



SECTIONS 127/284 – LIABILITY OF PROFESSIONAL ADVISERS

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Introduction

1. As is well known to all practitioners of insolvency, lawyers and accountants alike, section 127(1) IA 1986¹ provides:

“**[Dispositions etc. void after commencement of winding up]**. In a winding up by the court, any disposition of the company’s property²...made after the commencement of the winding up is, unless the court otherwise orders, void.”

2. The equivalent provision for bankruptcy, s.284(1), is in broadly similar terms. However, there are extra conditions/provisions³ and s.284(2) imports the following additional extending words which are relevant:

“Subsection (1) applies to a payment (whether in cash or otherwise) as it applies to a disposition of property and, accordingly, where any payment is void by virtue of that subsection, the person paid shall hold the sum paid for the bankrupt as part of his estate.”

3. Leaving aside s.284(2), the constituent elements of these provisions involve identifying:
 - a. a disposition⁴
 - b. of the debtor [company]’s property⁵
 - c. after presentation of a winding up / bankruptcy petition⁶. It should be noted that, by s.127(2), the section has no effect in respect of anything done by an administrator of a company whilst a winding up petition is suspended under para 40 of Schedule B1⁷.

For ease, reference will be made to s.127 only below, although a return is made to s.284(2) from paragraph 36 onwards.

4. The general purpose of s.127 has been established and agreed for over 140 years, namely, to:

“prevent during the period which must elapse before a petition is heard the improper alienation and dissipation of the property of a company in extremis.”⁸

¹ The equivalent Australian provision is the Corporations Act 2001, s.468(1), which is in materially the same terms and the Australian jurisprudence can accordingly be of general relevance and assistance

² "Property" includes: "money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property", see s436 IA 1986

³ e.g. s.284(6) states that a disposition of property will be void even if the property is not, or would not be, comprised in the bankrupt’s estate and the section is expressed not to apply to property held on trust for another. Further, there are necessarily special considerations by reference to the fact that the bankrupt is a human being who will have domestic and vocational needs on the way to “rehabilitation”

⁴ It is by reference to the true meaning of “disposition” that the case law relating to payments into and out of bank accounts indicate that only a “disponnee” of a disposition can generally be targeted for recovery, not a paying agent in the position of a bank in whose favour no disposition is generally made in relation to transfers out of its client’s account

⁵ In corporate insolvency, this means the company’s beneficial interest in property – thus, the provision will not bite if that beneficial interest has already been disposed of by (say) a pre-petition contract to sell land or pre-petition declaration of trust etc...

This would appear not to be the case under s.284 – see footnote 4 above

⁶ The voidness of any such disposition is inchoate in the sense that it is conditional upon a winding up order being made on that same petition

⁷ As to which, see *Re J Smiths Haulage Ltd* [2007] BCC 135

⁸ Lord Cairns in *Re Wiltshire Iron Co* (1863) 3 Ch App 443 (at 447)



5. The words of the section are wide to prevent the improper dissipation of the property. But the court has under the last words (“unless the court otherwise orders”) a discretion to uphold all proper transactions. Without such a discretion, the presentation of a petition, whether well-founded or not, might paralyse the trade of the company and work its ruin⁹.
6. Thus, the effect of the avoiding provisions in s.127 IA 1986 is that the decision as to which transactions a company can or cannot enter into post-petition is placed in the hands of the court. Trading without the protection of a validation order was one of the factors which caused Millett J in *Re Brackland Magazines Ltd* to appoint a provisional liquidator, stating¹⁰:

“In my judgment, there is a strong public interest in the present case in ensuring that Capex should not continue to trade while hopelessly insolvent without the benefit of a s127 order, without filed accounts, under the control of directors who are guarantors of the debt due to the [petitioning creditor] and with funds apparently obtained from other companies managed by them”.

7. The attitude of the court to validation orders as reported in the cases can be seen to be strict. So, for instance, in one of the 2 cases referred to in the current *Practice Note – Validation Orders* [2007] BCC 91 (see further below), *Re Fairway Graphics Ltd* [1991] BCLC 468, the following observations were made (with emphasis supplied) demonstrating the criteria adopted for the court’s approach:

“It is in my judgment a clear and well-settled point of practice in the Companies Court that validation orders (as they are called) are only made in respect of companies where the court is satisfied by credible evidence as to one or other of two factual conclusions. Either the court must be satisfied (and surprising as it sounds in connection with a company the subject of a petition for its compulsory liquidation, I have on occasion in this court been so satisfied) that the company is solvent and able to pay its debts as they fall due. Alternatively the court must be satisfied that a particular transaction (usually the sale of a substantial asset) is **beneficial to creditors**, because it produces an advantageous price **or some such benefit**, or that a series of transactions (usually the carrying on of the company’s trade) are likely to be profitable and therefore will increase the company’s assets and so be beneficial to creditors. The court looks to see that the validation order is likely to benefit creditors as a class.

In this case counsel has told me on instructions that the company has an overdraft facility with the National Westminster Bank plc of £100,000, of which £60,000 remains available. That statement, so far as I understand it, merely demonstrates that the company owes National Westminster Bank £40,000. That would not demonstrate the company’s solvency or ability to pay its debts as they fall due. It was said, with no evidence supporting it by way of documents from the bank, that the bank would be willing to allow further drawings against the overdraft limit. That would merely be to increase the company’s debts to the bank while repaying other debts. The net effect would be to leave the company’s total indebtedness unchanged.

It must be understood by people making application to this court that an order under s 127 will only be made upon the court being satisfied that the order will be for the benefit of *all* the company’s creditors, or that the proposed transactions are likely to benefit *all* creditors. It is not an adequate basis for an application for a validation order to say that one or two creditors, who may be the petitioning or a supporting creditor who are parties to the petition and who, naturally, want to be paid at once, consent to the making of a s 127 order.”

