Specified liability agreements

A trustee who seeks a cheap and simple alternative to an application for possession and sale may decide to enter into a specified liability agreement with the bankrupt. Here, the bankrupt agrees to pay a certain sum of money in consideration for which his interest in his home will cease to form part of his estate in bankruptcy. In other words, he buys back his interest. So, if there is equity of £10,000 in a property, and the costs of sale are estimated at £5,000, the trustee and bankrupt may decide to enter into a specified liability agreement under which the bankrupt will pay £7,500 into his estate.

Article continued >



Trustees have three years to deal with a bankrupt's interest in his home



#### (6) Charging orders.

The final alternative that a trustee might consider is an application for a charging order. An application can be made where a trustee is unable “for any reason” to realise the bankrupt’s interest in his home. If the application succeeds, the bankrupt’s former property will re-vest in him, but will be subject to a charge to secure “the amount of the bankrupt’s interest in the property” on the date the charging order is made, together with interest: see section 313 of the 1986 Act.

#### Conclusions

Where a bankrupt’s estate includes a beneficial interest in his home, a trustee in bankruptcy will now be faced with difficult questions as to what steps to take when the value of that interest is dropping or already non-existent. If a trustee gets it wrong or waits too long, the estate’s most valuable asset may be lost forever.

Gary Pryce has a practice which includes aspects of insolvency law, particularly where there are issues in dispute concerning ownership or the treatment of commercial or residential property interests in insolvency proceedings. His practice also includes property litigation and commercial litigation. Gary Pryce appeared for the Trustee in *Bankruptcy in Nicholls v Lan* [2006] EWHC 1255 (Ch), [2007] 1 FLR 744.

[gary.pryce@newsquarechambers.co.uk](mailto:gary.pryce@newsquarechambers.co.uk)



David Eaton Turner

## Appointing administrators: ‘pre-packs’ and procedural errors

**One alternative to winding up a company commonly considered – both by insolvent companies and by their creditors – is the appointment of an administrator, under the procedure provided in the Insolvency Act 1986.**

#### Objectives

The objectives of an administration are these:

- > The primary objective is to rescue the company as a going concern, though the legislation recognises that this may not be possible in every case.
- > If the administrator considers the rescue of the company not to be possible, he may pursue the secondary objective of achieving a better result for the creditors as a whole than would be likely if the company were simply wound up.
- > A third possible objective is to realise property in order to make a distribution to one or more of the secured or preferential creditors, but without unnecessarily harming the interests of the creditors of the company as a whole.

#### Procedure

The procedure is now set out in Schedule B1 to the 1986 Act. There are three ways in which an administrator may be appointed:

- > Out of court, by the company or its directors; or
- > Out of court, by the holder of a qualifying floating charge; or
- > By the court, on the application (in most cases) of the company or its directors, or of a creditor.

The ability to appoint an administrator out of court is a fairly recent development, available since 15 September 2003. The appointment is effected by filing prescribed documents at court but the court is not otherwise involved. An application to court must, however, be made if the company is already the subject of a winding-up petition.

#### Administration pre-packs

Increasing use is being made of (so-called) administration pre-packs, where the intended administrators set up, in advance of their appointment, a sale of all or the majority of the company’s assets, so that by the time of the creditors’ meeting (which the administrators have 10 weeks to call) a deal has been done, often with one or more former directors, or with a new company formed by the previous management.

#### Pre-packs endorsed?

The use of pre-packs is not expressly sanctioned by the legislation, but has received some recent judicial support.

*Re DKLL Solicitors* [2008] 1 BCLC 112 was an application for an administration order in respect of an insolvent partnership. The judge made an order despite the opposition of the Revenue, the majority creditor. The declared intention of the proposed administrators was to dispose immediately – and therefore before the holding of a meeting of creditors – of the business of the partnership to a newly formed LLP. The Revenue contended that it would be wrong to make an administration order, so allowing the ‘pre-pack’ sale to go ahead, where,

had a meeting of creditors been held, it would be in a position to defeat the proposals.

