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International Restructuring Newswire

A quarterly newsletter from the bankruptcy, financial restructuring and insolvency team at Norton Rose Fulbright

Fall 2019

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International Restructuring Newswire

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To our clients and friends:

As we put this issue to bed, the media is replete with stories regarding the timing of the next recession. But a recession is anything but a sure thing. As discussed in Blackstone's 2019 Fourth Quarter Report, the indicators are decidedly mixed. There are signs of an impending recession: GDP growth in the US is slowing as the effects of 2017 tax reform wear off. And the most reliable recession signal is "flashing", as the ten-year to two-year Treasury yield spread is inverted – which was the case before each of the past five recessions. But, conversely, consumer income and spending continue to grow, and the household debt burden remains low. So the signs of an upcoming recession in the US are decidedly ambiguous.

Globally, however, Blackstone reports that the economic outlook is dimming. Growth forecasts for 2019 and 2020 have been revised downward and, without a Brexit agreement, UK GDP growth is expected to be 2.5 percent lower through 2023. Further complicating the picture in the US is the enormous political uncertainty caused by the pending impeachment proceedings. And the trade war between the US and China is directly impacting China's growth which has been largely fueled by trade with the US.

With all of this global economic uncertainty, what better time to read the current issue of our *International Restructuring Newswire*, with articles from four different countries of the Norton Rose Fulbright network.

With this issue we welcome our new editor, David Rosenzweig. David is a Norton Rose Fulbright partner in the New York office and focuses his practice on cross-border restructurings and insolvencies.

Enjoy the issue.

Howard Seife
Global Head
Financial Restructuring and Insolvency

In the news

Cross-Border Restructuring – A Collaborative Approach
New York, NY: September 24, 2019
The financial restructuring and insolvency group co-hosted a client program with the Cayman law firm, Harneys on September 24. The event consisted of three panel sessions comprised of industry professionals presenting on a variety of cross-border restructuring issues. Eric Daucher moderated a panel where Andrew Rosenblatt and Alex Mufford spoke from the perspective of US and Australian law and practice.

Retiring LIBOR – Breakfast Briefing
London, UK: September 27, 2019
Radford Goodman took part in a panel discussion concerning the transition away from IBOR benchmarking at the end of 2021. The audience consisted a cross-section of the London financial services sector. Radford spoke to the litigation risks associated with the transition.

Insolvency and restructuring law reform in Spain Webinar
Sydney, Australia: September 30, 2019
Noel McCoy co-presented in a webinar hosted by University of Sydney Professor Jason Harris and Dr Zofia Bednarz, University of Málaga, Spain to discuss Spanish insolvency restructuring law and cross-border insolvency.

Australian Restructuring Insolvency & Turnaround Association
Sydney, Australia: October 3, 2019
Noel McCoy and Jonathon Turner presented to the Australian Restructuring Insolvency &Turnaround Association Sydney Forum on legislative reforms under Australian law designed to prevent pre-insolvency transactions leaving employee creditors worse off.

R3 Midlands Regional Meeting
Birmingham, UK: October 8, 2019
Mark Craggs presented on insolvencies in the Aerospace Sector at the Midlands Regional Meeting of R3, the Association of Business Recovery Professionals, together with Matthew Ward of EY.

New York State Bar Association
Tokyo, Japan: November 8, 2019
David Rosenzweig will be speaking on a cross-border insolvency panel at the New York State Bar Association International Section's Global Conference in Tokyo, Japan on November 8, 2019.

Morocco Bankruptcy Law Reform
Casablanca, Morocco: November 12-13, 2019
Mark Craggs will be participating in a workshop organized by the US Department of Commerce's Commercial Law Development Program relating to the implementation of Morocco's new bankruptcy laws.

INSOL World
Mark Craggs (London), Guillaume Rudelle (Paris) and Koen Durlinger (Amsterdam) have contributed an article, "The New EU Restructuring Directive", to the Q3 2019 edition of *INSOL World* (of which Mark is co-editor), which provides UK, French and Dutch perspectives on the new EU Directive on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.

International Corporate Rescue
Noel McCoy's article "The Singularis Work-around? Overcoming Limitations to the Common Law Power of Assistance for Foreign Insolvency Investigations" was recently published in *International Corporate Rescue* (Volume 16, Issue 4). The article considers an innovative approach to assist in cross border insolvency investigations for offshore jurisdictions.

Australian Restructuring and Insolvency Journal
Noel McCoy and Gabe Perrottet had an article published in the *Australian Restructuring and Insolvency Journal* (September 2019) entitled "Understanding the 'Better Outcome Test' in s588GA of the Corporations Act." The article examines new legislative provisions to relieve directors of insolvent trading liability if they undertake a business restructure.

Keeping up with the Joneses: In bold cross-border move, the DIFC enacts new insolvency law

Laura Smith

The Dubai International Financial Centre (the "DIFC"), one of the leading international financial hubs in the Middle East, Africa and South Asia (the "MEASA") region, has recently announced the enactment of the new DIFC Insolvency Law, Law No. 1 of 2019 (the "New DIFC Insolvency Law"), which became effective in June 2019. The introduction of the New DIFC Insolvency Law, comes after the financial collapse of Abraaj Group, which was recently fined a record US$315 million by the DIFC's financial regulator, the Dubai Financial Services Authority, after allegations of fraud and mismanagement. Importantly, the New DIFC Insolvency Law which will repeal and replace the Insolvency Law of 2009 and was the subject of substantial research and global benchmarking introduces a completely new rehabilitation provision for distressed companies in the DIFC in addition to the previously existing procedures such as company voluntary arrangements, receiverships and liquidations. In addition, the New DIFC Insolvency Law's incorporation of the UNCITRAL Model Law on Cross-Border Insolvency is hoped to facilitate a more efficient and effective restructuring regime, allowing the DIFC to play a more substantial role in cross-border insolvencies in the future.