8. Despite this apparent strictness, s127 is expressed in very general terms, and the legislature clearly envisaged that it was a provision which was to be applied so as to do justice in the circumstances of each case. What is “beneficial to creditors” is obviously very fact-sensitive and payments to professionals after presentation of the petition might well, in the broadest sense, be seen to be to the overall advantage of all creditors, depending on the services sought. In this respect, professionals will seek to rely on the broader statements of principle as to the ambit of the court’s validating discretion. In *Re Clifton Place Garage Ltd* [1970] Ch 477, the Court of

⁹ In the case of a voluntary winding-up no such considerations arise, as the winding-up originates in the voluntary action of the shareholders and also commences only as from the passing of the resolution to wind up.

¹⁰ As cited by Chadwick J in the decision reported at [1994] 1 BCLC 190 (at 193g-h)



Appeal approved of a summary of a holding of Vaisey J in *Re Steane's (Bournemouth) Ltd* [1950] 1 All ER 21:

“Held: the legislature, having omitted to indicate any particular principles which should govern the exercise of the discretion vested in the court by [the statutory predecessor of section must be deemed to have left such exercise entirely at large and controlled only by those principles which applied to every kind of judicial discretion; in exercising its discretion the court must decide what would be just and fair in the circumstances of each case, having special regard to the question of the good faith and honest intention of the persons concerned.”

9. However, the starting point is the basic premise of the legislation - that all unsecured creditors are to be paid rateably. For this reason, it is not proper to validate a payment which discharged in full a single unsecured creditor, unless the payment was a necessary part of a transaction which benefitted the general body of unsecured creditors¹¹. Payments made in good faith and when the parties were unaware that an application to wind up the company had been made will generally be validated where they relate to the company's need to continue business and earn income. However payments made merely to reduce pre-existing debts without any obvious benefit for the company are not likely to succeed. So, in the ordinary case, where the company is trading at a loss, the court is likely to be less disposed to make a validation order to enable further trading to take place¹².
10. Every case depends on its facts and a void payment can be validated, in whole or in part, on terms which protect creditors:
 - a. In *re Park Ward & Co Ltd* [1926] 1 Ch 828, wages fell due 3 days after the presentation of a petition and the moneys required were advanced by R, secured by a newly-created debenture, thereby avoiding the closure of the business (which was subsequently sold as a going concern). Although R had knowledge of the petition when it was created, the court validated the creation of R's debenture.
 - b. In *Re A. I. Levy (Holdings) Ltd* [1964] Ch 19, very precise directions were given by Buckley J as to the application of the proceeds of the transactions, including the payment into court as to the balance. Conversely, a transaction, however unusual, can be blessed if manifestly for the benefit of creditors.
 - c. In *Richbell Information Services Inc v Atlantic General Investments Ltd* [1999] BCC 971, the court validated a funding arrangement to enable litigation to be conducted to pursue a claim to recover assets claimed by the company.
11. In *Perpetual Trustee Co Ltd v BNY Ltd* [2010] 1 Ch 396, Patten LJ summarised the effect of s.127 as follows:

“**126** Where a winding up or bankruptcy order is made, the operation of the pari passu rule relates to property of the company or the bankrupt from the commencement of the relevant insolvency process. In the case of companies, winding up commences from the date of the presentation of the petition or, in a voluntary liquidation, from the date of the resolution to wind-up: see Insolvency Act 1986, section 129. Consistently with this, section 127(1) of the Act invalidates any disposition of the company's property or any alteration in the status of the company's members made after the commencement of the winding up unless the court orders otherwise.

127 On an application for a validation order in the period between the presentation of the petition and its hearing, the court will need to be satisfied that it is in the interests of the creditors generally that the transaction should be allowed to proceed: see *In re Gray's Inn Construction Co Ltd* [1980] 1 WLR 711, 717. In *Denney v John Hudson & Co Ltd* [1992]

¹¹ It was held in *Re May Power, Power v Kevin Brown and others* [2009] EWHC 9 (Ch) (following *Mond v Hammond Suddards* [1996] 2 BCLC 470) that the avoidance provisions were not only for the protection of the unsecured creditors and could be relied upon by persons other than the insolvency office-holder.

¹² *Re a Company No.007523 of 1986* (1987) 3 BCC 57



BCLC 901, 904 Fox LJ set out the following principles derived from that earlier decision of the Court of Appeal:

"(1) The discretion vested in the court by section 522 [of the Companies Act 1985] is entirely at large, subject to the general principles which apply to any kind of discretion, and subject also to limitation that the discretion must be exercised in 'the context of the liquidation provisions of the statute. (2) The basic principle of law governing the liquidation of insolvent estates, whether in bankruptcy or under the companies' legislation, is that the assets of the insolvent at the time of the commencement of the liquidation will be distributed *pari passu* among the insolvent's unsecured creditors as at the date of the bankruptcy. In a company's compulsory liquidation this is achieved by section 227 of the 1948 [Companies] Act (now section 127 of the Insolvency Act 1986 of the current legislation). (3) There are occasions, however, when it may be beneficial not only for the company but also for the unsecured creditors, that the company should be able to dispose of some of its property during the period after the petition has been presented, but before the winding up order has been made. Thus, it may sometimes be beneficial to the company and its creditors that the company should be able to continue the business in its ordinary course. (4) In considering whether to make a validating order, the court must always do its best to ensure that the interests of the unsecured creditors will not be prejudiced. (5) The desirability of the company being enabled to carry on its business was often speculative. In each case the court must carry out a balancing exercise. (6) The court should not validate any transaction or series of transactions which might result in one or more pre-liquidation creditors being paid in full at the expense of other creditors, who will only receive a dividend, in the absence of special circumstances making such a course desirable in the interest of the creditors generally. If, for example, it were in the interests of the creditors generally that the company's business should be carried on, and this could only be achieved by paying for goods already supplied to the company when the petition is presented (but not yet paid for) the court might exercise its discretion to validate payments for those goods. (7) A disposition carried out in good faith in the ordinary course of business at a time when the parties were unaware that a petition had been presented would usually be validated by the court unless there is ground for thinking that the transaction may involve an attempt to prefer the donee—in which case the transaction would not be validated. (8) Despite the strength of the principle of securing *pari passu* distribution, the principle has no application to post-liquidation creditors; for example, the sale of an asset at full market value after the presentation of the petition. That is because such a transaction involves no dissipation of the company's assets for it does not reduce the value of its assets."

