

Annual Review of
Insolvency & Reconstruction Law 1999

*Allen Allen
& Hemsley*

ALLENS
ARTHUR ROBINSON
GROUP

LAWYERS

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The summaries published in this review do not seek to express a view on the correctness or otherwise of any court judgment. This publication should not be treated as providing any definitive advice on the law. It is recommended that readers seek specific advice in relation to any legal matter they are handling.

PREFACE

Allens is one of Australia's most successful commercial law firms. As a member of the Allens Arthur Robinson Group, Allens is part of one of Australia's largest groups of lawyers with over 180 partners and 650 other legal staff.

Group members have offices in Sydney, Melbourne, Brisbane, Perth, Adelaide and the Gold Coast, and the Group's International Network operates from Singapore, Hong Kong, Jakarta, Port Moresby, Shanghai and Bangkok.

We are pleased to be able to offer this publication as part of Allens' service to clients with an interest in corporate insolvency and reconstruction law. This publication contains the first of what is intended to be an annual review of relevant case law in the area. We have not included any material on personal insolvency issues. The aim of the publication is to contain, in a single user friendly booklet, an outline of those cases which we believe would be of interest to clients.

You will see that most of the decisions are those of Australian courts but we have included some particularly relevant English decisions. Although the publication is mainly concerned with decisions made in 1999, reference is also made to a number of important decisions delivered or reported in late 1998. The publication is not intended to be exhaustive in any respect. We have tried to be selective in the interest of keeping the publication to a manageable volume and highlighting those cases which are of general interest to those involved in corporate insolvency and reconstruction, or which represent a significant development in the law. For that reason we have not dealt with the very many cases which concern the setting aside of statutory demands as most of these cases are determined on individual factual circumstances. In addition, we have not tried to provide an analytical critique and have not expressed any views on the correctness of the reported cases.

We would like to thank in particular **Simon Writer, Helen Condon and Tanya Caldwell-Eyles** who edited and contributed and **Mark Javed, Nicholas Coffey and Lewis Grimm** who contributed to the publication.

We hope that you find this publication both useful and interesting as a reference tool. As this is the first of an annual publication, we would appreciate receiving your feedback and comments.



Michael Quinlan
Partner (Sydney)



Paul Nicols
Partner (Sydney)

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GLOSSARY

Annual Review of
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Failure to keep proper financial records can lead to civil penalties.

Case Name:

Australian Securities
Commission v Forem-Freeway
Enterprises Pty Limited & Ors

Citation:

(1999) 17 ACLC 511, (1999)
30 ACSR 339, Federal Court of
Australia per Madgwick J

Date of judgment:

4 March 1999

Issues:

- ◆ Corporate record keeping
- ◆ Civil penalties
- ◆ Law s232, s286, s588E,
s588G, s588J, s1317EA,
s1317HA

The ASC succeeded in obtaining orders against the director of a company prohibiting that director from participating in a corporation for 12 years under s1317EA(3) of the Law, and requiring the director to pay compensation under s1317HA.

Mr Morton was the sole director of Forem-Freeway Enterprises Pty Ltd (*Forem*) which carried on the business of assembling and retailing computers and which was wound up on 25 September 1997 by the ASC. The ASC sought to recover monies from the director because apart from recovery from him, individual unsecured creditors would not recover amounts they had paid to Forem.

Section 1317EA gives the Court power to order a person to pay compensation if the Court is satisfied that a person has breached a civil penalty provision: s232(2) (requirement for directors to act honestly), s232(4) (reasonable care and diligence requirement), and s588G (directors' duty to prevent insolvent trading).

Under s1317HA of the Law a Court has the power to order a person to compensate the company in relation to the contravention. Under s588J a Court can also order an acting director to pay the company compensation equal to the amount of damage for a breach of s588G.

The Court held that Forem failed to comply with s286 of the Law which requires companies to keep accurate financial records and this resulted in no material being available to rebut the presumption of insolvency which arises pursuant to s588E(4).

The Court therefore held that Forem was trading while insolvent for a considerable period of time due to its fundamentally unusual method of trading. The Court went on to find that Mr Morton had acted dishonestly in dealing with a bank and the company's hire purchase vendor.

In reaching his conclusion Madgwick J discussed the "*legislative policy*" in regard to the disqualification of directors/officers of companies from "*managing*" corporations in the future suggesting:

"the present regime appears to have acknowledged the problems of misconduct by directors and other company officers. The duties and liabilities of such persons have been made more onerous."

Madgwick J suggested that the role of such legislation is to "*protect the public*".

Thus, Mr Morton, under section 1317EA(3)(a) of the Law, was prohibited from managing a corporation for 12 years and he was also required to pay \$200,000 by way of compensation under section 1317HA(1).

This case shows that the mechanisms available under the Law extend beyond recovery mechanisms and encompass protection to the public in the form of disqualification and compensation.

De facto directors must be as careful as real directors.

Case Name:

Deputy Commissioner of
Taxation v Austin

Citation:

(1998) 16 ACLC 1555, Federal
Court of Australia per
Madgwick J.

Date of judgment:

27 August 1998

Issues:

- ◆ De facto directors
- ◆ Practical direction of company
- ◆ Law s60, s588FA, s588FF, s588FGA

This case involved a cross claim by the DCT against the cross-respondent, Mr Austin, an alleged de facto director of the company, Talljade Pty Ltd.

The company's liquidator had previously brought a successful action against the DCT for the recovery of payments of group tax and penalties made by the company to the DCT on the basis of the unfair preference provisions (s588FA). In the present proceedings, the DCT sought to be indemnified from Mr Austin as a de facto director for most of the money recovered by the liquidator. The action was brought on the basis of s588FGA where, if the Court makes an order against the DCT under s588FF, the directors of the company are liable to indemnify the DCT. Mr Austin's defence was that he was not acting as a director.

Mr Austin and his wife were friends with Mr and Mrs Manasseh. The two wives ran a restaurant business that operated at two locations. The company in question was a \$2 company incorporated to incur debts for the supply of goods and services for the restaurant and the wages of the employees. Mr Austin was appointed a director for just over 3 months to help out at a time when both families were suffering serious personal problems. As a consequence of these problems, one of the restaurants was sold. Mr Austin then sought to resign as a director of the company. A document to this effect was prepared by the company's accountants, however it was never lodged with the ASC. Following the completion of this form at the accountant's office and his intended resignation, Mr Austin undertook a number of negotiations with the DCT on behalf of the company and made arrangements for the periodic repayment of the outstanding group tax and penalties. In addition, he countersigned a number of company cheques in favour of the DCT and other creditors, issued stop notices to the company's bank, negotiated time to pay debts with other creditors, and continued in negotiations to sell the other restaurant.

Included within the definition of a '*director*' under the Law is a person occupying or acting in the position of a director of the company, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act, in that position (s60). The Court decided that whether or not a person acts in the position of the director, whether validly appointed as such, will depend on a number of factors. These include the size of the company, the nature of its activities, the internal practices and structures of the company, and how the person was perceived by outsiders who dealt with the company. A further consideration is whether the person exercises the top level of management functions. In a large and diversified company a wide discretion must be conferred upon employees to carry out management functions.

However, in a small company with a limited range of activities and functions, it is more likely that persons acting as Mr Austin did, would be considered to be exercising the top level of management functions.

The Court held that the sum of Mr Austin's actions amounted to him being a de facto director at the relevant times. Although he intended to merely assist in times of difficulty, the length of time that he so acted put him beyond the realm of arguing that he was not occupying or acting in the position of director. Mr Austin had practical direction over the company and exercised top management functions, with the wives and Mr Manasseh exerting little control over him. As a result, Mr Austin was held to be a de facto director of the company and ordered to pay to the DCT over \$50,000 and the costs of the proceedings.

This case provides a clear warning to persons assisting in the running and management of small businesses to limit the scope of their involvement in the company's top management functions. In particular, such persons should avoid holding themselves out to be acting as a director of the company.

The word is a sword. Directors: be careful what you write.

Case Name:

Quick v Stoland Pty Ltd

Citation:

(1998) 29 ACSR 130, Full Court of the Federal Court of Australia per Branson, Emmett and Finkelstein JJ.

Date of Judgment:

25 September 1998

Issues:

- ◆ Reasonable grounds to suspect insolvency
- ◆ Company correspondence
- ◆ Law s588G

This case considered the insolvent trading provisions and examined the circumstances in which company directors ought to be aware that their company may be trading whilst insolvent.

The respondent, a creditor of the company in liquidation, had sued the appellant, who had been a director of the company, to recover debts incurred by the company to the respondent. To succeed in its claim for insolvent trading, the respondent had to prove that at the time the relevant debt was incurred there were reasonable grounds to suspect insolvency.

The respondent was not required to prove that the company was in fact insolvent at the time the relevant debts were incurred. All that was required to be proven was that there were reasonable grounds to suspect that the company was insolvent or may become insolvent as a result of incurring the debts.

In his consideration of a '*cash flow*' test of insolvency and the existence of reasonable grounds to suspect insolvency, Finkelstein J looked at the company's correspondence to determine whether it would be able to pay its debts as and when they became due and payable and as an indication of the existence of reasonable grounds to suspect insolvency. In particular, he had regard to three pieces of company correspondence. The first was a letter to a trade creditor stating that the company would be unable to pay its debt other than to provide it an item of equipment in partial discharge of a debt due to that creditor.

