

legal update

Your digest of recent chancery and commercial cases

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Bankruptcy Annulments

*Halabi v London
Borough of Camden
Council and others*
[2008]
All ER (D) 213 (Feb)

The recent decision in *Halabi* is likely to be an important decision with regard to bankruptcy annulments.

James Bailey (counsel for the applicant) summarises the effects of the case in this Special Edition of **legal update**.

Tim Akkouch (also of New Square Chambers) appeared for the trustee in bankruptcy.

Bankruptcy Annulments: the decision in *Halabi v London Borough of Camden Council and others* [2008] All ER (D) 213 (Feb)



James Bailey

■ Under Section 282(1)(b) of the Insolvency Act 1986 the court may annul a bankruptcy order if it at any time appears to the court:

“that, to the extent required by the rules, the bankruptcy debts and the expenses of the bankruptcy have all, since the making of the order, been either paid or secured for to the satisfaction of the court”.

■ Rule 6.211 of the Insolvency Rules provides:

“(1) This rule applies with regard to the matters which must, in an application under section 282(1)(b), be proved to the satisfaction of the court.

(2) Subject to the following paragraph, all bankruptcy debts which have been proved must have been paid in full.

(3) [Disputed debts and untraced creditors]”.

Although there are a number of annulment scenarios, a common situation is the bankrupt who simply failed to appreciate the significance of a bankruptcy petition and is in fact balance sheet solvent on account of

equity in a property that is now vested in the bankruptcy estate. Often a commercial lender will be persuaded to lend against this equity by advancing funds that are only to be used if the annulment is granted. The annulment has the effect of transferring the property back to the applicant such that security in favour of the lender can be effected.

A variation of the above can occur where the bankrupt, although balance sheet insolvent, manages to persuade a family member or friend to provide funding to pay the creditors together with the costs and expenses of the bankruptcy.

Whichever scenario arises, the creditors and trustee must be paid in full. However the court has a broad discretion in determining whether to make an annulment order, the exercise of which involves a consideration of factors beyond simply making these payments. The conduct of the bankrupt and public policy considerations are just two of the additional matters to which the court will have regard.

**Put simply ~
an annulment is
never a certainty.**

The requirement for payment of the debts causes a very considerable difficulty when the commercial reality of the annulment funding transaction is examined. The funder (whether a commercial lender or a family member) will not wish to pay off the creditors if the annulment is not ultimately granted since from the perspective of the applicant this amounts to throwing money down the drain. Once the money reaches the creditors, it is difficult to see a basis on which it could be recovered. The problem is that the court will require the creditors to be paid before it grants the annulment. The “chicken and egg” inter-relationship results in commercial deadlock.

There are two solutions to this deadlock that have been used in practice:

- (1) In *Engel v Peri* [2002] B.P.I.R. 961 Mr Justice Ferris held that, whereas the court could grant a conditional annulment order (he observed that that could be unwise since it could be unclear as to when, if at all, the annulment had taken place), a preferable solution was that the court could grant the order in unconditional form (the order would remain on the court file and would not be sealed by the court office until evidence had been produced showing that the trustee was satisfied that the bankruptcy debts had been paid);
- (2) The second solution is far more straightforward in its operation. The applicant’s

solicitors, having the lender’s funds in its client account, gives an undertaking to the court that upon the making of the annulment order, it shall forthwith pay the creditors and the trustee. This has been the standard practice in many county courts for some time.

Recently, however, concern with the undertaking option has been voiced by bankruptcy registrars of the High Court in London and they have refused to accept them. Presumably this is on the basis that the court does not have jurisdiction to make an annulment order in such circumstances.

That said, some applications for annulments heard in the High Court before Deputy Registrars have nevertheless been successful when supported by such an undertaking. The editors of *Muir Hunter* observe that the courts might not have jurisdiction to grant annulments based on undertakings.