128 I shall explain later, propositions (6) and (8) are particularly relevant to the issues canvassed on these appeals....

171.As mentioned earlier, dispositions of the property of a company are invalidated when they occur at any time following the presentation of the petition unless validated by the court. That power will, in practice, never be exercised unless the terms of the disposition offer full value to the creditors of the company.

12. As already noted, statements like these concluding words are not intended to be taken too literally. They certainly apply to dispositions for the purpose of continuing to trade and to one-off transactions. In this connection, the *Practice Note – Validation Orders* [2007] BCC 91 stipulates the minimum information the court is likely to require to enable it to consider whether to make a validation order and, if so, on what terms. By paragraph 6(g) and (h), the applicant is expected to produce: "(g) full details of the company's financial position including details of its assets...and liabilities, which should be supported, as far as possible, by documentary evidence e.g. the latest filed accounts, any draft audited accounts, management accounts or estimated statement of affairs....(h) a cash flow forecast and profit and loss projection for the period for which the order is sought.....".



13. Paragraph 9 of the Practice Note concludes:

“9. The court will need to be satisfied by credible evidence that the company is solvent and able to pay its debts as they fall due or that a particular transaction or series of transactions in respect of which the order is sought will be beneficial to or will not prejudice the interests of all the unsecured creditors as a class (*Denney v John Hudson and Co Ltd* [1992] BCLC 901; [1992] BCC 503, CA; *Re Fairway Graphics Ltd* [1991] BCLC 468).”

14. But payments for the provision of professional services are of a different character. Post-petition payments are frequently made to professionals for advice in circumstances which could not easily be assessed as giving “full value to ...creditors”. The principles in operation here are not so clear.

Payments to solicitors to pay for the defence of the petition itself

15. Where the issue is the company’s costs of defending the winding up petition, it has been said that the court is likely to validate payments to a company’s solicitor for the purpose of that defence¹³. This is a continuation of an older practice under the former equivalent provisions for bankruptcy¹⁴, although the former practice in bankruptcy was not extended beyond the payment of that which was necessary for the debtor on the ground of humanity¹⁵ and the modern approach is likely to be more forgiving¹⁶. Nevertheless, the merits of defending are plainly relevant to the question whether any such disposition will be validated.¹⁷ In *Robinson Cox v Woodings*¹⁸ the court refused to validate a payment to solicitors retrospectively in circumstances where another petitioning creditor was substituted after the advice was given and a winding up order made.

Validation of “preference” payments

16. Absent special circumstances, a payment which is de facto preferential in nature will not be validated, whether to a professional or otherwise¹⁹. This is because the statutory period for recovering preference payments ends with presentation of the petition, such that the post-petition period is one of even greater anxiety in terms of preserving the assets for creditors. In this context, payments of past debts (the very type of transaction which the provisions are designed to nullify) will be scrutinised more closely than (say) the repayment of moneys advanced post-petition to pay the wages to keep the company afloat. Following are 3 examples of cases where the court found that a preference had been intended and therefore refused validation.

17. The first is *Re Webb Electrical Limited* [1988] BCLC 382. Mr Webb (W) was a director of W Ltd, which was in financial difficulties. The company owed the Inland Revenue £42,000 and a petition to wind up the company was presented by the Inland Revenue in January 1981. W succeeded in paying off £18,000 of the debt owed to the Inland Revenue. Part of the £18,000 consisted of the cash takings, some £7,000, of a restaurant run by FW Ltd, of which W was a director and a shareholder. On 3 March 1981 W drew in his own favour a cheque for £7,000 on the bank account of W Ltd at the time when the company was the subject of an advertised compulsory petition. W then drew a cheque on his own account for £7,000 in favour of FW Ltd and in turn drew a cheque on the account of FW Ltd in favour of W Ltd for £7,000 which was paid into W Ltd’s account. W’s application for a validation order in respect of the payment of £7,000 from W Ltd to W on 3 March 1981 was dismissed. The court held that the question was not whether the company was or was not damaged by the payment but whether the payment was made with a

¹³ *Re Crossmore Electrical and Civil Engineering Limited* (1989) 5 BCC 37 (although a contributory’s petition case, Hoffmann J stated: “In the case of an ordinary petition by some wholly unrelated creditor it would I think be in the ordinary course of the company’s business for it to pay solicitors to defend itself against such a petition and therefore such payments should fall within the scope of a validation order under sec. 127.”)