The second was a letter from the company to a creditor regarding a \$242,000.00 debt which stated, '*We regret to advise you that we are unable to pay this debt at this time due to unforeseen circumstances that have put pressure on our ability to meet our liabilities. If there should be a change in our position, we will advise you accordingly, however the immediate future appears extremely clouded*'.

The third was a letter to the ANZ Bank stating that the company was only able to continue its operations with the assistance of the Bank's overdraft facility.

Finkelstein J decided that this correspondence was more valuable than financial records in indicating the insolvency of the company. On the basis of this correspondence, the Court found that the directors had reasonable grounds to suspect that the company was insolvent or might become so as a result of incurring the relevant debts.

It is important to note the relevant weight given by a Court to the company correspondence in determining whether there were reasonable grounds to suspect insolvency. This case indicates that all correspondence and action taken by the company or its directors will be used by the Court to determine whether there were reasonable grounds to suspect insolvency.

This case is important as it sends a clear warning to directors that they must continually assess the solvency of their company. In particular, company correspondence and other documentation may be used to find that there were reasonable grounds for the directors to suspect insolvency.

Knowing when to redline company activities - the liability of a passive director.

Case Name:

Credit Corp Pty Ltd v Atkins

Citation:

Unreported, Federal Court of Australia per O'Loughlin J.

Date of Judgment:

31 March 1999

Issues:

- ◆ Reasonable grounds to suspect solvency
- ◆ Passive directors
- ◆ Law s592

This case involved an application to the Court by a number of creditors of a company alleging that the former directors of a company in liquidation, Greenline Operations Pty Ltd (*Greenline*), were personally liable for specified unpaid debts of the company. The application was based on s592 of the Law.

Section 592 applies to debts incurred prior to 23 June 1993. It provides that if immediately prior to the incurring of a debt by the company, there were reasonable grounds to expect that the company would not be able to pay all its debts as and when they become due, and the company later becomes insolvent, a person who was a director (or any other person involved in the management of the company) at the time that the debt was incurred, will be liable for that debt.

Mr and Mrs Atkins were the only two directors of Greenline. The Atkins family moved away from Adelaide when Greenline obtained a contract, but Mrs Atkins and the children later returned to Adelaide. Mr and Mrs Atkins were subsequently divorced. In order to carry out its initial contract, Greenline had to buy numerous items of expensive equipment. At the end of the initial contract, Greenline had a large amount of equipment, however some of it was subsequently damaged and as a result Mr Atkins decided to purchase additional equipment. This news was conveyed to Mrs Atkins who said that this was not a concern to her.

There were a number of factors that indicated that the company was insolvent at the time that the debts to the company's supplying the equipment were incurred. First, Greenline had no income at all between the end of the initial contract and the start of its new contract. Second, there was the need for the regular preparation of list of outstanding creditors. Third, the company could not afford the relatively small amount of funds needed to pay its income tax for the year ending 30 June 1990. Fourth, Mr Atkins himself admitted that a number of creditors had not been paid because Greenline lacked the funds to pay them. The question for the Court however was whether there were reasonable grounds for Mr and Mrs Atkins to suspect that Greenline might be insolvent at the time of the purchase of the additional equipment or might become insolvent as a result of the purchases.

The Court had little difficulty in finding that Mr Atkins was aware of reasonable grounds to suspect the company's insolvency. He was the chief executive officer of Greenline and had actual knowledge of the inability of Greenline to pay its debts (including the repayments for the equipment purchased) as and when they became due.

Mrs Atkins also argued that she knew very little of the company's operations, and asserted that she believed at all times that the company was and would remain solvent. In support of this, Mrs Atkins asserted that her belief in Greenline's solvency was evident in the fact that she put her house at risk in her support of Greenline purchasing the additional equipment. She also asserted that, due to her distance from her husband, she was not aware of the financial circumstances of Greenline. It was not in dispute that Mrs Atkins was ever actively involved in the incurring of a business debt. However, the Court held that Mrs Atkins also had reasonable grounds to suspect that the company was insolvent, or would become insolvent by purchasing the additional equipment. She attended a meeting with the company accountant around the time that the relevant debts were incurred, at which she was given a list of outstanding creditors of Greenline. The accountant's timesheets indicated regular contact with Mrs Atkins, and thus she could not claim that she was unaware of the general financial circumstances of Greenline.

In this way, although Mrs Atkins had minimal involvement in the practical day-to-day running of the company, and was not actively involved in the incurring of any business debt, the Court held that she had actual knowledge of the company's financial affairs and had reasonable grounds to suspect that the company was insolvent or would become so by incurring the debts in question.

This case confirms that passive directors may still be found personally liable to pay certain company debts on the basis that they had reasonable grounds to suspect that the company was or would become insolvent as a result of incurring the debt.

Building towards insolvency - more passive insolvent trading.

Case Name:

Kenna & Brown P/L v Kenna & Ors

Citation:

Unreported, Supreme Court of New South Wales per Bergin J.

Date of Judgment:

2 June 1999

Issues:

- ◆ Directors' duties
- ◆ Reasonable grounds to suspect insolvency
- ◆ Defences to insolvent trading
- ◆ Law s588G, s588H

This case involved an action by a company, Kenna & Brown P/L (the company) and its liquidator against its two directors, Mr Kenna and Mr Brown, and an employee, Mrs Kenna. Amongst other things, the plaintiff claimed that the directors had reasonable grounds for suspecting the company's insolvency and were thus in breach of s588G.

The company was in the business of building, construction and property development. When the business was incorporated there was a division of duties between the two directors consistent with their areas of expertise. Generally Mr Brown would be responsible for the carpentry work, the supervision of building sites and tradesmen whilst Mr Kenna would remain back in the office running the business and the management of the office. Mr Brown attended the office once a week. In 1994 the company expanded its activities significantly, and commenced three new large building projects and employed two additional site supervisors. Mr Brown was not told of these developments until after they had occurred. Proper accounting records were not kept by the company. In particular, Mrs Kenna, who was responsible for the company's basic accounting procedures, did not keep records of cash payments received by the company which were subsequently misappropriated by Mr and Mrs Kenna. In March 1995 Mr Kenna approached the company's bank for an extension of the company's overdraft, however the bank declined the application. An administrator was subsequently appointed to the company.

The Court had little difficulty in finding that Mr Kenna had breached a number of his duties to the company. In particular, he was found liable under the insolvent trading provision, s588G.

Mr Kenna had actual knowledge of the dubious state of financial affairs as disclosed by the company's financial records, the commencement of the three new building projects in the absence of a cash flow projection or prepared budget, the failure to obtain extra funding from the company's bank, the continuation of trading where no additional funding had been obtained, and a number of outstanding debts owed by the company. As Mr Kenna was the director who had practical day-to-day management of the financial affairs of the company, he was objectively and subjectively aware that the company might be insolvent at the relevant times.

Mr Brown was also alleged to have breached s588G. Under the division of responsibilities within the company, Mr Brown had no involvement in the day-to-day financial affairs of the business. He was paid his wages on a weekly basis without delay, and was not aware of a number of demands for payment made by creditors.

However he did not request Mr and Mrs Kenna to inform him of the financial affairs of the company. In addition, he did receive a copy of the 30 June 1994 accounts, he did not attend the annual meeting with the company accountant to discuss the 30 June 1994 accounts as he was *'too busy'*, and he was aware that the company was financially *'stretched'* in late 1994. Although Mr Brown had no subjective knowledge of the company's insolvency at the relevant times this itself was not sufficient to rescue him from liability as an objectively reasonable person placed in Mr Brown's position in the same circumstances of the company would have had reasonable grounds for suspecting insolvency.

Mr Brown sought to rely on two defences to this liability. First, he sought to rely on the *'reasonable grounds to expect solvency'* defence under s588H(2). However, the Court found that he had not kept his commitment to meet with the company accountant and was aware that the company was financially *'stretched'* in late 1994. Despite the fact that Mr Brown was not informed of the new building projects and site supervisors until after the fact, he did nothing to alert the company accountant to this development. The Court held that Mr Brown was aware of these circumstances and they should have alerted him to the need for communication about the company's financial affairs and to take appropriate action to address this lack of communication. In this way, Mr Brown did not have reasonable grounds to expect the solvency of the company. Secondly, he sought to rely on the *'reliance on a competent and reliable person'* defence in s588H(3). However, the Court also refused this defence for a number of reasons, particularly because once he became aware of the three new building projects, he did not speak to Mr or Mrs Kenna about them or their possible effect on the company. It was clear that Mr Brown was not being kept informed of the financial situation of the company. The three new building projects were clearly relevant to the company's financial situation and Mr Brown's knowledge that he had not been provided with any information about these until the projects had been commenced indicated that the people responsible for providing him with financial information were not doing so in an adequate manner.

This case highlights the need for company directors and employees to be aware of their duties to the company. It also sends a clear message to directors who do not actively participate in the financial management of the company that they must ensure that they are kept sufficiently informed of the company's financial state on a regular basis.

Lifting the corporate veil on payments to defeat creditors.

Case Name:

Yukong Line Limited of Korea v
Rendsburg Investments
Corporation of Liberia & Others
(No. 2)

Citation:

[1998] 4 All ER 82, High Court of
England & Wales, Admiralty
Division per Toulson J.

