CHALLENGING TRANSACTIONS AT UNDERVALUE

Joint Liquidators of Grampian Maclennan's Distribution Services Limited v. Carnbroe Estates Limited 2020 SC (UKSC) 23

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Facts

1. Grampian MacLennan's Distribution Services Limited ("the Company") carried on business in the provision of haulage and distribution services. Until July 2014 it was controlled by two shareholders who were husband and wife and who were by then about 70 years of age.

2. It carried on business from subjects at an Industrial Estate in East Kilbride ("the Property").

3. The Company purchased the Property in August 2005 at a price of £630,000.

4. The Company obtained loan facilities from National Westminster Bank plc ("NatWest"). It granted a standard security over the Property and a bond and floating charge over its assets in favour of NatWest.

5. In March 2013 DM Hall were instructed to provide a valuation of the Property. They valued it at £1.2m, with that valuation falling to £800,000 if a restricted marketing period of 180 days was to be assumed.

6. By 2014 the buildings were described as "somewhat tired" in appearance and in need of further maintenance, repair and upgrading. Those works included rewiring and removal of asbestos. There was diesel contamination of the yard.

7. By 2014 the Company was in financial difficulty. In May 2014 the director consulted an insolvency practitioner as to whether he should place the Company in members' voluntary liquidation. On the assumption that the 2013 DM Hall report was accurate, the director believed that the sale of the property would allow the Company to pay its creditors in full and make a distribution to its shareholders.

9. No MVL was pursued, presumably because of doubt as to whether a sale could be achieved quickly enough or at a sufficient price. In June 2014 Mr and the shareholders sold their shares in the Company to a Mr Quinn, who became the sole shareholder and director. Mr Quinn purchased the shares in full knowledge of the Company's financial difficulties and in the hope that he could turn it around. It had valuable contracts, including for provision of distribution services to Cadbury and Tesco.

10. As at the date of Mr Quinn's acquisition of the shares, the Company's principal creditors were NatWest and ("HMRC"). Its total liabilities marginally exceeded £1m. Substantial sums were overdue to HMRC. Monthly loan repayments of about £4,600 were due to NatWest.

12. Shortly after Mr Quinn's acquisition of the shares the Company's invoice financing facility was withdrawn. Mr Quinn was unable to identify any alternative source of funding. The Company was unable to continue to trade. It was unable to continue to

service its borrowings. The NatWest facility fell into arrears. NatWest threatened to call up its security.

13. Mr Quinn arranged for the disposal of the Company's fleet of trucks. The trucks had been acquired on hire purchase. Their disposal produced little or no return to the Company but did reduce its outgoings significantly.

14. Carnbroe carries on business in property investment. It is controlled by a Mr Gaffney. As at 2014 he and Mr Quinn had known each other for a period of more than thirty years. They had had previous business dealings.

15. A negotiation ensued between Mr Gaffney and Mr Quinn in respect of the proposed purchase of the Property by Carnbroe.

16. Carnbroe was the only prospective purchaser to express an interest in the period between June and August 2014.

17. Mr Gaffney was aware of the Company's financial difficulties. In the course of the negotiation with Mr Quinn he intimated that he might prefer to wait for the Property to be repossessed and seek to purchase the Property from the heritable creditor or insolvency practitioner. The market for that type of commercial property was fairly flat.

18. A price of £550,000 was agreed. Mr Quinn considered this the best price that could be obtained for an immediate sale. He considered the price to be discounted to reflect the

Company's distress, its requirement for funds urgently, and its lack of alternative means of swift realisation. He considered that it was better to obtain a quick sale and to repay NatWest than to allow arrears to accumulate. He considered that the alternative to an immediate sale was repossession by NatWest. Since the Company could no longer service the NatWest borrowing default rates and compounding would apply.

19. Carnbroe sought loan finance from the Bank of Scotland for the purchase of the Property. The bank instructed DM Hall to value the Property. DM Hall confirmed their 2013 valuation of £1.2m reduced to £800,000 on the assumption of a restricted marketing period of 180 days.

20. Solicitors acting for the Bank of Scotland queried the discrepancy between the proposed price of £550,000 and the DM Hall valuation. By email of the same date Carnbroe's solicitor replied that the price had been discounted to reflect the Company's distress and in particular the pressure for repayment of the NatWest loan and the lack of any extended marketing period. Carnbroe's solicitor indicated that he had spoken to DM Hall who had indicated that the stated assumptions in the valuation report did not apply in these circumstances. DM Hall subsequently confirmed that advice by letter to Carnbroe's solicitors.