¹⁴ *Re Sinclair, Ex p. Payne* (1885) 15 Q.B.D 616; *Re A Debtor (No.490 of 1935)* [1937] Ch 92

¹⁵ *Re Pollitt, Ex p. Minor* [1893] 1 QB 455, CA at 458

¹⁶ *Rio Properties Inc v Al-Midani* [2003] BPIR 128

¹⁷ See: (the entertainingly named) *Re Surplus Trader Ltd* [2005] HKLRD 436

¹⁸ (1993) 11 ACSR 351

¹⁹ See e.g. *Re Airfreight Express (UK) Ltd* [2005] BPIR 250



bona fide view to assisting the company. The payment in question had not been made to benefit W Ltd but had been made to prefer W and therefore it was not an appropriate case in which an order would be made to validate the payment.

18. The second example is *Re J Leslie Engineers Co Ltd* [1976] 1 WLR 292. A petition to wind up the company was presented on September 14, 1970, and a winding up order was made on December 15. The respondents had done some work for the company in the summer of 1970. Their charges came to £1,050, and, without knowing about the presentation of the petition, they were pressing the company for payment. They were paid as follows:
 - a. on October 2 the controlling director H made out a "cash" cheque for £250 on the company's bank account. He obtained the cash and bought five money orders of £50 each and sent them to the respondents.
 - b. on November 5, H sent to the respondents a cheque for £800 drawn on the joint account of himself and his wife at the same bank. The joint account was overdrawn. H paid a cheque from the company's account to cover the overdraft and the £800 cheque and other cheques which he had issued on the joint account. The respondents presented the cheque without knowing that the company's moneys had been paid into the joint account to create a credit balance so as to meet the cheques. The respondents thought that the cheque was being paid by H and his wife from their own resources. On November 20 the cheque was cashed.
19. The liquidator applied for a declaration that the post-petition payment of £1,050 was void and for an order that the respondents should pay the £1,050 to the liquidator. It was held that:
 - a. as to the £250 - the term "dispositions" included dispositions of a company's property whether made by the company or by a third party or whether made directly or indirectly; that the payment of £250 was a void disposition within the section because the bank notes received from the bank were as much the company's property, and identifiable as such, as were the moneys in the account and they were throughout clearly identifiable as the company's property which passed directly from the company's hands into the respondents'; and that it was immaterial that the director took the bank notes and converted them into money orders. The payment of the £250 was clearly a preferential payment and to validate it simply because the creditor preferred did not know he was being preferred would be to defeat the whole purpose of the section; and that, accordingly, the liquidator was entitled to the declaration sought in respect of the £250 and an order for repayment of that amount.
 - b. as to the balance - "the property of the company" was not the credit balance in the joint account but the sum total of the rights of the company created by the transactions leading up to the creation of that balance, such that the payment by the bank of the cheque in favour of the respondents was not a disposition of the company's property avoided by the section. On that basis, once it was accepted that the respondents were innocent recipients without notice that the account from which they were paid had been fed by a payment of the company's moneys wrongfully procured by its controlling director, there was no principle on which they could be called on to repay. The court found that they were not volunteers in that they had used the moneys to pay their own creditors. Therefore, although the company might be able to trace its funds in the joint account, those funds could not be traced in the hands of the respondents. The judge (Oliver J) stated:

"I think that in exercising discretion the court must keep in view the evident purpose of the section which, as Chitty J. said *In re Civil Service and General Store Ltd.*, 58 L.T. 220, 221, is to ensure that the creditors are paid *pari passu*. Obviously there are circumstances where this cannot in fairness be the sole criterion in cases where, for instance, the creditor concerned has since the presentation of the petition helped to keep the company afloat, or has otherwise swollen the company's assets, salvage cases and that sort of thing."



20. Ultimately, the contrivances of the director were ignored save to the extent that they created legal rights and obligations which required analysis. The fact that the £250 was a de facto preference was fatal.
21. The 3rd example is *Re Civil Service & General Store Ltd* (1887) 57 LJCh 119. On the same day on which the petition was presented the company agreed to pay a trade creditor who was ignorant of the presentation of the petition £175, being part of a debt of £320 previously due to him, on the condition that he continued to supply the company with goods for a cash payment. The £175 was paid after the presentation of the petition, and also £13 for goods supplied. The winding-up order was subsequently made, and the payment of £13 was allowed, but the £175 was ordered to be repaid. The judge stated the case as put forward on behalf of the creditors in this way:
- “The argument of the respondents is a somewhat strange one. They say that the part payment of their debt was a condition of their supplying goods, and that they are therefore entitled to treat the transaction as a new and complete transaction.”
22. As he made clear, that was the case of the creditor. He continued:
- “But to affirm a transaction of that kind under the discretion conferred upon the court by s. 153, would be to exercise such discretion upon a totally erroneous principle.”
23. He further relied on the circumstance that, as he put it,
- “... the respondents, at the least, knew at the date of the agreement that the company was in embarrassed circumstances, although they do not seem then to have had knowledge of the presentation of a petition.”
24. Then, he identified the preference as the ground for refusing validation:
- “When, however, they actually received the two payments of £100 and £75, they were, in my judgment, aware of a petition having been presented. I can only treat the transaction as an attempt to get a preference over other creditors.”
25. Some of the reported decisions are not easy to reconcile with each other. The 3 cases above might be contrasted with the facts of and result in *Re Clifton Place Garage Ltd* [1970] Ch 477. On 30 November 1966, creditors presented a petition based on a debt of about £4,000 to wind up a company which carried on a garage and petrol filling station. The company's bankers froze its account. On 24 December 1966, debenture holders of the company's parent company, which wholly owned the company, appointed a receiver and manager of the parent company. The receiver considered that, without money to carry on the day-to-day business of the company and to pay its rent, the goodwill would be lost, the lease forfeited, and the business closed down, that it would be in everybody's interest to try to keep the business going temporarily to see what could be done with it. The receiver therefore advanced sufficient of the parent company's money to the company, on a day-to-day basis, to enable it to continue trading; the trading receipts of the company were paid to the receiver, into a special account. On 30 January 1967, the receiver having withdrawn his opposition to a winding-up order because of further facts he had discovered, the company was ordered to be wound up. Between his appointment and the winding-up order the receiver had advanced £4,878 to the company, which was used to pay its rent and for petrol, oil and trading stamps, and the company had paid the receiver £4,024 trading receipts. On an application by the receiver, in its winding-up, to validate this payment of trading receipts to him, the court held that, as the receiver had acted in good faith, and to validate the payment to him would merely give him back part of the money he had advanced (and of which the company and its creditors had had the benefit), the payment would be validated.