Date of judgment:

23 September 1997

Issues:

- ◆ Lifting the corporate veil

This case involved an attempt to lift the corporate veil and to make a director liable for a breach by the company

The plaintiff ship owner agreed to charter its vessel to Rendsburg Investments Corporation (**Rendsburg**) for three years. A director of Rendsburg had complete control over its affairs and held all of its beneficial interest. The charter was signed on Rendsburg's behalf by its sole director and beneficial owner. Shortly afterwards the plaintiff gave notice to Rendsburg of the expected delivery of the vessel. However the director sent a fax to the plaintiff informing it that it was unable to perform the charter agreement. On the same day, a significant sum of money was transferred from Rendsburg's bank account to a related entity (of which the director was also the sole director and beneficial owner). After discovering the nature of the relationship between the director and the two companies, the plaintiff subsequently added the director as a defendant. It submitted that he was liable for the breach of the charter and that he had conspired with Rendsburg to siphon funds away from it.

The plaintiff submitted that although the director was not originally a party to the contract, he was to be treated as such by reason of his subsequent improper conduct which was specifically designed to leave the plaintiff with no financial recourse to satisfy a likely judgment in its favour.

The Court acknowledged that the corporate veil can be lifted to make directors personally liable but that should only be done in limited circumstances. Accordingly, as the director and Rendsburg entered the charter party with no intention of using Rendsburg's corporate personality as a sham, the director should not be personally liable for the debt.

Thus the transfer of funds by Rendsburg to a related entity on the repudiation by the charter party, for the purpose of putting assets beyond the reach of the plaintiff, did not entitle the Court to treat the director as a party to the charter party and therefore liable in damages for Rendsburg's repudiation of it.

This case confirms that at common law (absent specific statutory provisions such as the insolvent trading provisions of the Law) the corporate veil will only be lifted in limited circumstances to make a director liable for the particular breach.

Setting aside a statutory demand.

Case Name:

In the Matter of Section 459G of the Corporations Law of Victoria; In the matter of Australian Underwriting Agencies Pty Ltd; Australian Underwriting Agencies Pty Ltd v QBE Insurance Ltd

Citation:

Unreported, Federal Court of Australia per Merkel J.

Date Of Judgment:

18 December 1998

Issues:

- ◆ Status of statutory demands
- ◆ Law s459G, s459H

This case involved an application by Australian Underwriting Agencies Pty Ltd under s459G of the Law to set aside a statutory demand by QBE Insurance Ltd.

The statutory demand related to a Court ordered winding up in insolvency. The application involved three issues:

1. whether the Court had jurisdiction to set aside the statutory demand;
2. whether the affidavit accompanying the statutory demand was defective and, if so, what consequences would stem from this, and;
3. whether there was a genuine dispute about the existence of a debt which would provide a basis for having the statutory demand set aside.

The respondent contended that the Court did not have jurisdiction to hear the case as the application and supporting affidavit were served on the respondent after the expiration of the twenty-one day limitation period. An address for service was set out within the statutory demand which specified the postal address, telephone number, and facsimile number for service. The applicant initially sent to the respondent by facsimile a copy of the application and affidavit within the twenty-one day period. The applicant also sent a hard copy of the application and affidavit to the respondent by post, but the documents did not arrive at the respondent's nominated postal address for service until after the expiration of the twenty-one day period.

The respondent claimed that service by facsimile is not proper service, and that as service by post did not occur until after the expiration of the twenty-one day period the Court had no jurisdiction to set aside the statutory demand. The Court held however that the inclusion of a facsimile number within the statutory demand indicated to the applicant that service could be effected by facsimile. In addition, the service by facsimile was sufficient to bring the served documents to the attention of the respondent. Accordingly, the Court held that it had jurisdiction to hear the application.

In relation to the second issue, the applicant contended that the affidavit accompanying the creditors statutory demand was defective because the Schedule purporting to set out the calculations used to determine the sum was illegible. The applicant claimed that prior to the service of the statutory demand the respondent had not made any claim for the alleged liability, and that the illegibility of the calculations made it impossible for the applicant to respond in detail to the claim. The Court held that the illegible calculations were more than a mere technical failure within the affidavit. The consequence of the illegible calculation was that it left the applicant in the position of being unable to determine the basis of calculation for a large claim of indebtedness at a time when it was obliged to either pay the alleged debt or to apply to set aside the demand within twenty-one days of its service.

Consequently, the applicant was unable to deal satisfactorily with the statutory demand in the manner provided for. Accordingly, the Court found there were good grounds for setting aside the statutory demand and did so.

Although it was unnecessary to contemplate the third issue in detail, as the Court had already held that there were grounds for setting aside the statutory demand, the Court briefly considered whether the facts in question suggested that there was a genuine dispute as to the existence or the amount of the debt. Section 459H allows a Court to set aside a statutory demand where there is a genuine dispute between the creditor and the alleged debtor as to the existence or the amount of the debt. A genuine dispute exists where the dispute is bona fide and the grounds for alleging the dispute are real. The respondent claimed that the applicant's affidavit contained a mere denial of indebtedness and as such did not constitute a genuine dispute. However, the Court agreed with the applicant's proposition that the applicant was unable to deal with the claim in any other way because of the absence of information caused by the illegible calculation. In this way, the Court considered that there was a genuine dispute as to the quantum of the debt claimed, particularly as the respondent did not adduce into evidence the basis of calculating the alleged debt, and that this would provide sufficient grounds for setting aside the statutory demand.

This decision provides a strong warning to creditors of insolvent companies who are seeking payment of debt under a statutory demand that they must provide full and clear particulars of the alleged indebtedness if they wish to successfully have the debtor company wound up by the Court.

Borrowers get several bites of the cherry.

Case Name:

Commonwealth Bank Australia
v McKinnon & Anor

Citation:

Unreported, Supreme Court of
Victoria per Warren J.

Date of Judgment:

12 October 1999

Issues:

- ◆ Mortgage securities
- ◆ Enforcement
- ◆ Setting aside default judgment

In this case the Victorian Supreme Court considered the circumstances in which it would set aside a default judgment obtained by a bank against its borrowers.

The Defendants mortgaged three properties to the bank.

On 7 October 1997 a default judgment was entered against the Defendants for possession of properties and for \$197,880.76. The Defendants then made several abortive attempts to get that judgment overturned:

- ◆ a Summons to set aside the default judgment was dismissed with costs on 18 December 1997, because the Summons was served late and there was no affidavit evidence in support. The Court also noted that the return date was changed to suit the holiday arrangements of the Defendant's solicitors. A writ for possession of the properties was issued on 2 February 1998;
- ◆ a second Summons was then filed but it was subsequently struck out in the absence of an appearance at the return date on 15 December 1998;
- ◆ the Defendants themselves then filed a further Summons on 2 July 1999, together with affidavits in support. That Summons was dismissed by the Master on 23 August 1999; and
- ◆ the Defendants then filed a Notice of Appeal, which came before the Practice Court on 20 September 1999, and was heard as a hearing de novo (O77.O5).

On 4 October 1999 the Court granted special leave to allow the Defendants to rely on further affidavits sworn by one of the Defendants on 30 September 1999, and which set out the reasons for delay in the Defendants bringing their application and the merits of their case. Leave was granted on the ground that the affidavits revealed an arguable defence on the merits, explained the delays, and that (following assistance by the Victorian Bar's pro bono scheme) this was the first time that the Defendants had been competently legally assisted to enable them to fully put their position to the Court. In the circumstances the Court considered that not to grant special leave would constitute "*a serious denial of justice*".

On the merits the Court found that the Defendants had relied on advice from the State Bank (the CBA's predecessor in title) and acted to their detriment. The Court also found that delay was due almost entirely to the Defendants' former solicitors. The Court noted that courts, as a general principle, will not deny a party the opportunity to litigate where the solicitor for the party, not the party itself, was responsible for the default in question. The Court also noted that its discretion to set aside a default judgment was extremely wide and is to be exercised having regard to the justice of the case.

Although the Court held that the Defendants satisfied the onus upon them, the Court considered two further questions: firstly, whether there was any useful purpose in setting aside the default judgment, and secondly whether the judgment could be set aside in part.

As the properties had been sold by the mortgagee in possession, the incoming purchasers were purchasers for value in the absence of fraud and by virtue of s42 of the *Transfer of Land Act 1958* (Vic) the incoming purchasers had an indefeasible title to the properties. Accordingly, in the Court's view setting aside default judgment for possession of the properties would be futile and pointless. The Defendants' redress if any lay in suing the bank for damages and also pursuing their former solicitors for damages for professional negligence. The bank did not play any part in the delay in making an application to set aside the default judgment. Accordingly the Court set aside the default judgment entered on 7 October 1997 for the liquidated sum, together with interest and costs. The judgment for possession was allowed to stand. The Defendants would need to pursue the remedies against the bank and their former solicitor in respect of the judgment for possession.

This case shows that banks cannot assume that their problems with a borrower are over once a default judgment is obtained. The case is an example of the Court giving borrowers multiple opportunities to run their case. On the positive side the case shows that in setting aside a default judgment, a Court will consider whether there is any useful purpose in setting the entire default judgment aside, whether setting aside the default judgment in part might be an appropriate remedy and whether the aggrieved party might have remedies lying elsewhere.

Put your loan agreements and any amendments to them in clear writing.

Case Name:

O'Connor v Esanda Finance Corporation Ltd

Citation:

Unreported, Supreme Court of Victoria per Byrne J.

