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Rescue culture: *MK Airlines Ltd (In Liquidation)* – administration expenses, misfeasance and priority

KEY POINTS

- In a judgment supportive of the rescue culture in English insolvency, the court has reaffirmed its flexible approach to the application of insolvency provisions and to look at the practical effect of transactions in relation to their impact on creditors.
- A third party injection of new funds into the administration estate used to pay a creditor outside of the statutory order does not breach the priority rules if the position of unsecured creditors is unaffected.
- Administrators are reminded of their joint liability in the case of joint appointments, and importantly their potential for liability for the wrong doing of a joint appointee in the case that the misfeasance relates to performance of their duties and adherence to the Insolvency Rules.
- The importance of carefully checking that settlement agreements settle the matters they are supposed to is highlighted in a passing reference in the judgment.

THE CASE

MK Airlines Ltd v Katz & Anor (Acting as Joint Liquidator of MK Airlines) [2018] EWHC 540 (Ch) is the judgment handed down on a successful appeal by Mr Oldham (a former administrator of the MK Airlines Ltd (the 'Company)) against a judgment awarded against him in the sum of £1,035,326.28 in the lower court. The £1,035,326.28 primarily related to remuneration drawn by Mr Oldham's co-administrators which the Company's liquidators at first instance successfully claimed were paid outside of the statutory order of priority afforded to administration expenses. Applying the law to the facts as she saw them, on appeal the district judge ('DJ') found that the statutory order of priority had not been breached and accordingly Mr Oldham had committed no misfeasance upon which the sums awarded against him were founded.

The judgment covers a lot of ground and much text is taken up with consideration of procedural issues and other points which were heard but did not require a ruling due to the DJ's main conclusion that no misfeasance took place. This article focuses on the treatment of the rescue funds to pay administrator's remuneration.

RELEVANT FACTS

The Company operated an air cargo business and held a sought after Civil Aviation Authority ('CAA') Air Operator Certificate ('AOC'). By June 2008 the Company appeared to be in financial difficulty and the Company's directors appointed two partners of Bridge Business Recovery LLP ('BBR') and Mr Oldham (a consultant at BBR) as administrators of the Company (the 'Administrators').

Transatlantic Aviation Ltd ('TAA') approached the Administrators to purchase the Company and was found willing to fund its administration with a view to saving it as a going concern, so as to preserve the AOC. TAA agreed to provide an $18m facility (the 'Facility') to fund the Company's trade during the administration and $750,000 to pay certain pre-administration costs. The goal was to return the Company to solvency.

A deed of indemnity (the 'Deed') documented the terms of the Facility and included a provision that if the Company's unsecured creditors approved a CVA the Company's shares would be transferred to TAA and the Facility made available. If the CVA were rejected TAA would purchase the Company's assets for $2m.

In the event the CVA was approved, but the CAA would not transfer the AOC to TAA. This meant that the Company had to continue to trade with the Administrators remaining in office (and incurring remuneration). During their period of trading the Company, the Administrators drew down funds from the Facility into various of the Company's bank accounts, meaning the funds provided by TAA became mixed with the Company's other funds. Eventually, relations between the Administrators and TAA broke down and the Administrators applied to court for removal from office. The court approved and with TAA's support appointed administrators from Grant Thornton to take control of the Company.

In June 2009 the Company's administration ended and control of the Company was returned to TAA (now the Company's shareholder). As part of that return of control various agreements and undertakings were entered into by TAA which, among other things, explicitly covered the Administrator's remuneration.

In April 2010, a petition to wind up the Company was presented by a creditor and a winding up order eventually granted.

In July 2014 the liquidators of the Company issued proceedings against the Administrators for misfeasance under para 75(2) Insolvency Act 1986 for paying out the Company's funds in breach of the priority rules then set out in IR2.67 Insolvency Rules 1986, on the grounds that there was then an unacceptable shortfall to administration expense creditors.