Proving that a professional has been preferred

26. This difficulty in finding a desire to prefer professionals is relevant when assessing post-petition payments to them. A payment of a professional which, had it been made in the preference period pre-petition would have been an unlawful preference, will not be validated if made post-



petition. However, the converse is not necessarily true – just because a payment to a professional would not have been an unlawful preference, it will not therefore be validated if made post-petition.

27. The decision in *Re Ledingham-Smith (A Bankrupt)* [1993] BCLC 635 may be used as an example. PKF were the accountants to a business partnership carried on by Mr and Mrs LS. Payment of PKF's fees was by standing order for £1,000 per month. By the end of September 1989, Mr and Mrs LS owed PKF approximately £7,900 for services rendered. Management accounts in November 1989 showed that the company had a net deficiency of £166,000 without anything being included in the accounts for goodwill which Mr LS valued at £250,000. PKF advised that the company's business should be sold or further capital injected into it. Mr and Mrs LS decided in December 1989 to sell it. By the end of 1989 Mr and Mrs LS owed PKF approximately £24,000. In January 1990 PKF made it clear that they would not continue to act for the partnership unless their outstanding fees were paid. It was agreed that the partnership would pay on a weekly basis the sum of £5,000 to PKF first to satisfy any fees incurred in that week and the balance to be used to reduce outstanding fees. The partnership was declared bankrupt in April 1990 and the trustee in bankruptcy sought to recover under s.340 of the Insolvency Act 1986 sums which had been paid to PKF during the relevant period as defined in s 341 of the 1986 Act. The accounting position for January and February 1990 was that invoices were raised for approximately £12,000 for work done and payments were made by Mr and Mrs LS of £14,000 made up of three payments of £4,000 under the arrangement for paying PKF's fees at the rate of £5,000 per week, and two payments of £1,000 under the standing order. The judge held that the payments made to PKF under the standing order for £1,000 were not preferences but that the payments made under the arrangement for paying the fees at the rate of £5,000 per week were preferences and accordingly ordered repayment by PKF of £12,000.
28. On PKF's appeal, it was held that there were 3 issues before the court: (a) whether Mr and Mrs LS had put PKF in a position which in the event of bankruptcy of Mr and Mrs LS would be better than if the thing had not been done (the 'preference in fact' issue), (b) if there was a preference in fact, whether Mr and Mrs LS were influenced by a desire to confer a benefit (the 'relevant influence' issue), and (c) on whom rested the burden of proof in showing the relevant influence or its absence (the 'burden of proof' issue):
- a. as to the preference in fact issue, in so far as there was preference it was only for the surplus which remained after the payment for the fees between January and February 1990 and this was a figure of approximately £2,300 and not £12,000 as the judge had ordered. The requirement of s 340(3) (b) of the 1986 Act was that the person receiving payment 'will be better' in a bankruptcy after the doing of the thing in question. On the facts, it could not be said that PKF would be benefited to the extent of the surplus of £2,300 since services were still being provided and fees incurred. Accordingly, there was no evidence that there had been a preference in fact with respect to any part of the three separate payments of £4,000.
 - b. as regards the relevant influence issue, 'desire' and 'influence' were not susceptible to any further definition and the question was one of applying them to the facts of a given case. It was not possible to infer on the facts a desire to prefer on the party of Mr and Mrs LS in making payment and therefore, if necessary, it was possible to conclude that the judge had been wrong in so finding.
 - c. as regards the burden of proof issue, it was clear from s 240(5) that the burden was on the trustee to show that a preference had been conferred.



29. Morritt J observed:

“The facts on which the deputy judge relied were knowledge of insolvency, the fact that Mr Ledingham-Smith authorised the endorsement of the cheque for £1,570 by and in favour of Pannell Kerr Forster on 24 January 1990, and Mr Ledingham-Smith’s signature to the authority of 18 February 1990 for payment of £21,317 to Pannell Kerr Forster out of the proceeds of sale of the business. Pannell Kerr Forster contend that these facts, neither singly nor collectively, prove the relevant desire or influence. They contend that the relevant payments were made because of the pressure exerted by Pannell Kerr Forster and the need to retain their services to effect a sale of the business as a going concern. The trustee points to the fact that other creditors, such as the supplier of the photocopiers whose goodwill was equally vital, were not similarly dealt with.

In my judgment the primary facts as found by the deputy judge do not warrant the inference that he drew. It cannot be said that at the time any of the payments of £4,000 was made in the event of the bankruptcy of the Ledingham-Smiths the position of Pannell Kerr Forster would be better. It might or might not be, depending on how much further work Pannell Kerr Forster did. If the necessary consequence was not to improve the position of Pannell Kerr Forster it is difficult to infer that the Ledingham-Smiths desired that consequence.

Mr Ledingham-Smith’s evidence was that he made the agreement and the payments because of pressure from Pannell Kerr Forster and the desire to retain their services. It may be that pressure does not displace desire in the way that it formerly displaced a dominant intention to prefer but it can certainly affect the question of desire.