Scope of the New DIFC Insolvency Law

The New DIFC Insolvency Law applies only to entities registered and operating within the DIFC. The DIFC was established in 2004 and is an independent jurisdiction separate from the Emirate of Dubai and the federal law of the United Arab Emirates with its own civil and commercial laws which are written in English and actually default to English law in the event of an ambiguity. The DIFC also has its own courts, with judges taken from leading common law jurisdictions including England, Singapore, and Hong Kong. The DIFC houses a large number of financial institutions, including wealth funds and private investors, and it also hosts multinationals, retail outlets, cafés, restaurants, residential space, public green spaces, hotels, and art galleries. As of June 2019, the DIFC had over 2289 active registered companies, including 671 financial firms and the size of its workforce stood at more than 24,000 professionals.[1] The financial services firms that joined in 2019 include Maybank Islamic Berhad from Malaysia, Cantor Fitzgerald from the United States, Atlas Wealth Management from Australia, and Mauritius Commercial Bank.[2] Certain other non-financial firms have also recently joined the DIFC including Guidepoint MEA, Medtronic Finance Hungary Kft., and Network International.[3] Moreover, in September 2019, it was further announced that the DIFC had risen up the ranks of the Global Financial Centres Index (the "GFCI") to the number eight position, representing the DIFC's highest ever ranking.

Given its rapid growth as a financial centre, it is unsurprising that the DIFC needed to update its existing insolvency regime in order to keep up with other globally significant jurisdictions in the international insolvency arena. With the goal of promoting the rehabilitation of viable businesses that are part of the DIFC while addressing the continuing

needs of the various stakeholders involved, the DIFC made several key changes as part of its enactment of the New DIFC Insolvency Law including: (1) the introduction of a debtor in possession procedure known as rehabilitation; (2) the introduction of a procedure that allows the management of a company to be replaced by a court-appointed administrator when there has been mismanagement of or misconduct by the company or management; (3) enhancing and modernizing existing rules and procedures; and (4) the incorporation of the UNCITRAL Model Law on Cross-Border Insolvency.

Change No. 1: New rehabilitation procedure

Part 3 of the New DIFC Insolvency Law introduces a new concept referred to as "rehabilitation," which mirrors the debtor in possession regime of chapter 11 in the US. A company is eligible for "rehabilitation" where it is or is likely to become unable to pay its debts and there is a reasonable likelihood of a successful rehabilitation plan being reached between the company, its creditors, and shareholders. To initiate a rehabilitation proceeding, the board of the company notifies the court in writing that they intend to make a proposal to the company's creditors of a rehabilitation plan (the "Rehabilitation Plan Notification") and upon such notice the court will convene and automatically initiate a 120 day moratorium period, which applies to all creditors. In addition to this moratorium period, any contractual provision allowing termination based upon insolvency is deemed ineffective unless the company agrees to termination, the court approves such termination, or where any sums due after the commencement of the moratorium period remain unpaid for a period of more than twenty (20) days where the company has agreed to pay such amounts.

Immediately prior to the Rehabilitation Plan Notification, the directors of the company shall appoint one (1) or more Rehabilitation Nominee(s). Each Rehabilitation Nominee must be registered as an insolvency practitioner under Part 10 of the new law. Notwithstanding the appointment of the Rehabilitation Nominee, the directors of the company will be permitted to manage the company's affairs during the implementation of a rehabilitation plan unless there is evidence that such officers or management were involved in fraud or mismanagement of the company, and in these cases, the management of the distressed company could be taken over by a court-appointed administrator (which is discussed in further detail below). In light of the continuing existence of the company, the court is permitted to sanction new priority (debtor in possession-type) funding during the rehabilitation process. This debt can be unsecured or secured, and if secured, such security can be over previously unsecured assets, on a junior basis to existing security, or on a senior or equal basis with an existing security holder, but only if there is adequate protection given to the existing security holder.

When the company or the administrator appointed has a proposal for a rehabilitation plan that is ready to be considered by the creditors and shareholders, the company shall propose to the Court notice and voting procedures, which shall separately classify secured creditors, unsecured creditors and shareholders for the purposes of voting. In connection with any such proposal, the Rehabilitation Nominee or administrator (if appointed) must file a statement with the Court concerning: (1) whether the proposed rehabilitation plan has a reasonable prospect of being approved and implemented; (2) whether the company is likely to have sufficient funds available to it during the moratorium to enable it to carry on its business; and (3) whether meetings of the company and its creditors and shareholders should be summoned to consider the proposed rehabilitation plan. Approval of any proposed notice and voting procedures is to take place during a separate "Directions Hearing" upon no less than ten (10) days' notice to creditors and shareholders. Approval of a rehabilitation requires at least 75 percent of creditors in each class that are present and voting to support the plan unless the class of creditors or shareholders are deemed unimpaired under such plan, in which case, a solicitation of the classes votes is not required. After voting has concluded and creditors have had the further opportunity to object to the proposed rehabilitation plan, the court is required to hold a "Post Plan Hearing," wherein it shall sanction (i.e., approve) the rehabilitation plan upon a finding that:

The New DIFC Insolvency Law introduces a new concept referred to as "rehabilitation," which mirrors the debtor in possession regime of chapter 11 in the US.

