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Compulsory private examinations and the art of war: a potent weapon in the right hands

Mike Pavitt and Theo Anderton examine the proper use of sections 236 and 366 Insolvency Act 1986 in the modern era and urge IPs not to back off from using their powers for the wrong reasons.

Readers of *Recovery* will be well aware that the power to apply to the Court to compel reluctant (or downright uncooperative) parties to produce information and evidence on pain of arrest and/or prosecution has long been lauded as one of the most valuable investigative weapons in the office holder's armory. By any measure its potential is immense, affording us the opportunity to seek out and put together the missing or hidden pieces of a jigsaw which may allow us to turn a gross deficiency into a much more acceptable return for creditors.

By and large, the power has stood the test of time, despite in particular the rise of human rights legislation. Even the various Insolvency (Amendment) Rules of the past few years have left this jurisdiction largely untouched. On the face of it, the Court's discretion is unfettered, yet the actual *use* of this power before the courts, particularly by smaller practitioners, remains comparatively rare; it was far more conspicuous a decade ago than it is today. Like so many rights and remedies available to us over time, it has fallen into something of a rut.

An underused power

The power suffers from a perception among many insolvency lawyers that the relevant case law is now so well settled that the counter proposition (that an application would be oppressive or unnecessary) is generally arguable, and it is all too easy in that sense to advise that the IP cannot fairly be criticized if he elects not to proceed, particularly where the application would be unfunded. It also suffers from a perception among many IPs that it is a risky and/or expensive route to follow and that the applicant IP will more likely than not have to meet the costs from funds in hand which could have been better employed elsewhere. We believe that both these perceptions are wrong and, in large measure, self-perpetuating.

Owing largely to these perceptions, the weapon's edge has become rather dulled by disuse. Certainly it has been used to good effect on occasion in recent years, which of course supports the case for dusting it off now, but these are the exceptions rather than the rule. In the main, whilst the sabre is very often rattled, the mere threat of its use has become empty, such that it no longer strikes fear into the hearts of a well-advised director or third party, who perhaps rightly suspects that we have forgotten (if we ever knew) how to use it.

Lawyers have become so used to the threat of s.236, and particularly of s.366, a threat often uttered by IPs themselves before they have instructed lawyers and often at a premature stage of the process, that many no longer take those threats seriously. Rather they see them for what they often are; a fairly blunt device employed by someone with limited funds and no real intention of spending them, designed to 'shake down' the easy target.

There is of course absolutely nothing wrong with threatening the use of the power in appropriate circumstances. This is particularly so where there is a realistic prospect of producing the desired information or evidence without recourse to the courts; if we can persuade the other party to produce the documents, or

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to attend our offices for a transcripted interview, as the case may be, in most cases this would be the ideal outcome. It is in any event helpful, in terms of the recoverability of the costs of the application, to have given adequate warning that an application is coming. However, to be effective, these threats must be real and we must therefore also be ready and willing to follow through on them.

Time to break free

So how do we break out of the rut and start to use these powers to best effect, for the purpose for which they were designed? Our suggestion is that – as with real swordplay – we can best achieve this by a virtuous circle of three repetitive steps:

- prepare your tools;
- train yourself (with help if you need it); and
- put what you have learned into practice.

These steps, reinforced time and again as we grow in the confidence of our newfound abilities, should act to harden our steel, stiffen our sinews and improve our aim and knowledge of our opponents until we achieve mastery and the ability to deliver lightning-fast surgical strikes. As a consequence, when we put our hand to our hilt, most opponents should give way, few should oppose us and those who do should find it difficult to parry or avoid our strike, such that when we can hit home when we need to.

In other words, the goal is that when we threaten to make an application under section 236 or 366, most prospective respondents will co-operate, those who ignore us will face an application which is well constructed and well aimed and those who seek to deflect the application will nevertheless be subjected to an order and an examination which brings the results we seek, and hopefully an order for costs.

Step one: know your weapon

Before we even consider actually drawing the sabre, we need to know something about it. Is it actually fit for purpose? Can we trust the blade not to shatter when it meets resistance?

Sections 236 and 366 have a long and distinguished pedigree. They have existed in some guise or other since long before the birth of modern insolvency law, but they do not exist in a vacuum. They sit squarely within the context of international and European law, and in particular human rights law, in which field they have been tested both squarely (direct challenges under the European Convention on Human Rights) and obliquely (continuous application by the English courts notwithstanding the incorporation of the ECHR into English law more than a decade ago through the Human Rights Act 1998). Their long history of tried and tested compatibility with Convention rights is perhaps not wholly surprising when we consider that the Convention itself owed much to English draftsmen when it was first proposed in the post-war years, but it should be noted that the English courts' terminology in applying these sections since 1986 has (often subtly) drawn heavily from the language of the Convention and/or the jurisprudence of the European Court of Human Rights, to which, as a public authority, they are obliged to have regard.

Firstly, the courts have recognized that in applying the Convention it is appropriate to afford English law a wide *margin of appreciation*, meaning for example that the mere fact that a German national would not be subjected to compulsory private examination if adjudged bankrupt in Germany would be no reason to deprive his English trustee of the use of these powers if he were adjudged bankrupt here under the EC Regulation.