The last payment was made on 12 February 1990. At that time negotiations were continuing on a number of fronts. Pannell Kerr Forster’s services continued until shortly before 21 February 1990. If the payment had not been made the subsequent services would not have been rendered. Even if the relevant desire existed in relation to the letter of 18 February 1990, circumstances by then had changed. Neither knowledge of insolvency nor endorsement of the earlier cheque seem to me to be sufficient. The treatment of the other creditors, which is not entirely clear from the evidence, does not in the circumstances seem to me to be sufficient to infer the relevant desire or influence in relation to the payments in question.”

30. Therefore the preference claim failed. However, suppose the payments had been made post-petition and prior to the making of the bankruptcy orders, an entirely different enquiry would have been made – whether payments could be said to have been for the benefit of creditors. It is submitted that this would have required the genuineness of the need to retain PKF and the value to creditors of the services they provided in respect of which the disputed debts arose. However, it is difficult to see how post-petition payment of PKF’s pre-petition invoices might have been validated by the court. All of these payments were to PKF beneficially. But there is another category of payment altogether. It is now worth mentioning circumstances where such professionals might receive funds post-petition as agent or intermediary.

**Solicitors / accountants operating post-petition quasi-bank accounts
(ii) liquidation**

31. There are situations where the company (by its directors) knows of the petition but wishes to carry on as normal without alerting third parties that there are any difficulties. Whether covert or open, devious or honest, the purpose of the arrangements and their economic effect will differ from case to case, as will their efficacy.
32. It is not uncommon for debtors (corporate or human) to anticipate the freezing of their bank account by setting up alternative (indirect) funding arrangements²⁰ for the carrying on of business - including the use of professionals to operate an account post-petition in their name. Relying upon the bank cases²¹, the professional argues that he is just an “agent”, not a donee, and that there has been no alienation of the company’s property in his favour.

²⁰ See e.g. *Re Airfreight Express (UK) Ltd* [2005] BPIR 250

²¹ In particular, *Hollcourt (Contract) Ltd v Bank of Ireland* [2001] Ch 555, *Coutts and Co v Stock* [2000] 1 WLR 906



Therefore, it is argued, he is not liable to repay any sums paid into or out of the account so set up. The bank cases characterise the bank in certain circumstances as a mere intermediate agent (see the facts of *Re J Leslie Engineers Co Ltd* (above)) where the bank was used as intermediary by the director. However, as a matter of both law and policy, banks are in a special position and this is recognised in relation to bankruptcy (s.284(5)). It is not clear to what extent it is legitimate to graft the jurisprudence relating to the effect of s.127 on a corporate client's legal relations with its bankers onto the operation of a quasi bank account operated through professionals.

33. It cannot be emphasised enough that the facts will dictate the legal outcome and only general principles can be referred to here. So:
- a. When a cheque is actually credited to a customer's bank account, the money will be treated as borrowed by the bank. Therefore it is treated as available as part of the bank's own working capital. From the customer's point of view, a right to payment arises. From this it can be concluded that a "disposition" has taken place in favour of the bank²².
 - b. When a cheque is credited to a solicitor's client account, it is not ordinarily open to the solicitor to deal with the moneys save in accordance with the client's instructions. On the face of it there is no disposition in favour of the solicitors in the conventional case where the client has control over the assets in the client account.
 - c. It follows that, in the unlikely event that client moneys find their way into the solicitors' office account or the client does not retain dominion over the moneys, there will be a disposition.
34. Use of the client account as a quasi-bank account might well not be sound professional practice and will also engage s.127 in respect of payments out of the client account to third parties. Amendments to the Solicitors' Accounts Rules 1998 (SAR) were made on 17 March 2004. Rule 15 related to the use of client account. Rule 15 note (ix) was amended to reflect the decision of the Solicitors' Disciplinary Tribunal known as Wood and Burdett to the effect that providing banking facilities through client account does not form part of a solicitor's practice. The note reminded solicitors that they were likely to lose the exemption under the Financial Services and Markets Act 2000 if a deposit was taken in circumstances that did not form part of a solicitor's practice. The Tribunal decision in Premji Naran Patel (No. 10511 -2010) related to the operation of Rule 15(ix) in relation to transactions in 2006. Of particular relevance is para 25.4 on p.11 where the Tribunal found that the client account was used because the client could not use conventional banking facilities. The Tribunal decision in Alistair Grove Brooks and others (No. 10730 – 2011) included an allegation that solicitors failed to exercise caution when providing their client with banking facilities contrary to note (ix) in relation to transactions during mid to late 2009. The Tribunal rejected it on the facts (paras 175-8). The SRA Practice Note issued on 8 September 2010 stipulated at para 2.5 under the heading "Solicitors as bankers":

"As a solicitor, it is not a proper part of your everyday business or practice to operate a banking facility for third parties, whether or not they are your clients. This was determined by the Solicitors Disciplinary Tribunal in the case of Wood and Burdett (case number 8669/2002 filed on 13 January 2004). You should not, therefore, be party to an arrangement that is tantamount to providing banking facilities through a client account, as stated in guidance note (ix) of rule 15 SAR.

With this in mind, you should assess each case on its own merit based upon the individual circumstances that present themselves. If there is a good reason to continue to hold your client's money pending its investment or use in further transactions on which you continue to advise and act, it is unlikely that this would amount to a breach of the SAR. However, you should review this position if there is likely to be any significant delay in receiving further instructions."