- The plan complies with the law and has been proposed in good faith.
- The arrangement is not unfairly prejudicial to each class of creditors and to the general body of creditors taken as a whole.
- Either (A) all classes of creditors have voted to accept the plan (or have been deemed to accept the plan) or (B) at least one class of creditors which would be impaired by the plan approves it.
- There have been no material violations of the notice and voting procedures approved by the Court at the Directions Hearing.
- No creditor is worse off than that creditor would have been in a winding-up of the company.
- The holder of any claims junior to any dissenting class will not be paid out any amount before the debtor pays the dissenting class in full.

If at the Post Plan Hearing the court does not sanction the Rehabilitation Plan, the court is required to immediately proceed to take steps to wind up the company.

Change No. 2: Introduction of court-appointed administrators

Part 4 of the New DIFC Insolvency Law allows for the appointment of a court-appointed administrator, who like a Rehabilitation Nominee, must be a registered insolvency practitioner. First, as noted above, one or more creditors may move for the appointment of an administrator where an application for Rehabilitation has been made and there is evidence of mismanagement or misconduct by the company or management. Upon appointment, the administrator shall manage the affairs, business, and property of the company and can seek approval of a Rehabilitation Plan under Part 3 of the New DIFC Insolvency Law. An administrator can likewise be appointed for the purpose of seeking approval of a Voluntary Arrangement under Part 2 of the New DIFC Insolvency Law, seeking approval of a scheme of arrangement under the Companies Law, or investigating fraud or wrong doing by the company and/or its management. The administrator possesses many rights including the general power to remove any director of the company and appoint another director and can also call any meeting of the shareholders or creditors of the company. Upon discharge, the administrator is also entitled to compensation for his services as well as reimbursement of any properly incurred expenses, both of which are to be given priority over other unsecured debts of the company.

Change No. 3: Enhancing and modernizing existing procedures

Part 6 of the New DIFC Insolvency Law further enhances the rules on voluntary and compulsory winding up and includes more detail with regard to "wrongful trading" in addition to a new section called "misconduct in course of winding up." As to both "wrongful trading" and "misconduct in course of winding up," section 115 entitled "Remedy" applies and gives those aggrieved the right to file an application with the court requesting that these wrongdoers repay, restore or account for the money or other property of the Company which they believe has been misapplied or retained. Additionally, Part 11 of the New DIFC Insolvency Law includes some additional provisions which modernize existing procedures by introducing the use of websites in section 140 and remote attendance at meetings in section 139 for purposes of bringing the New DIFC Insolvency Law up to speed with the latest technologies of today's business world.

Change No. 4: Incorporation of the UNCITRAL Model Law on Cross-Border Insolvency

Finally and perhaps one of the most important aspects of the New DIFC Insolvency Law is its incorporation of the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"). The Model Law was originally created to assist foreign countries to supplement their existing insolvency laws with a modern legal framework to more effectively address cross-border insolvency proceedings. The DIFC's adoption of the Model Law in Part 7 of the New DIFC Insolvency Law not only promotes the DIFC's goal of continuing to grow its presence in the international business world, but should also provide for a more predictable and coordinated approach for the many cross-border businesses in the DIFC which may eventually be involved in multi-jurisdictional restructuring proceedings. Specifically, the Model Law will apply where assistance is sought (1) in the DIFC by a foreign court or foreign representative in connection with foreign proceeding; (2) in a foreign state in connection with proceedings brought under the New DIFC Insolvency Law;

(3) where there are foreign proceedings and proceedings under the New DIFC Insolvency Law, in respect of the same debtor, running in parallel; or (4) where creditors or other interested persons in a foreign state have an interest in requesting the commencement of, or participating in, a proceeding under the New DIFC Insolvency Law.

Conclusion

Following recent legislative changes by the UAE and Saudi Arabia to its insolvency procedures, the New DIFC Insolvency Law represents yet another significant advance in insolvency legislation in the Middle East and should allow the DIFC to better position itself as player in cross-border restructurings in the future. The New DIFC Insolvency Law may also serve to raise the DIFC's attractiveness as an investment location as there will now be a predictable, orderly process in place to aid companies who may find themselves in financial distress. As with any new law, success will depend on its frequency of use and effectiveness in practice, however, based upon the DIFC's established court system supported by professionals that are skilled in business rescues, the New DIFC Insolvency Law should achieve its intended purpose of promoting a modern and efficient bankruptcy restructuring regime for the DIFC.

Laura Smith is an associate in our Dallas office in the firm's financial restructuring and insolvency group.

The administrator possesses many rights including the general power to remove any director of the company and appoint another director and can also call any meeting of the shareholders or creditors of the company.

[1] *DIFC Boosts UAE Financial Sector Development and Reports Significant Growth During First Half of 2019* (July 29, 2019), http://www.mondovisione.com/media-and-resources/news/difc-boosts-uae-financial-sector-development-and-reports-significant-growth-duri/.

[2] Id.

[3] Id.

And, more keeping up with the Joneses: The new EU restructuring directive and reforms in the United Kingdom

Matthew Thorn and Manhal Zaman

On 20 June 2019, the European Parliament and the Council published in the Official Journal of the European Union the text of Directive 2019/1023 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (the "Restructuring Directive"). The Restructuring Directive forms a key part of the EU's wider Capital Markets Union Action Plan.

The Restructuring Directive seeks to introduce a minimum standard among EU Member States for preventive restructuring frameworks available to debtors in financial difficulty and to provide measures to increase the efficiency of restructuring procedures. These new standards, once implemented, will represent a move for EU Member States further in the direction of debtor-in-possession-type insolvency regimes like chapter 11 in the United States and schemes of arrangement in the United Kingdom (and other common law jurisdictions).