The judge, however, noted that in several previous cases (e.g. *Re T&D Industries* (2000) and *Re Transbus* (2004)) the court had approved of decisions by administrators to dispose of assets before the holding of a meeting of creditors. He held that a majority creditor had no veto over the implementation of the administrators’ proposals. The Revenue’s opposition did not mean that it was not reasonably likely that the statutory objective of administration would be achieved. The judge in *DKLL* concluded that there would be a real prospect of the court authorising the proposed sale, notwithstanding the Revenue’s objection.

#### Statement of Insolvency Practice 16

Concern about possible misuse of pre-pack administrations has led to the introduction of Statement of Insolvency Practice 16, with effect from 1 January 2009. SIP 16 requires administrators to disclose to creditors in all cases where there has been a pre-packaged sale the following information in particular:

- > The background to their appointment;
- > Why they consider a ‘pre-pack’ would represent the best outcome for creditors;
- > Any valuations obtained;
- > Why it is not thought appropriate to trade the business, and offer it for sale as a going concern, during the administration;
- > The price being paid, and the name of the purchaser of the business; and
- > Details of any connection between the purchaser and the directors and shareholders of the company in administration.

#### Procedural errors

That it is possible now for appointments of administrators to be made out of court increases the risk of procedural errors, potentially with adverse consequences for both the administrators concerned and their appointors.



*That it is possible now for appointments of administrators to be made out of court increases the risk of procedural errors*



In *Re Blights Builders Ltd* [2008] 1 BCLC 245:

- > The sole director of an insolvent company died, and his executors exercised the votes attaching to his shares and appointed joint administrators out of court on 20 July 2006;
- > They were unaware that on 5 July 2006 a creditor had presented a petition for the winding-up of the company;
- > That petition was not sealed and issued by the court until 25 July, but its presentation dated back to 5 July when it had been delivered to the court.

Schedule B1 of the 1986 Act provides, at para. 25, that an administrator cannot be appointed out of court if there is a pending winding-up petition. The administrators applied to the court for a declaration as to the validity of their appointment.

The judge held that rule 7.55 of the Insolvency Rules (*'No insolvency proceedings shall be invalidated by any formal defect or by any irregularity ...'*) did not assist, for an appointment of administrators out of court by the company or directors could not be regarded as 'insolvency proceedings'. He concluded that the appointment of the administrators was invalid.

On the facts of that case there were few adverse consequences:

- > The petitioning creditor was happy that an order should be made appointing the same individuals as administrators;

- > The invalid administration had only been under way for a week or so when the appointees became aware of the situation;
- > The judge made an order under para. 34 of Schedule B1 that the invalidly appointed administrators should have an indemnity against the executors who had appointed them, and a further order under para. 104 that all their acts were valid in spite of the defect in their appointment. (Para.34(2)... of Schedule B1 provides that *'The court may order the person who purported to make the appointment to indemnify the person appointed against liability which arises solely by reason of the appointment's invalidity.'* The ambit of this provision is yet to be clarified).

The judge left outstanding, however, for a further application, the question whether the administrators would have any claim for remuneration for the period before they were validly appointed.

In *G-Tech Construction Ltd* [2007] BPIR 1275 the procedural defect arose in a different way. The company in general meeting resolved to appoint administrators out of court under para. 22 of Schedule B1. To make such an appointment effective one has to file at court a notice of appointment in a prescribed form. Unfortunately the wrong form was used. The defect only came to light nearly a year later when the administrator was about to bring the administration to an end. He applied for directions.

The judge held that rule 7.55 did not assist, and also that an order under para. 104 of Schedule B1 could not help cure the invalidity of the appointment itself. He made an order appointing the same office-holder as administrator, and additionally felt able to interpret para. 13(2) of Schedule B1 as enabling him to back-date that order by almost a year, with the intention that the administrator should be enabled to claim his fees and expenses for acting over the previous year.

#### Conclusion

The lessons are that:

- > Directors appointing administrators out of court should consider with their advisers whether they may have opened themselves to liability to indemnify those they appoint under para. 34 of Schedule B1; and
- > Administrators accepting out-of-court appointments should consider with their advisers, at an early stage, the procedural validity of their appointments.