Secondly, the courts must give a *purposive interpretation* to Convention rights when considering them over time, so for example the use of compulsorily obtained evidence in subsequent criminal proceedings became generally unacceptable over time as prevailing attitudes changed. This is of course reason enough not to allow ourselves to become too narrow minded when applying English case law precedent to section 236 or 366 situations; we should also be alive to Strasbourg case law and any departures it takes over time.

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Finally, the courts have to ensure that we strike a *fair balance* between the demands of the general interest of the (European) community and the requirements of the protection of the individual's fundamental rights. In practice this means that interfering with those rights is acceptable *provided* the interference can be justified as:

- lawful
- serving a legitimate purpose
- necessary in a democratic society, and
- proportionate.

These tests have been applied rigorously over the years and the powers of compulsory examination have consistently passed scrutiny (for a recent example see the s.366 case of *Rottmann v Brittain* [2009] EWCA Civ 473). Indeed, the class of accepted legitimate purposes have even been expanded in recent years (see for example the s.236 case of *Re Pantmaenog Timber Co Ltd* [2004] 1 AC 158). The safeguards which the courts can apply in terms of restricting the use to which compulsorily obtained evidence may be put are often cited as justification for the broad scope of the powers.

We can be confident, therefore, that as and when the Court grants us an order under s.236 or s.366 it is unlikely to be susceptible to challenge on the basis that the law behind the order is unsound.

Step two: it's how you use it

Even the surest of blades will be useless unless we also learn how to wield it, and how not to hurt ourselves in the process.

The parties entitled to use the power are a liquidator (including a provisional liquidator), an administrator, an administrative receiver or a trustee in bankruptcy. Some IPs will be very experienced at doing so, others will need training and/or guidance. All would do well, however, before embarking on a new application to remember the basic principles, starting with the recognized legitimate purpose for which we are entitled to use the powers.

The best statement of the legitimate purpose, cited with approval by the House of Lords in *Re British & Commonealth Holdings plc* [1993] AC 426 remains that of Buckley J in his 1968 judgment of *In re Rolls Razor Ltd*, which can be summarized as follows:

- to help the office holder "discover the truth" of the circumstances of the insolvent entity in order that he can, "as effectively as possible and… with as little expense as possible… complete his function"
- to put the affairs of the insolvent estate in order
- to identify and recover assets, and
- to discover facts surrounding potential claims, including claims against the potential respondent to the application.

As a starting point, therefore, whilst we will often be employing these powers against third parties, we should have no qualms about employing them against people who we think owe the insolvent entity an explanation for their conduct and against whom proper claims may well lie in due course.

Over time, the courts have also added to that list these additional, perhaps less obvious, legitimate purposes:-

- to reconstitute accounting or other business records
- to obtain information from third parties to enable contracts to be completed, and
- to investigate the causes of failure and the conduct of the respondent in contributing thereto with a view, for example, to disqualification proceedings.

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Getting a good footing

The skilled applicant will recognize the importance of good footwork; ensuring that the applicant is in exactly the right position vis-à-vis his opponent to make his strike. He will recognize that the application asks the court to make a delicate judgment between the competing interests of an office holder in requiring information and/or documents and the need not to impose an unnecessary and unreasonable burden on any respondent. He will know that factors such as inconvenience, the burden of work upon a respondent or potential exposure to future claims are not a bar to the making of an application, but that they are relevant factors to be taken into account when deciding whether an order should be made. He will appreciate that the more distant the connection between a respondent and the insolvent, the greater the justification he will be required to produce in order to obtain an order.

The skilful applicant will therefore have done a good deal of preparation before the application is issued, pursuing all appropriate and/or proportionate lines of investigation first in order that he can push off from firm ground by demonstrating to the Court why the balance should be struck in his favour. He will normally have given an appropriate level of advance notice to the respondent and flushed out and/or dealt with any potential defences, such as privilege. The unskilled applicant, by contrast, may get his footwork all wrong, either slipping on soft earth (e.g. by applying for the production of documents with the purpose of the insolvent entity benefiting from work done to which it would not have been entitled but for the insolvency, as in *Colishaw v O&D Building Contractors Ltd* [2009] EWHC 2445 (Ch)) or by flagging his strike prematurely (eg by betraying a settled intention to pursue before he has all the information).

Making your strike

The strike itself is all about timing and accuracy. If the applicant moves too fast or too soon (e.g. by issuing when he could easily and/or at lower cost have obtained some or all of the information from elsewhere) he will lose his balance and the strike will easily be deflected. If he misses his aim (e.g. by failing to follow the Rules on service of the order before an arrest warrant is issued, or applying against the wrong party), he will lower his guard and be exposed to a counter-strike (e.g. an order for costs).