Unlike EU Regulations, EU Directives do not have automatic effect and so Member States must implement the Restructuring Directive into national law by 17 July 2021, subject to a one year extension.

And, of course, Brexit must enter the discussion, since it is expected that by the implementation deadline the UK will have exited the EU. In any event, the UK has proposed its own standalone reforms similar to those contained in Restructuring Directive, on which draft legislation is awaited.

Why now?

The 2015 EU Insolvency Regulation (recast) provides for rules governing the allocation of jurisdiction for the opening of insolvency procedures in the EU (and, once opened, the rules applicable to those procedures), but does not seek to address or regulate disparities in national law between Member States. The aim of the 2019 Restructuring Directive is to provide for a harmonised minimum restructuring standard across the EU enabling "*honest entrepreneurs*" to better manage financial difficulties with a view to giving viable businesses a "*second chance*". Further, reducing the substantive differences in pre-insolvency regimes among Member States is expected to bring greater transparency, legal certainty and predictability.

Key elements of the procedure envisaged by the Restructuring Directive include: (a) debtors remaining in possession of their assets and day-to-day operation of their business; (b) a stay of individual enforcement of actions; (c) the ability to propose a restructuring plan that includes a cross-class cram-down mechanism whereby the plan is imposed on dissenting creditors in a class (holding no less than 25 percent of claims in that class) and across classes (subject to certain protections); and (d) protection for new financing and other restructuring-related transactions.

While the concepts are commendable in seeking to save viable businesses from liquidation, it is expected that there may be some stumbling blocks as Member States come to grips with implementing these rules into their national laws.

Key aspects:

A formalised restructuring plan with an option for a moratorium and cross-class cram-down

The Restructuring Directive lays down minimum standards for a restructuring plan with class criteria similar to UK

schemes of arrangement and in some aspects US chapter 11 proceedings. It is a matter for national law to determine class segments but, under the Restructuring Directive, at the very minimum, classes should be divided between secured and unsecured creditors. The reservation of class criteria to national law permits Member States to regulate class rights, voting rights and provide a legal framework for any contested claims. In addition, under the Restructuring Directive, Member States can set their own level of what constitutes a majority for approval purposes. However, such majority shall not *exceed* 75 percent as a percentage of debt, which is the threshold in a UK scheme of arrangement. This leaves room for Member States to lower the threshold in an attempt to market themselves as more attractive restructuring venues.

> *It is expected that the UK will have left the EU in advance of the 2021 deadline for implementation of the Restructuring Directive into national law.*

Unlike a UK scheme, however, the Restructuring Directive allows the plan to be imposed on dissenting creditors in separate classes. Similar to a US chapter 11 plan, the Restructuring Directive incorporates a cross-class cram-down mechanic where, if the plan is not approved by a class, it may still be approved by the court as long as dissenting classes are treated "*at least as favourably as any other class of the same rank*" and "*more favourably*" than any junior classes, and the plan has been approved by (i) a majority of the voting classes of affected parties, which must include at least one class of secured creditors or creditors senior to unsecured creditors, or (ii) one class of affected parties who are not equity holders, or similar.

In an attempt to encourage ongoing negotiations of a restructuring plan, the concept of a stay of individual enforcement actions, subject to the debtor meeting certain requirements, has also been introduced. A stay can be implemented for four months in the first instance and extended to a maximum duration of 12 months, provided that the debtor can effectively demonstrate that "relevant" progress has so far been made in negotiations on the restructuring plan, and that such extension will not unfairly prejudice the rights of affected parties or result in the liquidation of the debtor under national law.

Ban on *ipso facto* clauses

When a company enters an insolvency procedure this may trigger contractual rights allowing suppliers to terminate a contract due to the insolvency filing (so-called *ipso facto* clauses) – even where the relevant company has complied with all its other obligations under that contract. Undoubtedly, this can be detrimental to the continuation of the business as a going concern. In an attempt to alleviate some of the pain of struggling debtors, the new regime includes a prohibition on the enforcement of certain *ipso facto* clauses triggered by a debtor's entry into an insolvency procedure or, in some cases, the mere entry into restructuring negotiations. Again, this feature of the Restructuring Directive mirrors a similar right granted under chapter 11 which allows a company to preserve business-critical contracts while still carrying out restructuring negotiations. The recitals to the Restructuring Directive list certain examples of essential supply contracts to which this would be of particular importance such as, supply of gas, electricity, water, telecommunication and card payment services. It is hard to predict the impact that this change will have once implemented into national law, which will depend in large part on the approach to implementation in individual Member States; clearly, however, there is a balance to be struck between the benefits of company rescue and imposing restrictions on freedom of contract.

What about the United Kingdom?

At the time of writing, the UK will leave the EU on 31 October 2019 unless a deal is struck or an extension agreed before such date. In any event, it is expected that the UK will have left the EU in advance of the 2021 deadline for implementation of the Restructuring Directive into national law.

The UK has been working independently to further develop and refine its own insolvency regime so as to protect its status as a key forum for cross-border restructurings. The main features of the UK's proposals, which seem likely to form part of the legislation, include (i) the introduction of a restructuring moratorium (albeit with a shorter, 28-day duration, in the first instance) for "prospectively insolvent" companies, (ii) a restructuring plan (akin to a scheme of

arrangement but with the ability to effect cross-class cram-downs) and (iii) restrictions on reliance on *ipso facto* clauses.

