



Hare Court chambers provides a wide range of advocacy and advisory services, both in the UK and internationally. We pride ourselves on our approachable and friendly outlook and our ability to build strong relationships with clients. Our barristers have received over 40 individual rankings covering 15 practice areas across the legal directories including Civil Fraud, Commercial Litigation, Insolvency and Travel.

Authors Natasha Jackson and Peter Knox QC

Validation orders require more than good faith: a review of *Express Electrical Distributors Ltd v Beavis and Ors* [2016] EWCA Civ 765

KEY POINTS

- A validation order will only be justifiable if special circumstances exist to prove that a disposition made after the presentation of a winding up petition is for the benefit of the general body of creditors.
- An ordinary business transaction made in good faith will not in itself be sufficient to justify validation, even if it was entered into without the applicant's knowledge of the winding up.
- The applicant must satisfy the court on the evidence that the disposition is likely to be in the creditors' interests.

BACKGROUND

Express Electrical Distributors Ltd ('Express') is a company trading in wholesale electrical goods. Since 2011, Edge Electrical Ltd ('Edge') was a customer of Express, purchasing goods on credit in the course of their business installing electrical equipment in high value properties.

Express became concerned about disruptions to Edge's monthly payments from April 2013, and on 17 May 2013 the company decided to put Edge on credit hold until a substantial payment was made. Edge subsequently made a payment of £30,000 on 29 May 2013, which more than covered all invoices falling due in May. Express lifted the credit hold following this payment and continued to supply goods to Edge of significant value from 30 May to 19 June 2013.

Unbeknownst to Express, a petition to wind up Edge had been presented by another of the company's creditors on 22 May 2013, shortly prior to the £30,000 payment being received. This petition was first advertised on 17 June 2013, and the company was subsequently wound up on 15 July 2013.

The liquidators of Edge wrote to Express in December 2013 demanding repayment of the £30,000 in order to distribute it between the company's general body of creditors,

pursuant to s 127 of the Insolvency Act 1986 (IA 1986).

The case on appeal challenged the first instance decision of District Judge Obodai, upheld in the High Court by HHJ Hodge, declining to make the validation order sought by Express in relation to this payment.

STATUTORY STARTING POINT

Section 127 of the IA 1986 provides that:

'In a winding up by the court, any disposition of the company's property, and any transfer of shares, or alteration in the status of the company's members, made after the commencement of the winding up is, unless the court otherwise orders, void.'

When a company is wound up following a petition, the commencement of the winding up is taken (according to s 129(2) of the IA 1986) to be the date that the petition was presented.

As the winding up of Edge commenced on 22 May 2013, the payment of the £30,000 after this date would fall to be returned to the company for distribution among the creditors, unless the court exercised its discretion under s 127 to make a validation order permitting otherwise.

PARI PASSU

Sales LJ, giving the leading judgment, considered the principles underpinning the exercise of this s 127 discretion.

These principles were examined in the judgment of Buckley LJ in *In re Gray's Inn Construction Co Ltd* [1980] 1 WLR 711, CA, a case concerning a retrospective validation order sought by a bank under s 227 of the Companies Act 1948 (s 127's identical predecessor). In that case, the applicant bank had continued lending to a company following the presentation of a winding up petition by another of the company's creditors. The company continued trading during this period, but it later became clear that this was at a loss.

Buckley LJ emphasised that the basic foundation for the law governing liquidation is the *pari passu* principle: that the 'free assets of the insolvent at the commencement of the liquidation shall be distributed rateably amongst the insolvent's unsecured creditors at that date'. The court should only deviate from this principle and grant a validation order when 'special circumstances' render it beneficial to the company and its creditors that the company should be able to make certain disposals.

Explaining *Gray's Inn Construction*, Sales LJ outlined examples of when the court may be justified in making a validation order. He suggested this would be appropriate if the payment would enable the company to complete a particular contract for which the eventual profits will exceed the outlay. Validation may also be justifiable if a disposal would allow the company to carry on the ordinary course of business, although this will

Biog box

Natasha Jackson is a new tenant at 3 Hare Court and joined chambers as a pupil in 2015. Peter Knox QC is an experienced advocate in Commercial, Chancery, Professional Negligence, Property, and Constitutional and Administrative Law. He has been head of Chambers since 2013 and has since continued to have a strong presence in all these practice areas in the High Court, the Court of Appeal and the Privy Council. Email: natashajackson@3harecourt.com and peterknox@3harecourt.com

involve more speculation as to whether this is desirable for the general body of creditors; desirability will normally depend on whether the sale of the business as a going concern will likely be more beneficial than a break-up realisation of the company's assets.