A careful application itself should usually be made by way of a Form 7.1A application (whether or not there is an existing insolvency proceeding actually on foot before the Court). The application and supporting evidence should sufficiently identify the respondent and specify the order sought, including whether it is for an oral examination, clarification/additional information, a witness statement (with details of the matters the witness statement is to cover) or for production of books, papers or other records (in which case they should be specified). Merely requesting indiscriminately an account of all dealings by the respondent with the insolvent company/bankrupt will not suffice.

The application may be accompanied by others (where proper grounds exist) for ancillary orders in the form of interim injunctions, such as a “no say” injunction (restraining the respondent from disclosing the order to third parties), an order restraining the respondent from leaving the jurisdiction pending examination, or a search and seizure order. The skill in making a good application will often be shown in how the applicant puts together and presents his evidence in support, whether he includes a separate annex confidential to the Court, and whether he elects to apply with or (exceptionally) without notice.

Step three: know your opponent

Every new opponent deserves respect and differing opponents demand a slight variation in style. Some may oppose the application because they simply cannot be bothered to engage with you, others have something to hide, whilst still others have statutory or other duties which may make it difficult for them to co-operate without a court order. Even an inexpert swordsman will typically defeat an unarmed man, but an unarmed man may employ a hired blade, such as another IP or solicitor, or if he is himself very skilled and/or experienced he may avoid the strike and turn the weapon around. Likewise, an armoured opponent will feel only the best aimed strike. The applicant must be wary of these special cases and plan his attack accordingly.

The respondent in the case of an application pursuant to s. 236 IA 86 can be any officer of the company, any person known or suspected to have in his possession property of the company or supposed to be indebted to the company (including former or concurrent office holders), and any person the Court thinks capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the

company. In the case of an application under s.366 IA 86 the respondent can be the bankrupt, any current or former spouse or civil partner, any person known or suspected to have in his possession property of the bankrupt or supposed to be indebted to the bankrupt, and any person the Court thinks capable of giving information concerning the bankrupt's dealings, affairs or property. Persons include corporations (or a proper officer thereof) and some of the commonest entities facing applications are banks, auditors and solicitors. The Crown can also be a respondent.

Banks and solicitors in particular may, in certain circumstances, have legitimate concerns about confidentiality which should not be dismissed lightly. Often both will offer to co-operate with the applicant so long as they are compelled to do so by court order, and so long as suitable wording for the proposed order can be agreed, they will often take a neutral stance. The concerns of the respondent the applicant may need to address to avoid a failed application and/or facing costs against them include:

- a desire to limit the scope of the order sought in the first instance to documents, whilst reserving the right to apply back for oral examination once the documents have been considered
- a desire for the documents or classes thereof sought to be specified with particularity
- a concern that the documents sought are particularly voluminous, in which case their production might be sought and ordered in stages
- the need to exclude from the order sensitive information including evidence of criminal activity and/or money laundering reports. Respondents have a legitimate concern that staff should not be deterred from giving advice to those who have, or may have, committed offences and/or making full and frank internal reports, by the possibility that such reports (or the information which they contain) may be disclosed to third parties, or used in later civil proceedings, and
- where the cost of compliance with any order made is likely to be significant, the question of how the respondent's reasonable costs of compliance are to be met, and the applicant should be prepared to explain to solicitors that their duty of confidentiality in cases involving insolvent clients does not require their firm to bear the costs of opposing a court application without the client's instructions and funding.

In conclusion

The insolvency profession seems to be under every increasing scrutiny, from the OFT and elsewhere, and the expectation is that it must show value to creditors, particularly unsecured creditors. One way of demonstrating value is by results, and there is no question that the judicious use of compulsory examination powers can and does yield increased returns. In terms of the use of the powers to provide evidence in support of claims, very often the process will yield, at relatively minor cost compared with the cost of funding a full-blown piece of litigation, the evidence which will justify to solicitors, counsel and after the event insurers that a claim can properly be pursued on a conditional fee basis. It is therefore a route to securing access to justice for creditors.

Whilst an IP may think they are delivering value by minimising expenditure on investigations, very often the cost of a well planned court application, or well placed threat of such an application is not dissimilar to the time cost applied to the file pursuing reams and reams of often fruitless correspondence; fruitless, very often, because it is also toothless.

In some cases, creditors will perceive that they have obtained value merely because directors or other respondents have been put through the ringer and forced to account for their actions; in appropriate cases, these examinations may yield evidence which the Secretary of State can use to secure a disqualification. As a profession, IPs often complain that not enough is done to bring poor management to book and/or to take rogue directors off the streets; following *Re Pantmaenog* (supra) issuing appropriate applications under s. 236 is a legitimate way in which the profession can potentially contribute to this process, especially in the current environment where pressure upon the public purse is growing as never before.

We hope we have demonstrated by the above analysis that the more frequent use of these powers will increase their effectiveness, not just in terms of the overall number of applications, but in terms of the impact of each one on a case by case basis. If we have convinced you, we look forward to meeting you on the field of battle!

Contact

For further information or advice, please contact:

Mike Pavitt	E: mike.pavitt@bllaw.co.uk	T: 023 8085 7028
Theo Anderton	E: theo.anderton@bllaw.co.uk	T: 020 7814 6916

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