It is not currently clear what form the draft legislation will take or, indeed, where it sits in the overall scheme of legislative priorities in the UK.

What does the future hold?

The Restructuring Directive is commendable in its efforts to level the playing-field for preventive restructuring measures across Member States. It is perhaps not as ambitious in its scope as it could have been – notably, it does not attempt to harmonise substantive insolvency laws and it avoids other contentious areas such as interference with workers' rights under existing legislation.

Given experience to date under the Insolvency Regulation, we expect that there will be differences in approach and outcome as between Member States, as well as a degree of competition in the approach they take to implementation, with each Member State striving to establish itself as the top choice forum for multi-jurisdictional restructurings. Since the Restructuring Directive does not prescribe exact means of transposing its provisions into national law, we will not know the actual impact of this Directive until we have clarity around how each Member State plans to implement the EU framework. The UK will undoubtedly remain in the race too, albeit perhaps without restrictions binding on continuing Member States. In the case of a hard Brexit, it is hoped that the implementation of the UK's reforms would be given a certain priority in order to help maintain the attractiveness of the UK as a forum for cross-border restructurings. It will be clear from the matters discussed in this article that there will be many developments still to come in the coming days, months and years!

Matthew Thorn is counsel and Manhal Zaman is an associate in our London office in the firm's financial restructuring and insolvency group.

Ontario appellate court sets some limits on selling free and clear of encumbrances in Canada: *Third Eye Capital Corporation v. Dianor Resources Inc.*

Evan Cobb

Insolvency proceedings are often used by debtors to sell assets, or entire going concern businesses, "free and clear" of encumbrances in an efficient and expedited manner to maximize recoveries for both secured and unsecured creditors.

In Canada, similar to other jurisdictions, these sales will generally be entered into on an 'as is, where is' basis, supported by an 'approval and vesting order' directing that the transfer will be free and clear of encumbrances. Those encumbrances are then preserved, in accordance with their relative priorities, as against the proceeds from the sale transaction.

The breadth of interests that can be extinguished or 'vested out' through an approval and vesting order has been the subject of some uncertainty in Canadian insolvencies. Purchasers and sellers will of course want these orders to be drafted and interpreted very broadly. Holders of interests in the property being sold may have an incentive in certain circumstances to argue that their specific interest cannot be extinguished or vested out and must follow the asset.

This is not an easy issue to resolve. On one end of the spectrum are financial claims, such as security interests, that are regularly vested out without controversy. The security interest then effectively attaches to the proceeds of the sale. On the other end of the spectrum would be a third-party's clear ownership interest, such as fee simple ownership interest in land, which an approval and vesting order in Canada generally will not extinguish. In other words, an approval and vesting order cannot grant a debtor company the right to sell a third party's property for the benefit of the debtor company's creditors.

Between these two ends of the spectrum are the more difficult cases in the so-called grey area of the law, such as mining royalty interests that may be characterized as an interest in land rather than a financial interest. The treatment of these types of interests under approval and vesting orders in Canada has been inconsistent, which creates some uncertainty in the distressed M&A market.

But recently, the Ontario Court of Appeal has sought to add some clarity to this issue in *Third Eye Capital Corporation v. Dianor Resources Inc.* The Court of Appeal's decision provides a framework within which parties including debtors, secured lenders and purchasers may consider the appropriate scope of an approval and vesting order that can be applied to a broad range of interests.

Facts

Dianor Resources Inc. ("Dianor") was an insolvent exploration company focused on the acquisition and exploitation of mining properties in Canada. Dianor's secured lender, Third Eye Capital Corporation (the "Lender") successfully applied for the appointment of a receiver over Dianor's assets, including its flagship project in Ontario. The project was the subject of royalty agreements in favour of two parties and notices of these agreements were registered on title to the project. The royalties were not generating cash flow for the royalty holders at the time of the receivership.

The lower court approved a sale process that generated two bids for the project. The winning bid from the Lender was a credit bid worth C$2 million, plus the assumption of certain liabilities. The purchase was conditional upon

The Dianor Resources Inc. decision certainly will be welcomed by holders of mining and other resource royalties for the additional clarity it provides for the protection of their rights in an insolvency scenario.

the extinguishment of the royalty interests for which the Lender would pay C$400,000 in aggregate. The royalty interests were to be extinguished pursuant to an approval and vesting order.

The sale was approved by the Ontario court and an approval and vesting order was granted transferring Dianor's interest in the project to the purchaser free and clear of, among other things, the royalties. The transaction closed shortly thereafter.

One of the royalty holders appealed the approval and vesting order, though it did not move for a stay of the approval and vesting order prior to the closing of the transaction and its appeal was commenced after the applicable statutory appeal period expired. Despite the procedural and mootness issues, the Ontario Court of Appeal nonetheless went on to consider and provide an opinion on the substantive matters at issue in the appeal.

Decision

The Court of Appeal was asked to consider whether the royalty interests in the applicable project in this case could and should be extinguished pursuant to an approval and vesting order.

The court concluded that it had jurisdiction to extinguish or vest out interests in land. However, when considering whether that jurisdiction should be exercised, the court concluded that a rigorous 'cascade analysis' should be adopted.

First, the court should assess the nature and strength of the interest that is proposed to be extinguished. Not all interests in land share the same characteristics. For example, third-party fee simple interests or an easement in active use generally should not be extinguished through an approval and vesting order. On the other hand, security interests securing loan obligations, are and can be regularly extinguished through an approval and vesting order. The key inquiry is whether the interest is more akin to a fixed monetary interest that is attached to real or personal property or whether the interest is more akin to a fee simple interest that is in substance an ownership interest that is tied to the inherent characteristics of the property itself and that is of a continuing nature.