21. On 18th August 2014 Carnbroe's solicitors paid £473,604.68 directly to NatWest. In exchange NatWest delivered a discharge of the standard security over the Property. The Company disponed the Property to the appellant. The consideration was stated as £550,000. The disposition was delivered notwithstanding the stated purchase price not having been paid in full.

22. The balance of the stated purchase price was not paid until June 2016, after litigation had commenced.

23. One of the joint liquidators, Mr MacDonald, was appointed as provisional liquidator on 12th September 2014. He and his then colleague, Ms Coyne, were appointed as joint liquidators at a meeting of creditors held on 21st November 2014.

The Litigation

24. The liquidators raised proceedings for reduction of the disposition on the basis that it was at an undervalue all in terms of s242(34) of the Insolvency Act 1986. The relevant provisions are as follows:

> (4) On a challenge being brought under subsection (1), the court shall grant decree of reduction or for such restoration of property to the company's assets or other redress as may be appropriate; but the court shall not grant such a decree if the person seeking to uphold the alienation establishes—
> (a) ….
> (b) that the alienation was made for adequate consideration, or
> (c) ……
>
> Provided that this subsection is without prejudice to any right or interest acquired in good faith and for value from or through the transferee in the alienation.

Lord Woolman heard a short proof in the Commercial Court. An expert surveyor instructed for Carnbroe assessed the open market value of the Property as at the date of the transaction at £740,000. An expert surveyor instructed for the joint liquidators assessed the value at £820,000. In each case the valuation was made on the assumption of a bargain between willing seller and willing buyer at arm's length, with a proper marketing period and no element of compulsion. Both expert surveyors considered that a discount of 25-30% would be acceptable if there were a restricted marketing period and that a further discount might well be anticipated under "more stringent marketing conditions". As Lord Woolman recorded the evidence no one would have batted an eyelid at the prospect of a distressed sale of the type that had happened achieving £550,000.

The commercial judge's decision

25. The commercial judge directed himself as to the test of adequacy in the following passage ([2017] CSOH 8 at paragraph [6]):

> "[6] What constitutes adequate consideration? That question has been considered in a number of authorities: *Macfadyen's Trustee v MacFadyen 1994 SC 416* ; *Lafferty Construction Ltd v McCombe 1994 SLT 858* ; *Jackson v The Royal Bank of Scotland plc 2002 SLT 1123* ; and *Joint Administrators of Questway Limited & Ors v Stonegale Limited 2015 SCLR 619* . The test is an objective one. The defender need not establish that the consideration was the best that could have been obtained. It must, however, be not less than would reasonably be expected in the circumstances if the parties were acting in good faith and at arm's length. Put short, the court enquires whether the transaction was a commercial one. If the answer is yes, then the consideration is presumed to be adequate."

26. The commercial judge's conclusion on the issue of adequacy was expressed in the following terms (at paragraphs [30] to [32]):

> "[30] I conclude that Carnbroe has established that £550,000 did constitute adequate consideration for the property. While the purchase price fell short of the open market value, Grampian had very limited options. It was in a perilous financial position. It could not afford the leisure of a lengthy marketing period. Natwest was threatening to call up the standard security and to use other diligence against it in terms of the bond and floating charge it held. There was no other offer on the table. The earlier expressions of interest were just that. There was no solid proposal to accept.

> [31] Carnbroe's offer presented an opportunity to obtain a quick sale. To place the property on the open market would have involved significant expense. There would have been advertising costs and an estate agency fee of 1% to 1.5%. There was no clear indication that a sale would be achieved within the standard marketing period of 12 to 24 months. According to the surveyors' evidence, a stigma can attach to a property that remains on the market too long. It might be the subject of vandalism."
>
> [32] Mr Quinn and Mr Gaffney were not 'associates' in terms of the legislation. Nevertheless their long business relationship justifies very close scrutiny of the transaction. Both independent surveyors said that a price of about £555,000 *(sic.)* was not unusual or inappropriate if the property had been marketed on a closed basis for a period of six months. Mr Prentice said that if the open market valuation was taken to be £740,000, then in respect of the agreed purchase price "ordinarily I don't think it would raise an eyebrow."