FINDING FAITH

The appellant sought to argue that there is another basis for making a validation order: good faith. Unless there are grounds to suspect that a transaction was made in an attempt to prefer one creditor above the general body, it was submitted that the court should validate a good faith disposition made in the ordinary course of business at a time when the parties are unaware a petition has been presented.

The appellant's submission was founded upon a statement from Buckley LJ at p 718F-G in *Gray's Inn Construction*. However, Sales LJ considered that the 'muted' phrasing suggests he did not intend to lay down a binding rule, and that the expression was strongly caveated so as to be easily displaced. Furthermore, the authorities cited to support this proposition did not, upon the Court of Appeal's review, stand in support of the statement articulated from them. The strong assertion of the *pari passu* principle throughout that judgment overwhelmed this inconsistent comment.

The court did consider whether the Court of Appeal decision in *Re SA & D Wright Ltd; Denney v John Hudson & Co Ltd* [1992] BCC 503 could support the appellant's proposition. In *Denney*, the court gave weight to the finding that the dispositions had been in good faith in the ordinary course of business when deciding to validate the transactions. Sales LJ was not persuaded; he found that the court in *Denney* properly considered whether the transactions had benefitted the general body of unsecured creditors when making the orders, which were justified on the findings of fact.

CLARIFICATION

Sales LJ's conclusions are clear:

"The true position is that, save in exceptional circumstances, a validation order should only be made in relation to

dispositions occurring after presentation of a winding up petition if there is some special circumstance which shows that the disposition in question will be (in a prospective application case) or has been (in a retrospective application case) for the benefit of the general body of unsecured creditors, such that it is appropriate to disapply the usual *pari passu* principle.' [56]

WAS THE PAYMENT IN THE INTERESTS OF EDGE'S CREDITORS?

The Court of Appeal upheld that the 'special circumstances' threshold was not met in *Express v Beavis*.

Drawing an analogy to the facts of *In re J Leslie Engineers Co Ltd* [1976] 1 WLR 292, the court found that, since the goods to which the £30,000 payment related had already been delivered to Edge and were therefore already available for use in the business regardless of payment, the payment itself was not in the interests of the general body of creditors.

Moreover, there was no evidence demonstrating the purpose of the £30,000 payment, that Edge had obtained any benefit from it, or that any supplies received from Express post-payment secured any particularly profitable contracts benefitting the overall body of creditors. There was also nothing to support an objective to sell the business as a going concern.

The extent of the evidence was that Edge wanted the goods in order to continue its business generally, in the long-term hope that its position might improve. This, in the eyes of the court, was simply not 'special' enough.

A REMAINING WRINKLE

The Court of Appeal was clear in the view that *pari passu* remains the governing principle, even in retrospective claims where the parties were unaware at the time of the transaction that the petition had been presented. But Sales LJ went on to provide some interesting thoughts on the differing range of evidence available in prospective or retrospective applications.

Although the case on appeal didn't require ruling on this point, he raised the

question of whether the court should assess a retrospective order as though it had been asked for at the time of the transaction, or whether the benefit of hindsight ought to be used when exercising the discretion (the option seemingly preferred in *Gray's Inn Construction*).

CONCLUSIONS

This judgment has helpfully refined the law on how the discretion under s 127 operates. It makes clear that retrospective validation will not be available simply because a disposition was made in good faith in the course of business, entrenching the *pari passu* principle as the guiding light in liquidation and affirming that the interests of the general body of creditors reign dominant. But this case is not the final say on the matter. Questions remain in relation to how the evidence should be approached in retrospective claims that await resolution in an appropriate case.

Notably, the findings in *Express v Beavis* also underscore a critical point of practice. To get an order, the applicant must prove – with evidence – that the disposition has or will benefit the general body of creditors. If the basis of the application is that the transaction was to enable a contract to be fulfilled, it must be demonstrated that this would be profitable enough to outweigh the payment; if the order is sought to facilitate the sale of the company as a going concern, the applicant must prove that this sale would be of greater benefit to the creditors than a break-up.

The law has been cleared up, but the threshold for justifying validation under s 127 remains high. It is incumbent on the applicant to make out their case. ■

Further reading

- LexisPSL Restructuring and Insolvency: Practice notes: Validation orders – dispositions of property after commencement of winding up
- LexisPSL Restructuring and Insolvency: Checklists: Application for a validation order for a company – checklist
- Case reporter: *Wilson (as liquidator of 375 Live Ltd) v SMC Properties Ltd* (2015) 4 CRI 171