Second, the court should consider whether the parties have consented to the vesting out of the interest either at the time of the sale before the court, or through prior agreement.

Third, if the above factors are inconclusive, the court may then engage in a consideration of the equities as between the parties to determine if an approval and vesting order is appropriate in the particular circumstances of the case. This would include consideration of the relative prejudice to the interested parties and whether that prejudice could be adequately compensated for through a monetary payment.

Applying these considerations, the Court of Appeal found that the royalty interests in this case did not simply secure a fixed finite monetary obligation, rather they were in substance an interest in a continuing and inherent feature of the property itself. This, in absence of any agreement by the royalty holder to the subordination or extinguishment of its interest, was determinative. Therefore, the royalty rights should not have been extinguished by the approval and vesting order.

Due to procedural issues related to the appeal in this case, the approval and vesting order from which the royalty holder appealed was not reversed. However, the court's substantive analysis will remain relevant for future cases.

Practical implications

The *Dianor Resources Inc.* decision certainly will be welcomed by holders of mining and other resource royalties for the additional clarity it provides for the protection of their rights in an insolvency scenario.

The decision will also be very important to financial institutions and other parties who may provide secured financing to mining and other resource projects. In a default scenario, these lenders may need to rely on an approval and vesting order to monetize collateral for maximum proceeds. Secured lenders should diligently review any royalty or other interests that may affect the projects that are financed, as those lenders may not be able to simply rely upon an approval and vesting order to resolve these adverse interests in

the future. Lenders would also be advised to seek to negotiate contractual arrangements with royalty holders or other interest holders at the outset of the loan to ensure that the parties' respective interests are clearly agreed in advance of any potential future sale that may be required as part of an enforcement or insolvency sale process.

In cases where secured loans and royalty interests already co-exist on a particular mining or resource project, the decision in *Dianor Resources Inc.* will add clarity to the relative rights and negotiating positions of the parties in the case of any eventual insolvency related to the project.

The decision in *Dianor Resources, Inc.* provides clear support for the proposition that, in the circumstances of that case, a vesting order may not properly extinguish or vest out mining royalty interests and other similar interests in land. The analysis theoretically could apply to many other types of interests as well. That said, whether and the extent to which the *Dianor Resources Inc.* decision is applied in all jurisdictions in Canada or to interests other than royalty interests in land, such as purchase options, royalties on personal property, and stream interests, remains to be seen.

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The brewing controversy in Australia surrounding the application of the s 553C set-off defence to unfair preference claims

Daniel Vizor and Sarah Gard

The most basic feature of insolvency law is the *pari passu* rule. It holds that in the liquidation of an insolvent company, creditors of the same rank are treated equally, with each paid rateably. However, the rule is not absolute. Among the exceptions to the *pari passu* rule in Australia is insolvency set-off, as provided for under s 553C of the Corporations Act 2001 (Cth) (the "Act").

The interplay between insolvency set-off provisions and a liquidator's unfair preference claims has become more controversial in recent years. In Australia the courts historically have favoured creditors' rights to rely upon insolvency set-off in order to avoid entirely or reduce their liability for unfair preference claims under s 588FA of the Act. To date, the weight of authority on this issue clearly favours creditors. This is unlike other jurisdictions, such as the United Kingdom and the United States, which prevent or limit a creditor's right to set-off against a preference claim in an insolvency case.

The creditor-friendly law in Australia cannot yet be regarded as settled. The two most recent cases in Australia are notable for suggesting that there are "powerful contrary arguments" to the Australian courts' current creditor-friendly approach. Consequently, the courts may come to a view on the availability of insolvency set-off in the context of unfair preference claims that differs from the current approach and is more favourable to liquidators. We discuss the historical creditor-friendly case law in Australia, the recent cases questioning that approach, and conclude by identifying two of the more persuasive arguments that may be relied on by courts to change the creditor-friendly approach.

Framework of the Act

Subject to the qualification set out in s 553C(2) of the Act, s 553C provides for the mandatory set-off of mutual credits, mutual debits or other mutual dealings between an insolvent company and a person making a claim in the winding up of that company. Section 553C(2) of the Act prohibits anyone from claiming insolvency set-off where, at the time credit is given to, or received from, the company, they had notice of a company's insolvency.

Unfair preference claims are one of a liquidator's most effective means of increasing the pool of assets available in a liquidation for the benefit of unsecured creditors. Under s 588FA of the Act, unfair preferences arise where:

1. the company and a creditor are parties to a transaction; and
2. the transaction results in the creditor receiving more from the company, in respect of an unsecured debt owing to the creditor by the company, than they would have if the transaction were set aside and the creditor had to prove for the debt in the company's liquidation.

For an unfair preference to qualify as a voidable transaction, under s 588FC, the transaction must have been entered into within six months of the 'relation-back day', and at a time when the company was insolvent, or become insolvent because of entering into that transaction. The remedies available in relation to voidable transactions include, under s 588FF(1)(a) of the Act court orders directing the creditor to repay to the company some or all of the money received under the transaction.

Re Parker

Although not an unfair preference case, we start our analysis with *Re Parker* (1997) 80 FCR 1. The case concerned the operation of insolvency set-off in the context of insolvent trading claims brought against a holding company by the liquidators of its subsidiary under ss 588V and 588W of the Act.

The holding company argued it was entitled to set-off pre-liquidation debts due and owing to it by its subsidiary, against any liability arising from insolvent trading. In determining that the holding company was so entitled, the Court held (at [10]) that "the two debts are between the same companies. The burden of them would lie in the same interests… [and] [t]hey are commensurable, in that they both sound in money".