**David Eaton Turner specialises in corporate and personal insolvency, company law generally, banking, commercial litigation and related professional negligence matters. He is regularly instructed in relation to shareholder disputes, and by liquidators, administrators and trustees in bankruptcy, and by banks and their customers.**  
[david.eatonturner@newsquarechambers.co.uk](mailto:david.eatonturner@newsquarechambers.co.uk)



Stephen Schaw Miller

## Financial adventure and forensic archaeology: transactions at undervalue and limitation periods

**Financial adventurers sometimes prefer not to subject their own assets to the same risks that they are willing to impose on their creditors. Incorporating a company to carry on a risky business will usually provide legitimate protection for the members' assets, but personal liabilities can still attach to the unlucky or malleasant. Fear of the consequences tempts some to try to put their assets beyond the reach of their creditors.**

**The Insolvency Act 1986 enables both creditors and office-holders to set transactions aside where the debtor has transferred assets to others for no or no commensurate consideration. This article looks at the question what time-bars apply where claims are made for the purpose of digging into and setting such past transactions aside.**

#### Setting aside by office-holders

Both in company insolvency and in bankruptcy, the Insolvency Act 1986 (sections 238 and 339) gives office-holders statutory causes of action to set aside a prior transaction at an undervalue.

Only the office-holder can pursue them. In summary:

- > The office-holder need not show that the bankrupt entered into the transaction with any particular purpose.
- > In bankruptcy the trustee must establish (i) that the transaction occurred within the period of five years ending with the day on which the bankruptcy petition was presented and (ii), unless the transferee was an associate of the bankrupt (defined in section 435), that the bankrupt was insolvent when he entered into the transaction or became insolvent because of it.
- > In company cases, the period is two years before the onset of insolvency.

Can the office-holder's claim become statute-barred and, if so, after what period?

**Article continued >**

Answers were given in *Re Priory Garage (Walthamstow) Ltd* [2001] BPIR 144, a company insolvency. It was held that an application to set aside a transaction was an action on a speciality within the Limitation Act 1980, section 8(1) and hence prima facie subject to a 12-year limitation period, but that there might be cases which were taken outside the scope of section 8(1) by sections 9(1) and 8(2), so that the limitation period was reduced from 12 years to six. That would be so if it could fairly be said that the substance of the application was “to recover a sum recoverable by virtue of” the Insolvency Act. Time was taken to run from the date of the winding-up order, that being the first date on which it would have been possible for a liquidator to bring a claim under section 238, even though in fact no liquidator was appointed until some 18 months later.

Translating that to bankruptcy, the trustee must bring his claim under section 339 within six years, if it is a claim to recover money, or within 12 years, if other relief is sought; and it seems that time begins to run from the bankruptcy order, or arguably from the date of the first trustee’s appointment.

#### Setting-aside by victims too

Section 423 provides a similar cause of action that may be invoked either by an insolvency office-holder or by a “victim” of the transaction to set aside a transaction entered into by the debtor for no or no commensurate return in value. Unlike sections 238 and 339, it applies only where the debtor entered into the transaction for the *purpose* of putting assets beyond the reach of a person who was making or might at some time make a claim against him, or of otherwise prejudicing the interests of such a person in relation to his actual or potential claim. In this context a victim of a transaction is a person who is or is capable of being prejudiced by the transaction. A person may become a victim of a transaction even though it was not made with him in mind: *Random House v Allason* [2008] EWHC 2854 (Ch), para. 95. The ability of a victim to bring a claim has the consequence that the statutory cause of action may accrue before or without the appointment of an insolvency office-holder.

Questions about time under section 423 include the following.

- > When does the right to bring an action to set aside past transactions accrue?
- > Within what period from that moment must the action be brought?
- > Can that period be extended?
- > How long does a transaction remain vulnerable to being set aside? Or, looked at from the opposite

perspective, how far back in time can an action reach to catch a vulnerable transaction aside?