²² See Goode: Principles of Corporate Insolvency Law (4th Edn) para 13-131 and the cases cited



Finally in this context, the Solicitors' Accounts Rules 1998 have now been repealed and replaced by the SRA Accounts Rules 2011 as part of the SRA's move toward "outcomes-focused regulation". Rule 14.5 strictly prohibits solicitors from providing banking facilities for their clients through the client account. The use of the client account as a banking facility may result in the loss of the exemption status under the Financial Services and Markets Act 2000 where there is no underlying transaction supporting the deposit. It could also have implications under Anti-Money Laundering Regulations under the Proceeds of Crime Act 2002. The courts recognise the importance of these rules²³

35. Returning to s.127, the subjective intention of such an alternative funding arrangement might be relevant. In *Re Steane's (Bournemouth) Ltd* [1950] 1 All ER 21, the court referred briefly to the facts of an unreported case, *Re Howard (Sunbury) Ltd*, in which a lender funded the company with a view to acquiring it from the liquidator and improving it for his own ultimate benefit. It appears that such an intention, consciously directed at improving the position of the lender, was antipathetic to the purpose of the avoiding provisions. However, in the ordinary case and absent fraud/dishonesty, the subjective intention of the lender/directors should not trump an objective assessment of the effect of the operation of the alternative funding arrangement. If a net benefit to all creditors was thereby achieved, it is difficult to see why a validation order might not be made.

(ii) Bankruptcy

36. The position in bankruptcy would appear to be more complicated. It will be recalled that s.284(2) provides:

"Subsection (1) applies to a payment (whether in cash or otherwise) as it applies to a disposition of property and, accordingly, where any payment is void by virtue of that subsection, the person paid shall hold the sum paid for the bankrupt as part of his estate."

37. In *Pettit v Novakovic* [2007] BPIR 1643, a trade creditor of Mr Thussell (T) presented a bankruptcy petition against him on 3 October 2002 and a bankruptcy order was made on it on 11 April 2003. On 18 June 2003, Mr Pettit (P) was appointed T's trustee in bankruptcy. Meanwhile, on 19 March 2003, a payment of £75,761.79 (being part of the proceeds of sale of the T's home) was paid at T's direction by his solicitors to his accountant and business adviser, Mr Novakovic (N). When he received the money, N was aware that a petition had been presented. He paid the money into his client account. Between 19 March 2003 and 10 April 2003, N made payments out of the client account totalling £71,281.75, including £45,000 to T and £7,250 to himself. The remainder appeared to have been paid to T's trade creditors (in respect of T's business which N had purchased). When the bankruptcy order was made on 11 April 2003, the deficiency in the estate exceeded £151,000. P sought recovery of the £71,281.25 from N, who conceded that the £7,250 that had been paid to him was repayable.
38. The disputed parts of P's application were (a) for a declaration that N held the sum of £75,711 odd (part of the initial credit after adjustments) for the estate of T and (b) for a declaration that the payments of £71,281 made by N were payments made by or on behalf of T after the presentation of the petition and were void as against P by virtue of s 284 of the Insolvency Act 1986 (the Act). No relief was sought against the ultimate beneficial recipients of the monies, other than N himself, which he conceded. The district judge refused to make the declarations sought, holding that he was bound by the decision in *Hollcourt (Contracts) Ltd v Bank of Ireland* to refuse relief. P appealed.
39. HHJ Norris QC allowed the appeal in part holding :

²³ see (e.g.) the comments of Peter Smith J in *A-G of Zambia v Meer Care* [2007] EWHC 952 (Ch) (at paras 619 ff) and of Moore-Bick LJ in *Gurpinar v SRA* [2012] EWHC 192 (Admin) at [34] ("although it has to be recognised that any significant breach of the Solicitors Accounts Rules will normally attract a stringent penalty.")



- a. The district judge had been wrong to conclude that, of itself, the decision in *Hollicourt* required dismissal of P's application. *Hollicourt* was a decision on s 127 of the Act, relating to winding up rather than bankruptcy, and which was in materially different terms from s 284 of the Act. It was unwise to approach the words of s 284 of the 1986 Act with the assumption that they were designed to achieve the same outcome as the words of s 127 of the Act.
 - b. Part of P's application related to the payment by T's solicitors to N of £75,711. *Hollicourt* did not concern payments to the bank but payments by the bank (and the decision was relevant, therefore, only the second claim relating to the disbursement of the £71,281. It had nothing directly to say about the £75,711.
 - c. In *Hollicourt* the bank was only acting as agent of the company to make payments to creditors with no knowledge of the presentation of the winding-up petition. When he received the £75,711 and when he made payments of £71,281 out of it, N was aware of the presentation of the petition.
 - d. A 'payment' within s 284(2) of the Act could be, but was not necessarily, 'a disposition of property' falling within s 284(1) of the Act, since by virtue of s 436 the expression 'property' included money. 'Payment' was however the only label that could properly be applied to the process by which £75,711 belonging to T in his solicitor's bank account came to appear in N's bank account.
 - e. Because of the payment, N had to render an account to P of the property he had come to hold for the bankrupt as part of his estate in consequence of that 'payment'. N's only defence to a claim for an account or for money had and received could be that he had already accounted by repaying the sums to T before the commencement of the bankruptcy. He could not pray in aid payments made to third parties that, by virtue of his knowledge of the presentation of the petition, he knew would be void if made by T directly.
 - f. N had received £75,711, but had repaid T £45,000. Of the difference, N admitted receipt of £7,250 plus some additional monthly instalments and submitted to judgment in the sum of £9,700 plus £2,167.15 interest. N was ordered to pay an additional £23,461 plus interest computed on the same basis.
40. This is an example of an intermediary agent being visited with personal liability for operating a quasi-bank account after and with knowledge of the presentation of a petition. It may be that this decision is explicable by reference to the relation back of the title of a trustee in bankruptcy to the date of presentation of the petition (an irrelevant consideration in corporate insolvency). In that way, if title relates back because a bankruptcy order is made on the petition and an agent is found to have disposed of assets in the meantime, it is consistent with legal theory that the disposition or payment by the agent should be automatically void unless validated.