Date of Judgment:

15 December 1999

Issues:

- ◆ Hire purchase agreements
- ◆ Discharge of debts by hire purchase
- ◆ Superseded contract terms

In this case, the Victorian Supreme Court considered, on appeal, the question of whether an agreement (the *1994 Agreement*) between a finance company (*Esanda*) and a consumer buying goods under a hire purchase contract (the *Plaintiff*) in which the parties agreed that the plaintiff would pay off a debt by instalments, was a discharge of the pre-existing debt owed by the Plaintiff to *Esanda* under the hire purchase contract (the *1984 Agreement*).

In granting the appeal the Court noted that:

1. the Magistrate had accepted that the January 1994 Agreement created a fresh obligation in the Plaintiff to pay the amount outstanding by monthly instalments and at the end of the 6th month, the arrangement for the payment by instalments was extended for a further 6 months expiring in January 1997;
2. the terms of a letter which confirmed a telephone conversation on which the 1994 Agreement was alleged to have been based, could not be construed as an agreement to pay any sum by instalments. The correct analysis was that the January 1994 Agreement was an agreement to pay stipulated instalments in reduction of an outstanding debt, and that *Esanda's* agreement to forego its rights to immediate payment and any right to interest was given in exchange for the Plaintiff's agreement to make the instalments. The Court went on to say in relation to the 1994 Agreement:

"It was, at best, a variation of an existing hire purchase agreement; it did not discharge it and replace it with a fresh obligation to pay a sum of money."

The Court gave the following reasons for reaching this view:

- (a) the amount of the hire purchase debt was not agreed or even discussed between the parties in the telephone conversation of 18 January 1994. The Court noted that if a party wishes to prove an agreement under which a person is bound to pay a sum of money it must be shown that the sum was agreed upon, or that some machinery for fixing it had been agreed upon;

- (b) the terms of the 19 January 1994 letter confirming the substance of the 18 January 1994 telephone conversation were such that the subject matter of the agreement was a short term instalment plan. The Court also noted that a similar payment plan had been agreed to between the parties in July 1994, and possibly also July 1993. When the January 1994 Agreement expired the amount payable under the 1984 Agreement would again become payable and the parties would need to agree on a new instalment plan;
- (c) Esanda's case was poorly pleaded in that it alleged that the Plaintiff's obligation to pay the accrued principal and interest arose from a promise to pay made in the January 1994 Agreement. The Court found that there was no evidence of any such promise contained in the January 1994 Agreement, rather the contrary;
- (d) the Court also rejected a submission by Esanda that a new agreement to pay and the amount of the sum to be paid should be inferred by the previous dealings between the parties, finding that although a reasonable bystander would have inferred that the parties were discussing obligations of the Plaintiff under the 1984 Agreement to pay the money to Esanda, that did not warrant an inference that the parties were agreeing to discharge the obligations under the 1984 Agreement and to substitute them for a fresh promise to pay some moneys (ie the 1994 Agreement); and
- (e) the Court considered that if the January 1994 Agreement discharged the 1994 hire purchase agreement the hirer would lose the protections conferred on him by the *Hire Purchase Act 1959* (Vic). While accepting that that would be lawful, the Court held that it should not find such an agreement existed unless there is evidence to support that finding, and there was no such evidence.

The Court therefore held that at first instance the Magistrate fell into error in finding that the evidence before him, including that of prior dealings between the parties warranted the conclusion, as a matter of law, that a contract of the kind asserted by Esanda had been entered into in January 1994. The Court also held that if Esanda wished to recover the amount outstanding under the 1984 Agreement it should sue on the 1984 Agreement and prove its case in accordance with the terms of the 1984 agreement. The Court allowed the appeal and ordered indemnity costs against Esanda.

This case is a warning that interim arrangements between debtors and creditors for the payment of outstanding earlier debts may not override the original agreement unless both parties clearly intend that to be the case. In suing on agreements creditors should be alive to ensuring that their pleadings are appropriately drafted and that they are suing on the correct agreement.

Court refuses to rectify register due to incorrect application.

Case Name:

Western National Plant Pty Limited; Venetian Nominees Pty Limited & Anor v Western National Plant Pty Limited

Citation:

(1997) 17 ACLC 580,
Supreme Court of Western
Australia per Scott J.

Date of Judgment:

4 March 1999

Issues:

- ◆ Priority of charges
- ◆ Rectification of register
- ◆ Law s269, s274

In this case the Supreme Court of Western Australia refused to order a rectification of the register of charges under s274 of the Law on the basis that the applicants had made an incorrect application.

The applicants had removed their charges in order to allow a finance company to register its charge as a first priority. However, the finance company's charge was not registered. The applicants wanted to correct the register which described the Notification of Discharge as "*satisfied*". The applicants argued that the discharge was void *ab initio* and sought orders under s274 to rectify the register.

Section 274 provides that where a Court is satisfied that a particular with respect to a registrable charge has been omitted from, or misstated in, the register or a memorandum referred to in s269, the Court may order that the omission or misstatement be rectified. The Court has the power to make a rectification order if the omission or misstatement was "*accidental or due to inadvertence or to some other sufficient cause, or is not of a nature to prejudice the position of creditors or shareholders or that on other grounds it is just and equitable to grant relief.*"

The Court rejected the applicants' submission, holding that the discharge was not in any sense signed "*accidentally or due to inadvertence*", therefore it fell outside s274 of the Law. The Court held that the purpose of the discharge was to release the property under charge and this in fact had occurred. The Court considered that the misstatement was not something which was capable of satisfying any condition stipulated in s274(b) of the Law so as to require rectification of the Register. The Court thus held that it was beyond the powers conferred on it under s274 to rectify the register. The applicants failed to demonstrate a "*clear and unambiguous*" case – a failure which resulted in the dismissal of the application.

The Court suggested that the more appropriate application would have been an application to correct the memorandum of release under s269. Scott J held that the applicants' contention ought to have been that there was a relevant misstatement in the memorandum of release given under s269 in that it informed the respondent that the charge was "*paid*" or "*satisfied*" in full and all property was released.

Accordingly, His Honour found that if that misstatement was rectified, having regard to s269(2) of the Law the respondent would then be obliged to enter in the Register the particulars of the matters. Those particulars would then be stated in the memorandum which would, (presumably as from the date of its original lodgement), be a notification of what had occurred in respect of the charge.

The result would be that the charge would be left in force as from its original registration on 30 November 1993 – the applicants’ desired result.

This case clearly shows that financiers must be aware of the distinctions between applications for rectification of the register under s274 of the Law and applications to correct other documents under s269 of the Law.

The position of joint receivers and managers.

Case Name:

Kendle v Melsom

Citation:

(1998) 16 ACLC 466 High Court of Australia per Brennan CJ, McHugh, Gummow, Kirby & Hayne JJ.

Date of Judgment:

25 February 1999

Issues:

- ◆ multiple persons appointed receiver and manager
- ◆ meaning of *jointly and severally*
- ◆ Law s420, s424

In this case the respondents were receivers and managers who were appointed by the Commonwealth Bank of Australia (the bank) to the assets and undertakings of a company pursuant to a charge granted by the company to the Bank.

The company commenced proceedings against the receivers complaining that all actions performed by them in respect of the charged property were unlawful by virtue of the fact that the Bank did not have the authority under the charge to appoint them “*jointly and severally*” as was done under the appointment document. The main issue was whether multiple persons could be appointed as receivers and managers.

Brennan CJ and McHugh J held that a power conferred on a number of receivers did not require that every decision and act should have the concurrence of all of the receivers appointed as this would frustrate the purpose of appointing joint receivers. Rather, the appointment of one as representative or an agent could permit the smooth running of the receivership. The joint receivership would mean that the whole would determine the course of the receivership and have joint liability for the discharge of the duties of the receiver, but day-to-day matters could properly be left to an agent. Furthermore, the appointment was ineffective to the extent that the receivers’ powers could be exercised independently of the others, but this did not render the entire appointment invalid.

Gummow and Kirby JJ (with whom Hayne J was in agreement) held that the instrument appointing the receivers clearly did so on a joint basis, but also allowed the powers to be exercised by “*every such receiver*” Thus the charge allowed for independent action by individual receivers and meant that such actions were done with the leave and licence of the company. However, liability remains joint and several for the actions of all or any of the appointed receivers.

The case makes it incumbent on banks, receivers and managers and their legal representatives to clearly draft the appointment documents to avoid any challenge to either the appointment of receivers and managers or the exercise of their powers.

Can the receiver pay himself or herself from trust funds held by the receivership?

Case Name:

13 Coromandel Place Pty Ltd v
CL Custodians Pty Ltd (in
liquidation)

Citation:

Unreported, Federal Court of
Australia per Finkelstein J.

Date of Judgment:

1 March 1999

Issues:

- ◆ Receivers
- ◆ Receivers' remuneration and reimbursement

In this case the Federal Court considered whether receivers and liquidators' costs can be reimbursed out of trust funds under their control.

A solicitor, now deceased, procured investors to invest in joint ventures and then misappropriated the funds. The majority of the funds were placed into the solicitor's trust account and into the account of CL Custodians Pty Ltd (*CL Custodians*). The applicant was one of the parties induced into investing more than a million dollars. Following the solicitor's death, a receiver and a liquidator were appointed by the court.