In *Halabi*, the difference in practice between the county courts and the High Court was acknowledged by Registrar Jacques and the matter was referred to the judge for determination. Mr J.Jarvis QC (sitting as a Deputy Judge of the Chancery Division) heard the matter on 14th February 2008 and held that the combined effect of section 282(1)(b) of the 1986 Act and rule 6.211(2) of the Insolvency Rules was that the proved bankruptcy debts had to be paid and that it was not possible to construe the provisions as including a promise to pay even where that

promise was in the form of a solicitor’s undertaking. The applicant argued that the annulment jurisdiction pursuant to section 282(1)(b) was commercially vital, particularly with regard to the present economic climate. However there was also a real concern that the first stage of the Ferris J two stage process was not sufficient to protect a lender who typically required an annulment order before releasing, or permitting the applicant’s solicitor to release, the funds.

Can it be said that the first stage in *Engel* is an annulment order?

In *Halabi* the learned judge was sensitive to the predicament and affirmed the two stage process adopted in *Engel*. In response to an invitation from the applicant, he expressly stated in his judgment that the first stage was indeed an order of the court for an annulment and that it was simply taking effect in the future as permitted by CPR r.40.7.

In *Halabi* the order provided that it was not to be effective until the trustee confirmed the creditors had been paid, but provided that the “bankruptcy order . . . is hereby annulled”. The order was sealed shortly thereafter. Evidence of the order coming into effect was achieved by reference to an endorsement (attached to the order) which was to be separately sealed, but only upon confirmation from the trustee of payment.

The decision is to be welcomed in as much as it unifies High Court and County Court

practice, brings to an end the risk of annulment orders being made without any jurisdiction to do so, and provides a solution to the payment problem. However the solution is perhaps a little unexpected. If the first stage of an *Engel* order is indeed an order for an annulment, it is surely still the case that at the time of that order the bankruptcy debts have not been paid to the satisfaction of r.6.211(2).

Perhaps the best explanation is that the court has not annulled the bankruptcy at the first stage. Rather it has ordered an annulment to occur in the future (i.e. at the second stage).

Quite what a lender would make of this remains to be seen, but one does not have to work too hard to identify difficulties that should give solicitors acting for the applicant reason to be extremely careful in their relations with the lender.

In fact in *Halabi* the applicant put forward another mechanism to circumvent the deadlock as follows:

The trustee's solicitors give an undertaking to the applicant's solicitors that they will hold any funds paid over to the order of the applicant's solicitors. This should maintain the lender's position at that stage as the ultimate equitable owner of the funds. The trustee's solicitors indicate in this undertaking that, should an annulment order be made, they will cease to hold the money to the order of the applicant's solicitors the instant *before* the annulment order is made (thereby creating a *scintilla temporis*).

The argument is that as the court makes the annulment order, if it is minded to do so, it can rest assured that the creditors have been paid since the money is at that moment held to their order. The court rejected the argument that the trustee can properly be viewed as agent for the creditors, but accepted that if the trustee had obtained a letter from each creditor expressly appointing him or her as agent, the mechanism could work.

It is suggested that the *Halabi* agency scheme is perhaps as a matter of analysis neater than the two stage *Engel* process. However it is vulnerable to a practical difficulty ~ the consent to act as agent is required from every creditor. This is relatively straightforward where there are a handful of creditors in a recent bankruptcy, but it may be much harder where there are many.

The possible salvation comes from the fact that r.6.211(2) (the source of the difficulty since it requires payment) is confined to creditors who have *proved* such that the untraced creditors will not be relevant.

That said, in a very old bankruptcy (e.g. as in *Gill v Quinn* [2005] B.P.I.R. 129) creditors may have proved so as to fall under sub-rule (2), but still may not respond to the trustee's request for authorisation.

Whatever the best approach is, what can be said for certain is that county court practice is required to change, affecting bankrupts, their solicitors and insolvency practitioners across the country.

James Bailey was called to the Bar in 1999 and divides his time between insolvency and commercial chancery work. His practice has taken him to the United States, Italy, Hong Kong, Tokyo, the Bahamas and the Cayman Islands ~ where he is also called to the Bar.

He is recommended by the Legal 500 for his insolvency work and Chambers and Partners feature him as 'up and coming' in their insolvency and corporate recovery section.

James Bailey and Tim Akkouch are available to give presentations addressing the impact of *Halabi* and how to avoid various pitfalls in preparing for an application.

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