By way of reminder, IR 2.67 (now IR 3.51) provides that the priority of administrators' own remuneration generally rank behind the costs and expenses incurred to third parties by

administrators. The reason for this is obvious, namely that administrators, being persons in control of a company, should not be able to cause a company to incur liabilities to third parties which go unpaid while the administrators themselves take funds from a company's assets. Generally speaking administrators would not undertake work for which they would not be paid, therefore the rules of priority offer third parties a degree of assurance that in acting on administrator instructions they will get paid from an otherwise insolvent company.

DECISION OF THE LOWER COURT

In the lower court the Registrar found that the Administrators had paid their own remuneration out of company assets in contravention of IR 2.67 and that by doing so it was a misfeasance under para 75 and/or breach of trust/fiduciary duty.

Key to understanding the Registrar's ruling was the construction of the Deed. Importantly, the Registrar found that:

a. the Facility was provided for the benefit of the Company;
b. despite the wording of the Deed, it was not possible to contract out of the statutory rules on priority in insolvency (citing *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758). The Registrar had found that certain clauses in the Deed sought to alter the statutory order of priority;
c. the funds provided under the Facility were paid into the Company's bank account, mixed with other funds and therefore legally became the Company's property; and
d. as the terms of the Deed provided that Facility was for the benefit of the Company, the Administrators could not claim there was a constructive trust created in their favour to pay their remuneration.

The Registrar went on to make other findings in relation to the Company's solvency at specified periods and as to quantum, which in this article are not further considered.

DECISION OF THE DJ ON APPEAL

The DJ did not raise issue with the order of priority at IR 2.67, and affirmed the law as to the inability to contract out of the statutory order of priority (affirming British Eagle). However, the DJ's interpretation of the construction of the Deed differed significantly from that of the Registrar. This difference led to a significantly different finding in relation to treatment of funds provided by TAA under the Facility and accordingly the Administrators' use of those funds. The key elements from the DJ's judgment on this matter are:

a. IR 2.67 and the rule in British Eagle apply only to a Company's assets. The DJ was clear to say (our emphasis added):

> 'It does not prohibit white knights or late investors providing additional funds on terms, including terms which compel the purchase of new assets and give those funders first priority purchase money security interests over those assets, or terms that operate by way of a *Quistclose* trust requiring funds to be used only for nominated purposes and not to be at the free disposal of the company (*Barclays Bank Limited v Quistclose Investments Ltd* [1998] UKHL 4)… This does not offend the Insolvency Rules.'

b. Nominated purposes may include preferential payment of particular debts outside the statutory order of priority if the source of funds comes from a third party. The rationale being that the position of unsecured creditors (including administration expense creditors) is unaffected. One unsecured creditor simply replaces another. The only qualification being that the injection of third party funds has to be genuine. In other words, a white knight could not inject funds in order to repay a debt a company owed to that same white knight as that would be a scheme which would use company assets to prefer an unsecured creditor.
c. Provided the provisions of the Deed were in that permitted form there would be nothing improper about its terms. It would follow that the Administrators' use of the funds advanced as envisaged by the Deed would not be a misfeasance by the Administrators. It is worth quoting again the DJ's words in this respect: *'Indeed [such an arrangement] may be the sole means of rescuing the company and permitting its continued trading during the rescue process'*.
d. The DJ did not accept the liquidators' argument that the only legal way that a payment by TAA in relation to the Administrators' remuneration could be effected was by means of a separate bilateral contractual arrangement between TAA and the Administrators, with funds paid into the personal accounts of the Administrators.
e. With the Company trading at a loss ($1m per day at end of the administration) it would be normal for the Administrators to seek alternative means of payment (so not simply out of Company funds). It was possible for TAA to agree to pay the Administrators' remuneration. The usual effect of this would be TAA being subrogated to the Administrators' priority, but the Deed provided that TAA's claim to funds put into the Company would be subrogated behind all other creditors of the Company (presumably in order to obtain creditor approval of the CVA). The DJ found that the Deed was a subordinated loan granted for the specific purpose of rescuing the Company (and its group), with specific provision for the Administrators' remuneration to be paid in priority to other administration expenses, so giving the appearance of altering the usual statutory order of priority.
f. It is without question that legal title to the funds advanced by TAA vested in the Company upon payment into the Company's account. It is also without question that the Company's property should be paid under the IR 2.67 order of priority. However, the TAA funds were not beneficially owned by the Company and accordingly the beneficial owners had a right to have those funds appropriated