The Court held that the receiver's costs and expenses could be paid out of the assets of CL Custodians, notwithstanding that those assets were held in trust for the investors. The Court reached this decision on the basis that Courts appoint receivers when necessary to safeguard the interests of all persons who are or may be interested in the assets placed under receivership. Once the Court has decided that particular assets should be subjected to a receivership it is right and proper that those assets should be applied to satisfy the receiver's costs. The fact that the assets do not belong to a party to that suit in which the receiver is appointed does not affect the receiver's entitlement to be paid out of the assets under its control. Finkelstein J used as authority cases that refer to a receiver's indemnity subsisting over the assets under his or her control. The receiver is lawfully in possession of the assets by reason of a Court order and that has been held sufficient to charge the assets with the receiver's costs.

The arguments above were held to equally apply to a provisional liquidator's costs and expenses. The Court clarified the distinction between work related to winding-up a company (which cannot ordinarily be charged against trust assets) and work related to adjustments of trust assets (which can be charged against trust assets).

In general liquidation matters, if a liquidator's work is unrelated to beneficiaries it is difficult to see how the costs could be charged against these assets. The most likely case where a liquidator's costs in winding up a company which is a trustee will be chargeable against the trust assets is where it can be shown that the liquidation is necessary for the proper administration of the trust. This would be unlikely unless the trustee company acted solely or significantly as trustee. Where a company acted significantly as trustee the liquidator will be required to estimate the proportion of its costs that are attributable to the administration of trust property which will be chargeable against trust assets.

The Court ordered that the receiver and the provisional liquidator were entitled to have their costs and expenses deducted from any money that CL Custodians held on trust. The Court held that, provided a liquidator is acting reasonably, he or she is entitled to be indemnified out of trust assets for costs and expenses in carrying out the trustee's activities including:

- ◆ identifying or attempting to identify trust assets;
- ◆ recovering or attempting to recover trust assets;
- ◆ realising or attempting to realise trust assets; protecting or attempting to protect trust assets; and
- ◆ distributing trust assets to the persons beneficially entitled to them.

However, costs and expenses incurred by a liquidator in respect of a separate trust or for investors without property in the specified trust cannot be charged against trust assets.

The message for insolvency practitioners is that, subject to the limitations discussed above, assets held on trust may be applied to a Court appointed liquidator's or a receiver's reasonable costs and expenses, even where the assets under their control do not belong to a party to the suit.

Impact of S420A on a receiver's duties when exercising a power of sale.

Case Name:

Jeogla Pty Limited v Australia & New Zealand Banking Group Limited

Citation:

Unreported, Supreme Court of New South Wales per Einstein J.

Date of Judgment:

11 June 1999

Issues:

- ◆ Receivers and managers
- ◆ Powers and duties of receivers
- ◆ Law s420A

Einstein J of the Supreme Court of NSW considered the issue of the extent to which section 420A of the Law has extended the common law relating to the exercise of a power of sale under a mortgage. The law in this area has been conflicting until recently.

Section 420A provides that a controller (be they a director, officer, or a receiver) acting under a power of sale must take reasonable care to sell a property for market value or the price best obtainable in the circumstances existing when the property is sold.

This case considered this issue against an interesting factual background. The bank held a mortgage over a rural property, Jeogla Station, and certain elite beef cattle. The bank appointed a receiver to the property and charged him with conducting the marketing and sale of Jeogla, the livestock and the plant and equipment. The receiver then retained a number of real estate agents to value the property and a real estate agent to market and sell the property and an expert to value the livestock.

The mortgagors of Jeogla alleged that the sale of the property and the livestock were for undervalue and therefore the receiver was in breach of s420A.

It is important to note that the livestock were an integral part of Jeogla, as it was a world-class cattle breeding facility for high-grade cattle. This meant that the receiver gave the purchaser of the property a right of first refusal over the livestock to allow the property to be sold as a going concern.

The valuations of the livestock were found to be incorrect, as the valuer had valued them in the wrong market which resulted in them being seriously undervalued. The market that the cattle were valued in was the “*production sale market*” rather than the “*dispersal sale market*”. This allowed the judge to find that a breach of s420A existed.

Einstein J found that s420A imposes a far higher duty than the ordinary common law on a company receiver. This duty requires that the receiver take “*all reasonable care*” in selling the property.

The section is unclear as to whether the receiver is required to make a sale soon after the power of sale becomes exercisable. Einstein J found that the receiver is not under an obligation to sell for an “*absolute maximum price*” but for the market price at the time the property is sold. This may mean that where the market is flat, the price will be lower than might be expected in a good market. However, the receiver must also act in the interests of the mortgagee and so the timing of sale may be determined with these in mind.

Furthermore, Einstein J found that the notion of “*market price*” is determinable by reference to the market that most accurately reflects the true value of the asset concerned. Given that the valuation of the property was in relation to the wrong market, the receiver was not entitled to rely on that valuation as he could not delegate the obligation under section 420A to another.

Receivers should be aware that their obligations under section 420A are considerably higher than those under the common law. They must make “*all reasonable*” steps to sell for market value or for as close to market value as possible. In doing so, receivers are entitled to rely on the advice of experts, but cannot rely on that advice in the event that it is incorrect to absolve them of their duty under section 420A.

Receivers can enter into litigation funding deals despite the rules of maintenance and champerty.

Case Name:

Hawke v Daniel Efrat Consulting Services Pty Limited

Citation:

(1999) 30 ACSR 640; (1999) 17 ACLC 733, Federal Court of Australia per Branson J.

Date of Judgment:

14 April 1999

Issues:

- ◆ Funding of litigation by a company in liquidation
- ◆ Maintenance and champerty
- ◆ Law s420, s424

In this case the Federal Court was asked to consider whether a receiver had the power to enter into an agreement with an insurer to fund litigation to recover the unpaid balance of a purchase price.

In 1996 Efrat Consulting Services Pty Ltd (*Efrat*) entered into an agreement to sell its assets to Spectron Security Print Pty Ltd (*Spectron*). At the time of trial, Spectron owed Efrat \$486,927 plus interest on the unpaid balance of the purchase price for Efrat's assets. Efrat, in receivership since June 1997, lacked the financial capacity to pay the costs associated with legal action against Spectron. The receiver considered entering into an agreement with FAI in order to fund the litigation (the *Agreement*).

Prior to entering into the Agreement, the receiver formed the view that the Agreement was fair and reasonable from both Efrat's and the secured creditor's points of view. Nonetheless the receiver made an ex parte application for directions under s424(1) of the Law, as to whether it had the power to enter into the Agreement. The Court was also asked to consider whether the Agreement was illegal and void as contrary to public policy on the ground that its performance would have been in aid of maintenance and champerty which are traditional otherwise to public ruling.

Branson J held that the receiver had the power to enter into the Agreement. Having noted the trend in recent years toward limiting the applicability of maintenance and champerty, the Court held that s420(2) of the Law evinced an intention to expand the powers of a Receiver so as to allow the Receiver to dispose of a cause of action in circumstances which would traditionally offend the common law rules against maintenance and champerty.

The Court was unable to identify any principle why a receiver's powers of sale should ordinarily be more restricted than a liquidator's powers of sale. The Court also noted that, in contrast to a liquidator, a receiver's general power of sale was not a statutory but a contractual power, deriving from the Debenture. On the basis of the above reasoning, the Court held that the receiver had the power to enter into the Agreement at the time it did and the Agreement was valid, not being contrary to public policy.

This case gives new hope for receivers hoping to fund litigation because it shows that receivers do have the power to enter into contracts to fund litigation which would traditionally have offended the common law rules against maintenance and champerty.

When is a casting vote properly used?

Case Name:

Re Martco Engineering Pty Ltd

Citation:

(1999) 32 ACSR 487, Supreme Court of New South Wales per Santow J.

Date of Judgment:

12 July 1999

Issues:

- ◆ Casting vote set aside or varied
- ◆ Law s600B

This case considered the proper use of the chairperson's casting vote at creditors' meetings.

Under s600B of the Law, a person, or their proxy, who voted against a resolution that was passed on the casting vote of the chairperson, can apply to have it set aside or varied by the Court. Under the same section, a person may also apply to have taken as having been passed a resolution which was lost at a meeting because of the casting vote of the chairperson. Again, that person must have voted in favour of the resolution.

The Court had considered the question of how a chairperson can properly exercise a casting vote in a July 1999 decision (*Re Coalleen Pty Ltd (Administrators Appointed)*) (1999) 30 ACSR 2000). This case held that a Court must assess the appropriateness of a casting vote according to whether:

“The administrator has properly exercised the casting vote in the interests of creditors as a whole, such as in circumstances where the vote or votes which prevent one of the two conditions being fulfilled would represent an outcome unfair to the remaining creditors if not reversed by our casting vote”.

In the present case the Court found in favour of the applicant for the following reasons:

- ◆ the applicant was the major creditor and had sought the winding up of the company;
- ◆ the directors voted in favour of the motion and may have had a preference that was recoverable against them in a winding up;
- ◆ the claims of the remaining creditors totalled \$1,700 and they would receive only \$119 more under a deed, while the applicant's claim was \$90,903.31;
- ◆ the creditors' interests would not be prejudiced if the court set aside the resolution, as the applicant had offered to pay them this difference; and
- ◆ there was evidence of deficiencies in the valuation made by the administrators.

This case provides a useful guide for administrators and creditors on the proper use of the chairperson's casting vote at creditors' meetings.

Administration and the fruits of the questionable charge.

Case Name:

Re Lin Creations Pty Limited;
Lin Creations Pty Limited v
Morton

Citation:

Unreported, Supreme Court of
Victoria per Byrne J.