Morton v Rexel

The liquidator in *Morton & Anor v Rexel Electrical Supplies Pty Ltd* [2015] QDC 49 sought to recover unfair preference payments made to the creditor totalling approximately A$200,000. Relying upon *Re Parker*, the creditor sought to set-off against this liability, a A$90,000 debt owed to it by the company for goods supplied and delivered.

The liquidator argued that:

1. permitting a creditor to set-off debts which the company owed it, against any liability for unfair preference claims, would frustrate the purposes of Part 5.7B of the Act; and

2. at the time the company incurred liability for the amounts it owed to the creditor, the creditor had notice of facts indicating that the company was insolvent. Consequently, s 553C(2) of the Act prevented the creditor from setting-off against any unfair preference liability, the amounts owed to it by the company.

The Court held that the first of these arguments was inconsistent with *Re Parker*. This meant that if the Court was to accept the liquidator's argument, it would necessarily be departing from *Re Parker*. Citing *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* (2007) 230 CLR 89 at 151[135]), the Court considered it could only take this step if *Re Parker* was 'plainly wrong'. (As to whether this is the correct approach, there is conflicting authority. See, for example, the *Walker Corporation Pty Ltd v Sydney Harbour Foreshore Authority* (2008) 233 CLR 259 which applied *Marshall v Director-General, Department of Transport* (2001) 205 CLR 603 at 632-633 [62].) Unable to reach this conclusion, the Court rejected the first argument.

As to the second argument, subject to one exception, the Court found at the time the company incurred liability for the amounts it owed to the creditor, the creditor had actual notice of facts that would have indicated to a reasonable person in the creditor's position, that the company was insolvent. Consequently, the Court held that apart from the creditor's January invoice (in respect of which the creditor was entitled to a set off), the creditor was otherwise prohibited from setting-off any other amounts owed to it by the company under s 553C(2).

Hussain v CSR Building Products Limited

In *Hussain v CSR Building Products Limited, in the matter of FPJ Group Pty Ltd (in liq)* [2016] FCA 392, the liquidators submitted that the cases referred to above had been wrongly decided. The liquidators argued this was because:

1. allowing set-off in the context of unfair preference claims would lead "to the peculiar result that a creditor who is paid [its] entire debt by preference payments will be disadvantaged as compared [with] a creditor who is paid only part of [its] debt by preference payments" (at [233]); and

2. to allow creditors to "happily accept preferential payments knowing that those payments will be treated as 100c in the $ for the purposes of a set-off for the balance of the outstanding amounts" is 'perverse' (at [244]).

The Court rejected the first of these arguments, holding that there was nothing peculiar about the outcome described. It was instead, "the plain effect of the legislative provisions and the legislative policy". In other words, it was precisely the result that could be expected from a straight-forward application of the relevant provisions of the Act.

The Court also rejected the second of the liquidators' arguments. Unless a creditor is aware that a company is insolvent at the time payments are made, there is nothing perverse about the creditor accepting them. Further, any perversity which might otherwise arise from accepting payments with knowledge of a company's insolvency, is already dealt with by s 553C(2) of the Act.

Despite rejecting the grounds upon which the liquidators relied in arguing the above cases were wrongly decided, the Court went on to express the view that there are (at [235]):

> "powerful contrary arguments that might have been made [by the liquidators in this case] to suggest that a set-off is not available against a liquidator's claim to recover preference payments."

Without identifying what the "powerful contrary arguments" were, the Court held that as a result of the liquidators' failure to raise them, it would be inappropriate for the Court to assess those arguments. There was also no utility in doing so, given the Court's finding that there was insufficient evidence to establish that the company was insolvent at the time of making the relevant payments.

Stone v Melrose

Stone v Melrose Cranes & Rigging Pty Ltd, Re Cardinal Project Services Pty Ltd (in liq) (No 2) [2018] FCA 530 is the latest case to be decided on these issues. The liquidators in this case sought to recover unfair preference payments totalling approximately A$310,000, while the creditor sought to set-off against this, an A$80,000 debt owed to it by the company.

The liquidators accepted that the balance of current authority allows creditors to rely on insolvency set-off in the context of voidable transaction claims. Despite this, the liquidators "made a formal submission" that insolvency set-off is not available in relation to preference claims. They urged the Court not to follow the cases referred to above, which they considered were "plainly wrong".

The purpose of the liquidators' formal submission was simply to preserve their ability to raise the above issues on appeal if necessary. Consequently, the liquidators made no attempt to develop these arguments in the context of this first instance proceeding. Without the benefit of detailed submissions to the contrary, the Court adopted the approach taken in *Re Parker*.

Despite this, on the basis that the creditor was found to have had actual notice of facts revealing that the company was insolvent, the Court held that the creditor could not avail itself of s 553C of the Act. It was relevant to this that the company had made multiple promises to make payment, none of which were met, despite the creditor's persistence in continuing to follow payment up.

The position in the UK and the US

Before turning to consider where to from here for insolvency set-off in the context of unfair preference claims in Australia, it is interesting to compare the Australian courts' approach against the approach taken in the UK and the US.

Rule 4.90 of the *Insolvency Rules 1986* (UK) provides for insolvency set-off in the UK on terms which are very similar to s 553C of the Act. Under r 4.90, insolvency set-off applies where, before

liquidation, there have been, "mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in liquidation". If there have been such mutual dealings then "account shall be taken ... and the sums due from one party shall be set-off against the sums due from the other" and "only the balance (if any) of the account is provable in the liquidation". Like Australia, mutuality is essential - sums due from the company to another party will not be included in the set-off.