27. That conclusion may be seen as having four component parts. The first is a series of subsidiary findings made on the evidence. These were (a) that Grampian could not afford the luxury of a lengthy marketing period, because it could not service its borrowings or pay other creditors; (b) that NatWest was threatening enforcement action; (c) that there was no other offer on the table, the earlier expressions of interest not having been pursued; (d) that there was doubt as to whether a sale at full value would be achieved in 12 or even 24 months of marketing; (e) that there were costs associated with a marketing process; and (f) that there were risks associated with a lengthy marketing period.

28. The second part of the reasoning is an assessment of Grampian's realistic options, consequent upon the primary findings in fact. That assessment is that Grampian's choice was not between the Carnbroe offer and a conventional marketing process, but between the Carnbroe offer and a forced sale, either by NatWest in exercise of its security rights, or by an administrator or liquidator, whether appointed by NatWest or by the court following a creditor petition.

29. The third part of the reasoning is a finding on the evidence that if the property was marketed on a closed basis (that is following cessation of trading) for a period of six months a price of £550,000 was neither unusual nor inappropriate. That is a specific finding of the consensus of opinion between the two expert surveyors who gave evidence.

30. The final part of the reasoning is the conclusion that in the foregoing circumstances the statutory test of adequate consideration had been met. Implicit in that conclusion is that there was insufficient basis for confidence of any better outcome being achieved by any alternative course of action.

31. There was however a sting in the tail for Carnbroe. Because it had not paid the full £550,000 price and had only paid the balance two years late after litigation had commenced the joint liquidators had been justified in raising the action, and so they were awarded the expenses notwithstanding Carnbroe's successful defence.

The First Division's decision

32. The joint liquidators reclaimed. First Division (The Lord President (Carloway) and Lord Drummond Young and Malcolm) reversed Lord Woolman's decision: 2018 SC 314. The Division endorsed the commercial judge's general analysis of the meaning of the provision, and quoted with approval the dictum of Lord Cullen in *Lafferty Construction* that is closely paraphrased by the commercial judge. The Division nevertheless reversed the commercial judge. The Division identified the issue in the following terms (at paragraph 23):

> "… in any case of a forced sale that is driven by the need for liquidity the price obtained is likely to be less than the full market price that would be obtained through an ordinary sale in the open market without any element of compulsion. Thus any such sale is likely to be prima facie at an undervalue. The critical question for present purposes is how such a sale should be treated for the purposes of sec 242 of the 1986 Act, and in particular in determining whether the sale at an undervalue constitutes 'adequate consideration' within the meaning of sec 242(4)(b) . In particular, is the circumstance that the sale is forced, driven by the seller's need to maintain liquidity, a factor in assessing the adequacy of consideration?"

33. The Division answered that question in the negative. The starting point in the Division's reasoning was that the insolvent company is in the position of trustee for its creditors and obliged to manage its affairs with their interests in mind. An aspect of that duty is a duty not to alienate its assets other than in return for "full consideration" (see paragraphs [13] and [14]). The protection of creditors and the policing of that duty is the fundamental rationale for section 242. Having regard to those factors "the courts should take a relatively strict view of the adequacy of consideration." (paragraph [24])

34. The Division acknowledged that it might be legitimate to discount for an urgent sale in order to address a pressing requirement for liquidity if that was necessary to ensure the continuation of the business, but held that such discounting was not permissible where there was no prospect of salvaging the business. The conclusion (at paragraph [25]) was as follows:

> "[25] Furthermore, if the debtor's business is about to come to an end, the need for a forced sale to maintain the liquidity of the business and hence its continuation simply disappears. In that situation the company or other entity carrying on the business should observe the general policy of the law of insolvency by giving paramount importance to the interests of creditors as a body; in other words, considerations based on insolvency should prevail over the need for payment of debts as they fall due. In such a case, if a sale of assets is necessary in order to pay creditors, the sale does not require to be a forced sale, because the urgent payment of debts has ceased to be a relevant consideration. Instead, assets may be disposed of in the normal way, with appropriate marketing and advertising and time for potential purchasers to reach

a considered view about the property that is for sale. For these reasons we are of opinion that the need for a forced sale to provide immediate liquidity is not normally a factor that should be taken into account in determining the adequacy of consideration obtained for a sale of the debtor's assets in any case where the debtor has ceased business or is about to cease business. In that event the continuation of the business will not be part of the consideration for the sale because the business is not going to continue. That is the normal situation, although we accept that there might be exceptional cases where the payment of a particular debt as a matter of urgency is necessary in order to protect the general interests of the creditors. For example, it might be that a sale at an undervalue enables an important debt to be paid with the result that formal insolvency procedures are avoided. Such cases will be exceptional, however, and will turn on their specific facts. We observe that we see nothing exceptional in the present case, where Grampian's financial difficulties were major."