Date of Judgment:

3 December 1999

Issues:

- ◆ Company Administration
- ◆ Appointment of administrator by chargee
- ◆ Charge procured by fraud
- ◆ Law s436C, s447A

In this case in the Victorian Supreme Court examined whether a Court should, on an interlocutory basis, interfere with an administration which was alleged to have been brought about by a chargee allegedly appointed by fraud.

Lin Creations Pty Limited (*Lin Creations*) operated a fruit and vegetable shop in Footscray and a grocery store in Springvale. The company's chargee had appointed an administrator pursuant to Part 5.3A of the Law. The administrator closed down the Springvale business on the day of its appointment.

The company's sole director sought interlocutory, temporary and final relief, seeking orders that the administrator permit the director to reopen the Springvale business and manage the company's business during the administration, upon the director giving certain undertakings. The basis of the application was that the charge over the company's business was alleged to have been procured by fraud and further, that it was meaningless due to certain drafting deficiencies.

The director was from a non-English speaking background and alleged that when she executed the charge she thought it was a sale agreement for the purchase of the Springvale business. The director had received \$100,000 from the chargee which she alleged was a deposit on the sale price of the Springvale business of \$580,000. An executed loan agreement was before the Court and the chargee had submitted that the chargee had demanded repayment of the \$100,000 loan plus a \$50,000 penalty interest. The landlord of the Springvale business had also determined the lease of the property in which that business was conducted.

In refusing the relief sought Byrne J made the following findings:

1. arguments about whether the form of the charge complied with s436C(1) of the Law were not sufficient to grant the relief sought. Section 436C(1) states that a person who is entitled to enforce a charge on the whole, or substantially the whole, of a company's property may appoint an administrator if the charge has become and is still enforceable;
2. the company appeared to be solvent;
3. *"The spirit of Part 5.3A is, generally speaking, the conduct of the affairs of the company under administration is given to the administrator and the creditors. The Court should rarely intervene and only then where the statutory procedures are not operating properly. The Court will be particularly reluctant to interfere where this would involve a direction to the administrator as to any commercial aspect of the administration"*;

4. the Court raised the issue but did not give a firm view on whether s447A of the Law, either with or without Part 9.5, would warrant the relief sought. (Section 447A gives a Court the power to make such orders as it thinks appropriate on how Part 5.3A of the Law is to operate in relation to a particular company, and Part 9.5 states the general powers of a Court to grant relief under the Law.);
5. while acknowledging that there may be a real issue to be tried in relation to the circumstances in which the charge was executed, Byrne J found that a valid Part 5.3 administration was in place, and in that context he was not satisfied that the balance of convenience favoured interfering with the administration in the circumstances; and
6. Byrne J also noted that if it should later appear that the charge was void, then the company's remedy lay in damages.

The case is an example of a case in which even though there was a real issue as to the validity of documents on which a Part 5.3A administration is founded , the Court was not prepared to interfere with an otherwise valid administration.

Being impartial means being fair to everyone.

Case Name:

Re Spargold Enterprises Pty Limited; ex parte Geoffrey David McDonald & Anor

Citation:

Unreported, Supreme Court of New South Wales per Santow J.

Date of Judgment:

21 June 1999

Issues:

- ◆ Duty of impartiality owed by deed administrators to all creditors
- ◆ Termination of DOCA
- ◆ Fairness to post DOCA creditors
- ◆ Law s445D, s447E

This case involved an application by the two administrators under a DOCA who were previously administrators of the Company Spargold Enterprises Pty Limited, a company which was hopelessly insolvent.

The deed administrators applied to terminate the DOCA under s445D of the Law. This was to prevent a distribution of dividend pursuant to the DOCA, which would leave nothing for the post DOCA creditors.

The judge noted that the provision of credit by the post DOCA creditors had allowed the company to continue to trade for the benefit of the pre DOCA creditors. The post DOCA creditors should thus not have to incur additional expense in funding a challenge to the distribution of dividend. In this situation, under s447E, the Court would most likely have made an order restraining the distribution of dividend. Termination of the DOCA would prevent such distribution without need for order under s447E.

The deed administrators had standing to make the application for termination as interested persons under s445D.

It was held that the deed administrators owe a duty of impartiality to all pre and post deed creditors and that distribution under the DOCA would unfairly prejudice post DOCA creditors. Termination of the DOCA was ordered, allowing time for the pre DOCA creditors to be given notice and to make submissions.

Ability of company administrators to conduct examinations.

Case Name:

Re Italo-Australian Centre (Subject to a Deed of Company Arrangement)

Citation:

(1990) 30 ASCR 388, Supreme Court of Queensland per Lee J.

Date of Judgment:

22 March 1999

Issues:

- ◆ Company Administrators
- ◆ Powers of examination available to administrators
- ◆ Law s435C, s438, s438D, s597

The Italo-Australian Centre (the Company) was placed under administration by its directors and subsequently a DOCA was entered into.

Under the DOCA, the administrator had the power to conduct public examinations of various parties to assist with investigations and to prosecute any potential action available to the Company for breach of duty or negligence by any party which resulted in the company suffering a loss.

Orders were sought by the applicants that the administrator be limited in its enquiries to matters within the DOCA. Another order was sought requesting that the administrator provide the applicants with written notice outlining the examination so as to ensure it was within the scope of the administrators powers. This later order was rejected because prior notice of the scope of examination may defeat or affect the purpose of such an examination.

Administrators of DOCA are given powers of examination pursuant to s597 of the Law, and need only show that they are acting in the performance of their duties under the deed and not for any extraneous purpose. In the present case the only extraneous purposes asserted would arise if questions were asked in respect of matters for which neither the administrator nor the company could bring an action pursuant to the DOCA.

An extraneous purpose, it was held, was a purpose entirely outside the scope of the sections conferring the power to conduct a public examination. This would not however exclude questioning on matters relating to possible insolvent trading, preferential payments and the like.

Section 438 refers to an administrator “*of a company under administration*” as owing a duty to ASIC to report possible offences. However “*administration of a company*” ends when a DOCA is executed as per sections s435C(1)(b) and s435C(2)(a). It was held that s4380D imposes an obligation on an administrator of a company under administration (not an administrator acting pursuant to a DOCA) to report to ASIC any offences or possible offences, but that does not prevent an administrator acting pursuant to a DOCA from asking questions in relation to any possible offences.

An administrator of a company under a DOCA therefore, is not prohibited from asking questions of an examinee and about possible offences either directly regarding an offence or in the proper and general course of enquiry.

Restraining securities holders from acting in relation to companies under administration.

Case Name:

Debis Financial Services
(Australia) Pty Ltd v Allied
Bellambi Collieries Pty Ltd
(Receivers Appointed)
(Voluntary Administrator
Appointed)

Citation:

Unreported, Supreme Court of
New South Wales per Hamilton J.

Date of Judgment:

10 September 1999

Issues:

- ◆ Rights of holders of securities
- ◆ Restraint of rights in relation to companies in administration
- ◆ Law s441D

This case considered the circumstances in which the Court should restrain a chargee, receiver or other person from exercising rights arising under a charge when the chargor company was under administration but the enforcement of the charge had begun before administration.

Allied Bellambi Collieries Pty Limited (*Bellambi*) operated a colliery. In those operations Bellambi used a continuous coal miner machine (the *machine*) which was charged in favour of Debis Financial Services (*Debis*). Bellambi was in default of its obligations under the charge which gave Debis a right to repossess the machine. Debis appointed a receiver of the machine under the charge before the VA commenced. Among the rights which Debis had under the charge was the right to do or cause to be done anything requested by it to assist in the execution, or exercise, of any power conferred by the charge, such as, for instance, the powers to repossess and sell. Under the charge Debis was entitled to charge Bellambi for any costs it incurred in recovering the machine.

The machine was 14 kilometres down the coal mine at the time of the application. It was a large machine and it would be difficult and costly to remove. Debis sought an injunction from the Court to facilitate recovery of the machine and the administrator sought orders from the Court under s441D(2) of the Law to prevent the machine's recovery during the continuation of the administration. Pursuant to s441D(3) of the Court could only make the order sought by the administrator if it was satisfied that what the administrator proposed to do during the administration would "*adequately*" protect Debis' interests. The administrator was proposing to carry into effect a suggested DOCA. At the time of the application there was only a week to go before the final creditors' meeting to determine whether to enter into the DOCA or to go into liquidation. The proposed DOCA included the simultaneous execution of an Agreement under which the colliery operation would be sold (the *Agreement*). The Agreement contemplated either that the machine may or may not be purchased along with the colliery the machine could obviously only be purchased if the amount owing to Debis was paid out.

There was evidence that it was the present intention that the DOCA and the Agreement would only be entered into if the purchase of the machine was effected and Debis paid out. If that happened Debis' problems would be over. The problem was that intentions can change and if the sale of the colliery went ahead without the machine being sold the machine would still be in the depths of the colliery. Debis would then have a problem as, although it would have rights as against Bellambi and over the machine itself, the new owner could operate mining operations in the colliery and might object to being disturbed or disrupted by the removal of the machine blocking access to the colliery for some time.

Hamilton J noted that there was little or no authority on the exercise of the Court's discretion under s441D(2) of the Law. In approaching the exercise of that discretion the Court needed to take into account the policy of the Law in relation to administration and in relation to the exercise of the rights of creditors of the company during the administration. Hamilton J thought that some assistance could be derived from decisions relating to s444F of the Law, which is the corresponding provision of the regime prevailing during the subsistence of a DOCA. Previous authority had noted that the authorities indicated a reluctance to deprive a secured creditor of its proprietary rights or to sanction an arrangement which would cause those rights to depreciate substantially in value and that it was unlikely to be the case that a secured creditor who was deprived significantly of its rights, or of the value of its interests, without substantially equivalent compensation, could be described as being adequately protected.