Non-Insolvency Act remedies

41. There are wider considerations. A solicitor is a trustee of his client's moneys, which will normally be held subject to the Solicitors' Accounts Rules²⁴. It was established in *Twinsectra*²⁵ that solicitors may incur liability to a third party for funds which are held if they give an undertaking to use the funds for a specific purpose. Moreover, if directors after petition presented make payments, they do so at their peril, and are personally liable if the payments are improper²⁶. Professionals might be visited with accessory liability. Solicitors may be liable for dishonest assistance in a dishonest or fraudulent design²⁷ – which might include diversion of funds in fraud of a client's creditors. The test is whether, objectively, the professional was acting as an honest

²⁴ See footnote 23

²⁵ *Twinsectra v Yardley* [2002] 2 AC 164

²⁶ *Re Neath Harbour Smelting and Rolling Works* [1887] WN 87, 121; *Re Civil Service and General Store* (1887) 57 LJ 119; *Wilson v Masters International Limited* [2009] EWHC 1753 (Ch)

²⁷ See *Twinsectra*, *Walker v Stones* [2001] QB 902 and *Gruppo Torras v Al-Sabah* [2001] Lloyd's Rep PN 177



person would in the circumstances. If there was “blind eye” dishonesty – not asking those questions which an honest person would ask – this will also suffice. It is not difficult to conceive of circumstances where a solicitor/accountant and directors of a corporate client know of the petition and consciously resolve to move banking operations away from the bank (i.e. prior to freezing) and into a safe haven client account (knowing that they obtain a validation order because they cannot comply with the provisions of the Practice Note (above)). Depending always on the facts, accessory liability is a distinct possibility in such circumstances.

Economics

42. In all matters concerning ss.127/284, the court will look at the overall economic effect of the operation of the quasi-bank account. The commercial and pragmatic approach of the court can be seen from the facts of *In re Tramway & Construction Co Ltd* [1988] 2 WLR 640, where a petition was presented to wind up a company which was the registered proprietor of a building site. The site was charged to a bank as security for the company's indebtedness, but its indebtedness to the bank far exceeded the value of the site. It was realised that further finance was needed to bring the development of the site to completion and that the company was at risk of being wound up in the meantime by other creditors. For a consideration representing the company's indebtedness to the bank, O Ltd agreed to take the company's place both as debtor to the bank and as owner of the site; and the bank would lend O Ltd the additional finance required to enable the development to be completed. 3 days before the winding up order, the company effected the transfer of the site to O Ltd for £179,336; its market value was then £85,000. Subsequently, the bank released its charge over the site and O Ltd executed a fresh charge in favour of the bank to secure its own indebtedness. When it was realised that the transfer of the site from the company to O Ltd was a void disposition unless validated, the bank took out a summons in the company's winding up proceedings seeking a validation order. It was held that in considering whether or not to make an order validating an unauthorised transfer of assets in a winding up, a comparison of the position of unsecured creditors according to whether or not a validation order was made was the wrong approach for the court to adopt; while the court's discretion under section 227 of the Companies Act 1948 should not be exercised so as to permit an unauthorised disposition to reduce the assets available for unsecured creditors, it was nevertheless unfettered by any statutory criteria and, subject to that principle, should be exercised so as to enable justice to be done as between the unsecured creditors and the claimants under the unauthorised transfer; accordingly, since the court would have made an order authorising the transfer of the site to O Ltd had an application been made to it prior to the date of transfer, and since the transfer did not operate so as to reduce the assets available for the unsecured creditors, the court would make a validation order.
43. The court went on to find that, in any event, since O Ltd had, in the belief that the transfer was valid, paid £179,336 odd to the company in consideration for the transfer to it of the site and in order to enable the company to discharge its secured indebtedness to the bank, O Ltd was entitled in equity, by subrogation, to keep alive for its benefit the bank's charge, as a security for repayment of the money, if the transfer proved to be invalid: accordingly, if the transfer were not validated, the money paid by O Ltd to the company would be repayable to O Ltd and would to the extent that the money had been applied in discharging the company's indebtedness to the bank, i.e. to the extent of £163,886.25 be secured by the bank's charge (with interest).
44. So, if, with knowledge of a petition and insolvency, a funder advances sums to the company's solicitors for payment of trade creditors pending acquisition, the question whether there is a disposition of the company's property and whether any such disposition has reduced the assets available for unsecured creditors will depend on the precise arrangements made.

Postscript – solicitor's lien and void dispositions

45. *In re Capital Fire Insurance Association* (1883) 24 Ch D 408 concerned a solicitor's lien on his client's documents. An order having been made for winding up a company, applications were made by the official liquidator against B., a solicitor employed by the company before the winding-up, that B. might be ordered to deliver up the following documents:



- a. The share register and minute book, which were in B.'s hands before the commencement of the winding-up
 - b. Other documents which came to B.'s hands after the presentation of the winding-up petition, but before the winding-up order
 - c. Documents relating to allotments of shares which had come to B.'s hands before the presentation of the petition.
46. *B.* resisted the applications on the ground that he claimed a lien. The judge ordered that all the documents should be delivered to the liquidator subject to the lien, if any, of *B.* On appeal, it was held that the order was correct as regarded (i) the share register and minute book, for that the directors had no power to create any lien on them which could interfere with their being used for the purposes of the company; and (ii) as to class 2; for that a solicitor could not assert against documents which came to his hands pending the winding-up any such lien as would interfere with the prosecution of the winding-up. However, the Court of Appeal also held that the order for delivery of class 3 must be discharged, for that the winding-up order could not defeat any valid lien existing at the time when the winding-up petition was presented.

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