The Appeal to the Supreme Court

35. The Inner House refused leave but the Supreme Court granted it. The principal argument on appeal was that transactions involving distressed sellers are commonplace. The decision of the First Division would have wide ranging consequences for any party transacting with a distressed seller, and might render many completed transactions vulnerable to reduction. In particular, the decision would lead in practical terms to the imposition of an onerous requirement on the part of a prospective purchaser to make much more wide ranging inquiry of the seller. Moreover the distinction drawn, between legitimate discounting for distress where there is scope to save the seller's business, and illegitimate discounting where there is not such scope is unlikely to be susceptible to robust assessment by prospective purchasers. The purchaser can rarely know what is going on with the seller's business and the seller can hardly be expected to disclose it. The policy of the law ought to facilitate transactions rather than impede them. Where it is thought, after the event, that a seller's conduct in discounting an asset for sale is

worthy of criticism that is more appropriately pursued by action against the directors than against a purchaser.

36. The original focus of this argument was in the approach that the courts ought to take to assessing adequacy of consideration. The approach of the Australian courts was commende. In Australia, the test for identifying a transaction that might be set aside as being at an undervalue has been stated as "whether there was a bargain of such magnitude that it could not be explained by normal commercial practice.": see *McDonald & another v. Hanselmann* (1998) 28 ACSR 49 per Young J at p53, under reference to *Demondrille Nominees Pty Ltd v. Shirlaw* (1998) 27 ACSR 535. The argument was that so draconian were the consequences of reduction of the disposition and so difficult was it for a purchaser to make a reliable assessment that a generous margin should be afforded before the Court intervened.

37. The Court was evidently troubled by the practical application of Lord Drummond Young's analysis and the likely deterrent effect on rescue transactions. But it was equally unsympathetic to what was obviously a decree of sharp practice or sailing close to the wind on the part of Carnbroe. The solution was to take a step back in the analysis. The joint liquidators pursued reduction informed by a view of the law derived from the decisions in *Short's Tr v. Chung* 1991 SLT 472, *Cay's Tr v Cay* 1998 SC 780 and *Baillie Marshall Ltd (in liquidation) v. Avian Communications Ltd* 2002 SLT 189. The import of those decisions was that reduction of the challenged transaction was the primary remedy and the provision in s242 permitting to the Court to grant "other redress" did not open up any general equitable jurisdiction. The Court called for further submissions on whether those cases were correctly decided.

The unfair consequences of reduction

38. The construction of the section derived from *Short's Trs* has anomalous results in practice. Compare four examples. First, if the recipient of heritable property disponed for no consideration at all still holds it when the liquidator challenges then reduction is available. The liquidator would in that event receive that which the company should have received - the true value of the property - but no more. Secondly, if the same recipient sells the property on within a short time to a third party who pays full value in good faith then reduction is not available. The court would in that event grant "other redress" presumably in the form of an order against the original recipient to account to the liquidator for the true value of the property. The practical outcome is essentially the same as on reduction. Thirdly, if the transaction is one where a price is paid which is held not to be "adequate consideration", perhaps only by a narrow margin, the outcome is very different. If the recipient still holds the property reduction is available, and *Short's Tr* suggests that in that event it is not open to the Court instead to grant "other redress". The purchaser at undervalue is therefore dealt with more harshly than the recipient of a gift. The disposition is reduced and the purchaser ranks unsecured for the return of the price. The purchaser is very significantly worse off than if it had avoided the transaction altogether or if it had paid full value. The insolvent company is significantly better off. The creditors get a windfall. Fourthly, if the same purchaser sells on before the liquidator's challenge then reduction would not be open and the remedy would be "other redress". There is nothing in either the statutory wording or in any authority to suggest that in those circumstances the Court would require to order repayment of the gross onward sale price as "other redress" while leaving the purchaser to rank unsecured for the return of the original inadequate price. The only reason for such an outcome would be to treat such a purchaser equally with one liable to suffer

reduction. It seems obvious that the fair outcome would be an order to pay only the shortfall.