Hamilton J took those comments on board and then turned to consider whether or not the protection proposed by the administrator during the administration would be adequate. He considered that "*adequate*" was a word importing notions of relativity when used in the context of s441D(3).

The administrator proposed to enter, if he could, into the DOCA and the Agreement. In response to Debis' concern that upon a sale its position may be weaker, *vis á vis*, a purchaser, than at present it was, *vis á vis*, Bellambi, the administrator suggested an undertaking. The undertaking relevantly provided that he would not sign a Sale Agreement unless it provided that the Purchaser assented to the Vendor or the chargee of any charged assets on the premises removing those assets from the premises upon giving reasonable prior notice to the Purchaser. That right was to be restricted to such times as would cause as little disruption as reasonably possible to the operation of the Business by the Purchaser and would be subject to any applicable statutory requirements. As a condition of exercising that power the chargee would be required to:

- ◆ pay all costs directly related to the removal (excluding loss of production costs); and
- ◆ pay to the Purchaser any costs reasonably incurred by the Purchaser in complying with any statutory requirements relating to the removal.

Hamilton J noted that as a matter of reality (as Bellambi was in administration) if Debis wished to recover the machine all it could do during the administration was to incur for itself the costs of removal of the machine and debit them to the account of Bellambi. Hamilton J felt it was a fairly remote possibility that Debis would in fact suffer any additional difficulty or significantly greater costs in recovering the machine in the following week when the company would be either in liquidation or the DOCA and Agreement had been entered into. He felt that the administrator's proposal which would bind the Purchaser would largely remove that disadvantage because it would permit the removal of the machine even if that caused some disruption to the operation of the colliery and would not require Debis to compensate for that disruption. In those circumstances, he felt that Debis' interests would adequately protected and exercised his discretion under s441D(2) of the Law. He made the point that in exercising that discretion, he bore in mind:

- ◆ the shortness of the remaining duration of the administration;
- ◆ the protection afforded to Debis whether the DOCA came into effect or not and whether the Agreement came into effect or not; and
- ◆ the general policy of the Law to permit companies to be returned to viability or to arrange for enterprises which companies have conducted to be disposed of as going concerns, so as to effect the greatest return to the creditors and contributories.

This case is an important contribution to the Law in relation to the factors which the Court is likely to take into account when it is asked to exercise its discretion under s441D. It shows that even where a chargee has validly exercised its rights before the chargor company goes into administration the chargee will not necessarily be able to utilise all of its contractual powers under the charge. If such rights are challenged to successfully ward off that challenge the chargee should gather clear evidence of how it will be prejudiced if it is not able to exercise those powers.

Landlords' rights to land leased by administered company.

Case Name:

Re Java 452 Ltd (Administrators Appointed); Permanent Trustee Australia Ltd v Stout

Citation:

Unreported, Supreme Court of Victoria per Byrne J.

Date of Judgment:

9 July 1999

Issues:

- ◆ Possession of real property occupied by company in administration
- ◆ Law s440C

In this case the Court considered the circumstances in which a landlord should be given leave to take possession of real property occupied by a company in administration.

Java 452 (**Java**) ran a café under the name “*Java Express*” on the ground floor of 452-470 Flinders Street, Melbourne. It held the premises as assignee of a lease granted by the owner Permanent Trustee. Java ran into financial difficulties and Permanent Trustee gave notice of default under the lease asserting non-payment of rent. Administrators were appointed and called a meeting of creditors. A resolution at that meeting that the company be wound up was not carried. Offers were received for the purchase of the business outright which involved an assignment of the lease.

Permanent Trustee commenced proceedings seeking leave to take possession of the premises in accordance with the Law. It claimed that the lease had been terminated and that it had negotiated a substantial lease with another party thereby requiring possession of the property.

A term of the lease provided that where a valid notice of default is issued the lessor may re-enter the premises and thereupon the term “*will absolutely cease and determine*”. Byrne J found that although there had been no physical re-entry, correspondence from Permanent Trustee terminated the lease. However, the relevant correspondence terminating the lease was sent after Java had been placed in administration. Byrne J concluded that at common law Permanent Trustee had a present right to possession which it might enforce by re-entry or by an action for possession.

Byrne J then turned his mind to the effect of Pt 5.3A of Law on the issues before him. He stated that:

“The scheme of Pt 5.3A is to confer on the creditors of a company which is insolvent or likely to be so the power to determine its future. ... The intention of the legislation is to create a short breathing space for the company and those in control of it. It prevents creditors during this period, even secured creditors, from engaging in a disorderly and distracting grab for the assets of the company which might prejudice the interests of the creditors as a whole and jeopardise the possibility that the business of the company might be continued under a company deed of arrangement or otherwise with the support of the creditors.”

However, provision is made for a number of exceptions to such moratorium:

- (a) where a lessor has taken steps by the beginning of the administration to recover the property;

- (b) with the administrator's consent; or
- (c) with the leave of the Court.

In the present case Byrne J thought that only option (c) was available to him on the facts. In exercising his discretion, a discretion which did not offer any guidance on how it should be implemented, Byrne J stated:

"I see my task as that of giving effect to the object of Pt5.3A ... I bear in mind that the discretion under s 440C is given to the court without qualification and it would not be appropriate for the court to set out, even as guidelines, a list of matters which might fetter its exercise."

Permanent Trustee argued, on this point, that refusing the relief sought would impose a hardship on the landlord and the proposed tenant. The administrators argued that invoking the orders sought would invariably produce the result that the company must go into liquidation. The administrators had recommended to the creditors that the company execute a DOCA involving the assignment of the lease to a purchaser, either immediately or in the future and in the interim trade on with a view to being able to pay dividends to creditors.

Byrne J agreed with the later argument and refused the application so that the creditors might have the fullest opportunity to consider their options. He recognised that his decision could only be effective until the holding and conclusion of the second meeting of creditors (which was only 6 days away in this case) and that thereafter Permanent Trustee may be free to exercise its rights to possession without constraint. This time, however, would be sufficient to give the creditors time to consider their options especially in relation to the assignment of the term of the lease which did now not exist and which the lessor refused to grant. If they decided that Permanent Trustee should be bound by the lease, it would be for a future Court to determine whether Permanent Trustee should be so bound.

This case is a helpful analysis of the emphasis the Court will give to the preservation of the rights of creditors to determine the future of the property and will be keen to ensure that the company has the best opportunity for revival and so will not act to deny that opportunity unless the company is beyond salvage.

Administrator fails to bring home the bacon.

Case Name:

National Australia Bank Limited v
Premier Pork Pty Limited

Citation:

Unreported, Supreme Court of
New South Wales per
Windeyer J.

Date of judgment:

27 July 1999

Issues:

- ◆ Notice period for creditor meeting
- ◆ Extension of time
- ◆ Law s439A, s447A

In this case the administrator of Premier Pork Pty Limited (Premier Pork) sent a letter out to creditors to convene the second meeting of creditors one day outside the five days after the convening period required by the legislation.

On 26 July 1999 the administrator applied for an extension of time of one day to rectify that error. On the same day as that matter came before the Court, the Court also considered a Summons for the winding up of Premier Pork founded on a statutory demand served on 13 December 1998, claiming a debt of in excess of \$1 million which had been stood over a number of times since 8 April 1999.

The administrator had been appointed on 30 June 1999. The first creditors' meeting was held on 6 July 1999. On 20 July the administrator sent the letter to creditors convening the second meeting of creditors on 28 July 1999 which was one day outside five days after the convening period.

As the application was not made within the convening period there was no power under s439A(b) of the Law to extend the time. The application was made under s447A of the Law to extend the time limit.

In Windeyer J's view the power to grant such an order could only be exercised where the application was made by the administrator, and not where the administrator had failed to make the application in his own name but had made the application in the name of the company as occurred in the present case. On that technical basis Windeyer J found that the application should fail. Nevertheless he considered the substance of the application.

The administrator argued that the Court should be quick to assist in the case of a procedural mistake. Windeyer J found that that was partly true but said that:

“ . . . the periods fixed by law for the calling of meetings during an administration ought not to be regarded as guidelines only. Administrators must be expected to take proper care in the exercise of their functions. Proper care includes an ability to count.”

The principal reason the administrator advanced for the exercise of the discretion to extend the time period was to enable a DOCA to be considered by the creditors. The administrator supported the proposed DOCA on the basis that:

- ◆ it was unlikely that there would be any realisations by a liquidator for the benefit of unsecured creditors:

- ◆ there was a potential claim available to Premier Pork against National Australia Bank (**NAB**). (That claim was said to be a cause of action in respect of the refusal by the NAB to provide commercial bills which the NAB had contracted with Premier Pork to provide to it); and
- ◆ pending the provision of litigation funding Mr Achilles Constantinidis had agreed to fund the proceedings on behalf of the company but that funding would not be available in the event of a liquidation.