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to their claims as would any other claimant on the Company's property with a trust or security interest.

g. Further a misfeasance by the Administrators in application of Company funds to their remuneration requires there to be some loss to administration expense creditors caused by the premature payment. As the TAA funds were provided for a specified use (accepted by the Company by its execution of the Deed) of payment of the Administrators' remuneration (and by inference creating a beneficial interest in those funds in favour of the Administrators) there was no misfeasance arising from such application. The protection creditors have against administrators simply using funds to pay extortionate remuneration is the remuneration approval process. In this case the creditors had approved the Administrators' remuneration.

h. The DJ found that it was possible that the Administrators were beneficially entitled to funds provided to the Company by TAA for their specific benefit, and applied Quistclose. Further, the mixing of the funds provided by TAA in the Company's accounts with other monies had no overall negative effect on creditors when compared to the instance that those funds were not mixed. For example, if $1m of new funds for a purpose was provided to the Company and mixed then paid to the Administrators there was no difference to creditors than the case in which $1m of new funds for a purpose was provided to the Company and segregated. The net position for creditors was the same. Accordingly, (see para G above) there was no loss caused to creditors by the Administrator's actions and therefore no misfeasance on that basis.

COMMENT

The conclusions reached by the DJ evidence the courts' willingness to protect the rescue culture of the present administration regime and to apply the law practically to obtain a fair outcome for creditors (and administrators). TAA provided funds to promote the rescue of the Company which included funds for the benefit of the Administrators (without which the rescue could not be attempted). Applying *Quistclose*, this meant that there was no 'alteration' of the statutory priority and the Administrators were entitled to receive their remuneration ahead of other administration expense creditors.

However, the case highlights the need for good drafting when documenting a rescue facility and the need for solicitors drafting the rescue documents to be clear as to the distinction between administrators and the insolvent company. Further, it highlights that a prudent administrator may wish to set up a separate account into which rescue funds are first deposited with the administrator then allocating on to the other accounts of the company according to need.

JOINT AND SEVERAL LIABILITY OF JOINT ADMINISTRATORS

As stated previously, the DJ goes on to consider other elements of the Registrar's decision such as solvency and quantum which, as a result of her findings set out above, did not need to be further considered. They do, however, provide for a complete rounded judgment commenting on all points on which she heard submissions. One particular point in relation to administrators' joint and several liability stands out for comment.

The liquidators had originally brought the misfeasance claim against all three of the Administrators. However, it transpired that the BBR Administrators had been released from all claims by the Company as a result of a settlement agreement relating to the Administrators' remuneration which had included TAA, the Company and BBR Administrators as parties. Accordingly, the present claim by the liquidators could only be continued against Mr Oldham, who as a consultant (but still joint appointee) for some reason had entered into a separate settlement agreement with TAA but not the Company as a party.

The DJ commented that the usual rule was that joint and several co-appointees would have to be found to have assisted, have notice of or be put on enquiry to the misfeasance of a co-appointee to be jointly responsible for a misfeasance, drawing analogies to case law on receivers, directors and trustees. However, in this case as the misfeasance (if it had stood) related to the due observance of the statutory priority rules any joint and several appointee would also be responsible for the wrong doing of the other since the misfeasance would not have happened had the innocent appointee performed his/her duty properly. The inference is that all appointees will be held liable for any breach of the Act or Rules by a co-appointee even if unaware. In practice this may not make much difference since it is common for co-appointees to be partners and so jointly and severally liable in any event. ■

Further reading

- RANDI Blog: Determining the priority of payments in an insolvency (*Oldham v Katz (acting as joint liquidator of MK Airlines)*), 10 April 2018
- LexisPSL Restructuring and Insolvency: Practice note: Waterfall of payments in liquidation – the position under the Insolvency (England and Wales) Rules 2016
- LexisPSL Restructuring and Insolvency: Practice note: Contracting out of expense claims in administration and liquidation – the position under the Insolvency (England and Wales) Rules 2016