39. There is no reason to suppose that Parliament intended such anomalous outcomes. In particular in the wider context of substantial insolvency law reform directed at promoting a rescue culture it is inconceivable that Parliament intended to impose a significant deterrent to rescue transactions involving purchases from distressed businesses. The purchaser at undervalue is in a uniquely poor position. Not only must it rank as an unsecured creditor for return of the price, but it is in a worse position than other creditors because it is unable to rely on the doctrine of balancing of accounts in bankruptcy which would ordinarily allow a party which was both creditor and debtor of the insolvent company to set the liabilities off against each other.

Short's Trustee

40. The facts of *Short's Tr* were unusual. The properties in question were dilapidated and subject to a significant statutory repair notice. But they were located in an area of relatively high value property, and once refurbished were readily saleable. The debtor had purchased each flat very cheaply from a company that wished to be rid of the flats to avoid coming under obligation in respect of the repairs, and had sold them shortly thereafter to the defender's husband at a modest uplift of £1000 per flat, but still substantially below their market value. The defender had acquired them gratuitously from her husband. The trustee sought reduction and made no claim for "other redress". The defender failed to establish adequacy of consideration, the price actually paid being about a third of the true value. The defender submitted that reduction should be refused

and that “other redress” should instead be granted, in the form of an order for payment of the difference between the actual price and the market value. The Lord Ordinary declined to entertain that submission on the basis that the trustee sought only reduction with no alternative conclusion for “other redress” and the defender had not put “other redress” in issue in the pleadings.

41. The defender reclaimed. In the Inner House it was conceded that the consideration had not been adequate and the only issue was as to the appropriate remedy. The defender amended to put in issue the possibility of “other redress”. It appears that the principal argument was that the property had appreciated substantially in value, and it was said that the sequestrated estate would gain a windfall if the disposition were to be reduced. Although the Court did not say so in terms it seems reasonable to infer that the view was taken that there was nothing particularly inequitable about market appreciation accruing to the sequestrated estate rather than to the defender, presumably on the view that the sequestrated estate would equally have been liable to suffer market depreciation if that had occurred. The observations at p476J-L make clear that the Court had some difficulty with the proposition that a party to a transaction that had been vitiated was nevertheless entitled to claim the profit arising from the transaction.

42. Curiously, there is no mention of the more obvious argument: the inequity of the defender being unable to recover the original (inadequate) price, and therefore being worse off than of the transaction had never occurred. That however may be explained by the relatively unusual circumstances of the defender having received the properties entirely gratuitously and her husband, who had since died, having paid the price. It is

not clear from the report whether the defender even had title to seek repetition of the price; there is certainly no indication that that point was put in issue.

43. In these circumstances it is unsurprising that the Second Division should have been disinclined to order anything other than reduction. To the extent that the opinion of the Court went beyond the disposal of the case at hand it was *obiter*. There is no indication that the Court received full argument on the point. Given the absence of argument directed at return of the price it is not clear that the Court can properly be taken as having ruled out "other redress" in a situation such as the present where the purchaser had paid many hundreds of thousands of pounds.

44. *Cay's Trs* was a very different case on its facts. The alienation was of cash. The reasoning at p788D-G is, with respect, plainly unsound. It assumes the correctness of *Short's Trs* on a reading of the *ratio* of that case that is wider than is merited; and from that erroneous starting point proceeds to reason that because there is no discretion in respect of reduction or restoration of property then there must by parity of reasoning be no discretion in a case involving alienation of cash. On a correct construction of the section, with the Court being free to choose whichever remedy meets the justice of the case the difficulty does not arise.

45. The Supreme Court agreed. It overruled *Short's Trustee* and *Cay's Trustees.* It held that Carnrboe had not proved adequacy of consideration because although the correct comparison was with a sale by a liquidator or a heritable creditor Carnbroe, on whom the onus lay, had not established what price would have been achieved. The action was

remitted back to the Inner House to determine what remedy was appropriate. Predictably thereafter it settled (albeit settlement was finally agreed only today).

Conclusions

46. There are three conclusions. First in undervalue cases reduction will rarely be appropriate, unless accompanied by a refund of the inadequate price. Other redress in the form of a top up of the price is the more likely remedy. Secondly, purchasers should take proper advice and assemble proper evidence. It seems clear Carnbroe could have justified this transaction at this price or something close to it if it had taken a bit more care. Thirdly, if discounting for distress it is necessary to be able to establish in evidence the impact of the distress. That will generally come from evidence of the likely approach and corresponding costs and outcomes of a forced sale process.