#### (1) Accrual of right of action

The Court of Appeal addressed the first question in *Hill v Spread Trustee* [2007] 1 WLR 2404, a claim made by a trustee in bankruptcy. All three judges were agreed that a cause of action under section 423 would accrue when a person acquired the status of being a victim of the transaction in question. But they divided 2:1 on whether there was only one cause of action, which accrued when it could first be shown that there was a victim, or a series of causes of actions, accruing both as and when different persons became victims *and* as and when an insolvency office-holder was appointed. The majority preferred the second position. In consequence, if the claim was brought by the trustee in bankruptcy, time began to run against his claim only from the date of the bankruptcy order, even though time might already have begun to run, or even have expired, against a claim which might have been pursued by a victim under the same section in respect of the same transaction.

What if the action under section 423 is brought by a victim? Time will run against his claim from the date when he became a victim: *Random House v Allason*, above. In *Giles v Rhind* [2008] BPIR 342, the section 423 claim was aimed at setting aside a deed made in 1992 transferring part of the debtor’s beneficial interest in the matrimonial home to his wife. At first instance, the judge said that the right to bring the claim to set aside the transaction in the deed accrued in 1993, when the claimant’s underlying claim against the debtor for breach of contract first arose; for at that point the claimant became a person capable of being prejudiced by the transaction. But in the Court of Appeal the claimant was held able to rely on concealment to extend the limitation period, whenever it began, so the case was decided without resolving the question.

#### (2) Time-limits

The answer to the second question, what the relevant periods are, is that given in *Re Priory Garage (Walthamstow) Ltd*, above: the period is 12 years under section 8(1) of the 1980 Act, unless the claim is for money, in which case it is six years under sections 8(2) and 9.

#### (3) Extensions

What about extensions of the limitation period? It may be long before a victim of a transaction establishes his claim against the debtor; and further time may elapse before he discovers the transaction and its effects. Here the decision in *Giles v Rhind* will help. For the Court of Appeal held that by making the transfer with the relevant intent (as it was assumed

that he had), the debtor had deliberately committed a breach of duty when the breach was unlikely to be discovered for some time, within section 32(2) of the 1980 Act (deemed concealment). Hence the creditor could rely on the extension of the limitation period conferred by the section. Crucially, ‘breach of duty’ is not confined to cases where the defendant is already under some positive obligation to the claimant, but it extends to the wrong involved in entering transactions with the purpose of putting assets beyond the reach of creditors generally.

#### (4) Reaching into past

Finally, there is the question of reaching into the past. Where a claim is brought under sections 238 or 339, rather than section 423, the reach is defined by the 1986 Act: no transaction can be challenged if made more than five years before the petition was presented (bankruptcy) or more than two years before the onset of insolvency (companies). Hence arises the importance of ensuring that a petition is presented as early as possible. And even if the transaction falls within that period, the requirement of insolvency must be satisfied too. But the reach into the past of an action brought under section 423 is much greater. No statutory period of vulnerability is defined. So where a trustee in bankruptcy or other insolvency office-holder is appointed, the reach back in time of the claim over past transactions will be limited mainly by the practical ability to find the evidence needed, particularly convincing evidence of purpose.

Lapse of time may still be a relevant factor because, since the power to grant a remedy is discretionary, the court could refuse to make any order if injustice would ensue from disrupting some transaction long settled and acted on by third parties in good faith; and the court may not make an order where the defences of receipt in good faith set out in section 425(2) apply. But where these factors are not in play, office-holders and victims may be able to reopen long-past transactions, with or without resort to section 32 of the Limitation Act 1980. Financial adventurers should continue to fear forensic archaeologists.

**Stephen Schaw Miller acts and advises extensively in insolvency matters, both corporate and individual, on behalf of office-holders, directors and bankrupts and is one of two editors of *Personal Insolvency: Law and Practice* (4th ed., 2008). He also does a range of chancery work mainly focused on property or business disputes.**  
[stephen.schawmiller@newsquarechambers.co.uk](mailto:stephen.schawmiller@newsquarechambers.co.uk)

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New Square Chambers  
 12 New Square  
 Lincoln’s Inn  
 London  
 WC2A 3SW

T 020 7419 8000  
 F 020 7419 8050  
 E [clerks@newsquarechambers.co.uk](mailto:clerks@newsquarechambers.co.uk)  
[www.newsquarechambers.co.uk](http://www.newsquarechambers.co.uk)

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