Despite the similarities between r 4.90 and s 553C, the courts in the UK have taken a very different approach to the application of insolvency set-off in the context of unfair preference claims.

In the UK, recoveries made from unfair preference claims are not considered company property. They are instead treated as having a special status which stems from the nature and underlying statutory basis for unfair preference claims. Relevant to this, unfair preference claims must be brought by liquidators (not the company), for the benefit of unsecured creditors, among whom liquidators must distribute any recovery made (see *Re Oasis Merchandising Services Ltd* [1998] Ch 170 at 181-183 and *Lewis v Commissioner of Inland Revenue* [2001] 3 All ER 499 at [36]-[37]). For this reason, insolvency set-off is not available in the context of unfair preferences in the UK.

In the US, the US Bankruptcy Code limits a creditor's ability to set-off a debt against a trustee's preference claim. Under s 547(c)(4) of the US Bankruptcy Code, a preference defendant may only seek to set-off debts for "new value" in the form of "money or money's worth in goods, services or new credit" that is provided by the creditor to the company after the preference payment at issue was received by the creditor. The policy behind the US approach is to incentivise creditors to continue doing business with distressed companies. However, the timing is critical since unlike in Australia, a debt already in existence at the time that a preference payment is received cannot be used to offset against a preference claim. The debt must have been the result of a subsequent extension of credit.

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Looking forward

By noting that there are "powerful contrary arguments" to the courts' current creditor-friendly approach, *Hussain v CSR Building Products* and *Stone v Melrose* suggest that insolvency set-off could yet be held to be unavailable in the context of unfair preference claims. Of the various arguments in favour of such a view, those identified below relating to mutuality are likely to be among the more persuasive.

A lack of mutuality between a creditor's liability for unfair preferences and any amounts owing to the creditor by the company may be said to arise in one of two ways:

1. first, there is arguably a disconnect between the parties against whom the above claims may be brought; and/or
2. second, there is a timing issue relating to when liability arises for unfair preferences the effect of which means that, as at the time insolvency set-off ought to be assessed, there are arguably no mutual credits, mutual debits or other mutual dealings capable of being set-off.

The first issue arises because unfair preference claims are required to be brought by liquidators, whereas the creditor seeks to set-off against this, amounts owed to it by the company. The Court in *Re Parker* rejected this argument (albeit in the context of an insolvent trading claim) having regard to s 588FF of the Act. This enables orders to be made directing creditors to pay unfair preference amounts "to the company" (at p 11). On this basis, the Court in *Re Parker* downplayed the 'procedural' role played by liquidators in bringing insolvent trading claims which were, "as a matter of substance", company claims (at p 11).

Even if this analysis is accepted, however, it is not a sufficient basis upon which to establish mutuality. As Rory Derham points out in relation to unfair preference claims (see Derham R, *Set-off against statutory avoidance and insolvent trading claims in company liquidation,* 89 ALJ 459 at 475), this is because the company is not the beneficial owner of such claims. It follows from this that the company cannot charge or assign such claims prior to it being wound-up, and any recovery made from such claims

cannot be accessed by the company for its own purposes, but must instead be distributed by the liquidator for the benefit of unsecured creditors.

There is a strong argument for saying that, absent beneficial ownership in any unfair preference claims by the company, there is a lack of mutuality between such claims and any amounts owing to the creditor by the company. In those circumstances, insolvency set-off should not be available to creditors in defence of unfair preference claims.

In relation to the timing issue identified above, *Re Parker* held (at p 15) that the date for assessing whether insolvency set-off should be allowed ought to be the same as the date fixed under s 553 of the Act for determining what debts are provable.

Section 553 establishes that to be provable in a winding-up, the circumstances giving rise to a claim must have occurred *before* the 'relevant date'. (Unless a company enters into administration prior to being wound-up, the 'relevant date' will be the day a winding up order is made, or a resolution winding the company up is passed.) For the purposes of insolvency set-off, this principle should apply both to the creditor's claim against the company and to the unfair preference claims against the creditor.

The principle that insolvency set-off must be assessed having regard to circumstances in existence before the relevant date, creates obvious difficulty in the case of unfair preference claims. Before an unfair preference claim may be brought, the company must first have been wound-up. However, in the case of a company that is wound-up without first being put into administration, the winding-up necessarily commences on the relevant date, not *before* it. This would appear to rule out the availability of insolvency set-off.

Against this, it has been suggested that insolvency set-off may still be available in relation to liquidator claims on the basis that these constitute contingent liabilities (*Re Parker* at p 11-12). This appears contrary, however, to the generally accepted view as to when contingent liabilities arise. In order to constitute a contingent liability, there must be an existing obligation out of which, on the happening of a future event, an obligation to pay a sum of money would arise (see *McLellan v Australian Stock Exchange Ltd (*2005) 144 FCR 327 at [9]).

This cannot easily be applied to unfair preference claims. Among other things, payments made may only be recovered as unfair preferences where a company is being wound-up and a court is satisfied that the payments are voidable in accordance with 588FE. Only then may a court make one or more of the orders set out in s 588FF of the Act. It is difficult to reconcile the language and scheme of these provisions with an obligation which could be said to exist before a winding-up.

For these reasons, we consider that a court could yet determine that insolvency set-off is not available to creditors in defence of unfair preference claims. This would upend current Australian law, but at the same time bring it closer in line to other similar jurisdictions such as the UK and the US.

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