Windeyer J found that:

- ◆ there was nothing to show that the support of Mr Constantinidis would have been valuable support;
- ◆ the administrator had received no information at all from the directors;
- ◆ the Report as to Affairs signed by one of the directors was not a report at all because there was no information given in it; and
- ◆ most importantly that there was no foundation whatsoever for the proposed cause of action against the bank

Windeyer J found that there was no suggestion anywhere that the NAB was obliged not to withdraw credit and was obliged to review the overdraft facility. He found there was no basis to suggest that litigation funding might be available and that there was nothing to suggest that legal advice had been obtained as to the possible success of any action against the bank.

In all of the circumstances Windeyer J came to the clear view that there was no proper basis put forward to support the DOCA, that no proper consideration would have been given to the DOCA as no basis had been shown for the proposed legal action and that there was no evidence that any director supported it. He found that it was in the interest of all concerned that the company be wound up and that the liquidator could then determine whether or not there were grounds for any claim against the bank and he so ordered.

The case provides some useful lessons for administrators as follows:

- ◆ administrators should make their best endeavours to comply with the statutory period set out in the Law;
- ◆ the power to grant extensions of time under s447A of the Law might later be the subject of review by superior Courts following Windeyer J's comments;
- ◆ administrators must be expected to take proper care in the exercise of their functions and that includes an ability to count the time periods set by the Law;
- ◆ if an administrator decides to seek an order under s447A to extend the convening period the application should be made in the administrator's name; and
- ◆ if an administrator wished to seek an order extending the time period evidence of the potential benefit to creditors of the continuation of the administration should be provided to the Court to support the exercise of that discretion.

When is a deed of company arrangement a deed?

Case Name:

MYT Engineering Pty Limited v
Mulcon Pty Ltd

Citation:

Unreported, High Court of
Australia per Gleeson CJ,
Gaudron, Gummow, Kirby and
Hayne JJ.

Date of Judgment:

13 May 1999

Issues:

- ◆ DOCAs
- ◆ Definition of "deed"
- ◆ Law s445G

In this case Mulcon Pty Ltd, an unsecured creditor of MYT Engineering Pty Ltd (MYT), sought to have MYT's DOCA terminated on the ground that it was not a "deed".

Two directors of MYT spoke by telephone at a time when one was on his way to the airport to fly overseas. That director had been told by the other that the DOCA had to be executed that day. Accordingly the director flying overseas gave his fellow director authority to sign all necessary documentation relating to the "execution" of the relevant documentation. The remaining director then arranged for the company seal to be stamped on the document and then affixed the seal both as a director and secretary. As MYT's articles required that every document to which the seal was affixed should be signed by a director and countersigned by another director or secretary. There was no countersignature.

A majority of the Court held that the term "deed" as used in Part 5.3A of the Law does not import a requirement that the document be executed as a "deed" within the normal meaning of "signed, sealed, and delivered". Rather, the document may be executed in a way that any other instrument or agreement not under seal could be executed. This was based on their view that as Part 5.3A does not explicitly set out the requirements for "execution" of a DOCA it could not have been intended that the formal legal process of a document to be executed and delivered under seal applied.

In contrast a minority of the Court took the view that the term "deed" had one legal meaning and that by using that particular word the legislature clearly intended that a DOCA executed under seal. The minority then considered that as the defective deed substantially complied with the provisions, its validity was rescued under s 445G(3).

This case warns that administrators should be careful to ensure that a company's articles are complied with when making a DOCA. However, it suggests that if a DOCA is not properly signed, sealed and delivered it is likely to be valid regardless of this.

Suit yourself - applying to set aside a deed of company arrangement.

Case Name:

Konica Australia Pty Ltd v Aprolab Flashpoint (Australia) Pty Ltd

Citation:

Unreported, Supreme Court of Victoria per Gillard J.

Date of Judgment:

29 July 1999

Issues:

- ◆ DOCAs
- ◆ Application by creditor to set aside resolution for deed of arrangement
- ◆ Law s600A

An application by a creditor to set aside a resolution to execute a DOCA passed at a meeting of creditors was refused by the Supreme Court of Victoria in this case.

The applicant was a creditor of the respondent company. The company appointed an administrator as it was unable to pay its debts. At a meeting of creditors, a resolution was passed to execute a DOCA whereby the creditors would receive part payment. Although the administrator recommended against it, the DOCA was executed. The administrator recommended that the company be wound up because this would result in a greater return to creditors, as calculated in his report. On this basis, the applicant creditor applied to the Court for an order that the resolution to execute the deed be set aside pursuant to s600A(2) of the Law.

The applicant had to establish each of the following:

- (i) **a proposed resolution voted on at a meeting of creditors;**
The resolution to execute the DOCA was passed at the creditors' meeting, satisfying the first limb.
- (ii) **if the votes of "related creditors" were disregarded, that resolution would have failed; and**
"*Related creditors*" include creditors who are directors of the company, relatives of a director or relatives of a director's spouse. Of the 17 who voted for the resolution, 7 were "*related creditors*". For a creditors' resolution to be passed, there must be a majority both in votes *and* in value of the debts. If the 7 "*related creditors*" were disregarded, the resolution would not have been passed. Accordingly, this limb was satisfied.
- (iii) **the passing of the resolution was either:**
 - (a) **contrary to the interests of creditors as a whole; or**
Gillard J was not satisfied that the interests of creditors "*as a whole*" would be disadvantaged by the deed. Some creditors would be directly advantaged by the DOCA and there was a possibility that others would be paid in full if the company continued in business successfully.

(b) has prejudiced or is reasonably likely to prejudice the interests of the creditors who voted against the proposed resolution to an extent that is unreasonable

The applicant asserted that it was prejudiced by the lost opportunity to recover more on a winding up based on the calculations made by the administrator. However, Gillard J weighed the evidence (and lack of evidence) and time frames involved to decide that the administrator's calculations overestimated the returns to the creditors in the event of a winding up. Consequently, the third limb was not satisfied by the applicant creditor.

Gillard J ordered that the applicant's proceeding be dismissed and that the applicant pay costs.

This case is a good guide to the matters a creditor needs to establish if it wished to challenge a resolution of a meeting of creditors in favour of the company executing a DOCA.

Valid termination of a deed of company arrangement.

Case Name:

K&D Sherry Pty Limited (In Liquidation); McLellan v Commissioner of Taxation (Commonwealth)

Citation:

Unreported, Supreme Court of Victoria per Byrne J.

Date of Judgment:

6 August 1999

Issues:

- ◆ Procedural irregularity
- ◆ Validating provision of s1322(2)
- ◆ Law s588FE, s1322

At issue in this case was whether or not a DOCA had been validly terminated to result in the winding up of the company (*Sherry*). The applicants were *Sherry's* liquidators, who had sought to recover payments made by *Sherry* to the respondents on the basis that these payments were preferential and therefore voidable pursuant to s588FE(2).

The respondents sought to argue that the deed administrators had not complied with the termination provisions of the DOCA and that, in effect, the DOCA remained on foot, precluding the liquidator from bringing any actions in respect of potential voidable transactions.

Sherry's creditors had voted in favour of the DOCA, which contained a provision which attempted to set out events which would trigger its automatic termination. Such termination would result in the automatic passing of a special resolution by creditors that the company be liquidated. Once a default event occurred, the administrator was required to give creditors two days notice that the company would be placed in liquidation (the **Notice Requirement**).

It was common ground that a default event occurred and the administrator promptly sent creditors a letter informing them of this fact and that he had decided to grant the *Sherry's* directors an extension of time within which to rectify the default. This letter stated that if, by a nominated date, *Sherry* failed to rectify the default it would be placed in liquidation.

By the nominated date *Sherry* had not rectified the default event and the administrators sent a further letter stating that a special resolution in favour of *Sherry's* liquidation was deemed passed and that *Sherry* was therefore in liquidation. The respondents submitted that neither of these letters satisfied the Notice Requirement and that therefore *Sherry* was not in fact in liquidation. The liquidator argued that the Notice Requirement was merely a procedural step and should not vitiate the clear intention of the DOCA.

The liquidator sought to rely on s1322(2) which provides that a procedural irregularity does not invalidate a proceeding if to hold otherwise would cause substantial injustice.

The Court concluded that the administrator had not complied with the Notice Requirement. The question which therefore arose was whether this failure to comply was a "*mere procedural irregularity*" which might be saved by s1322(2).

The Court decided that the notice given was a procedural irregularity and that the special resolution that Sherry be liquidated was validly passed. Therefore the right of the liquidator to bring actions against the respondents was confirmed. It was not considered that any substantial injustice would occur.

The case highlights the importance of clear drafting of termination provisions in DOCA but also illustrates the potential for s1322(2) to be used to validate procedural irregularities caused by an administrator's failure to comply with a procedural requirement contained in the Law itself or with in a DOCA.

Winding up adjourned!

Case Name:

Waste Recycling and Processing Services of NSW v Local Government Recycling Cooperative

Citation:

Unreported, Supreme Court of New South Wales per Santow J.

Date of Judgment:

28 May 1999

Issues:

- ◆ Winding up
- ◆ Adjournment
- ◆ Law s440A(2), s440A(3), s435A, s444A(2)

This case considered a winding up application to allow a newly-appointed administrator time to consider the prospects of the company and the best interests of creditors.

A creditor of the defendant company made an application to the Supreme Court for an order to wind up the company. The company's newly-appointed administrator applied to adjourn the hearing of the creditor's application.

Under the Law, the Court has discretion to adjourn an application for such an order if it is satisfied that it is in the interests of the creditors for the company to continue under administration. The objective is to maximise the chance of the company continuing to exist, but if this is not possible, to maximise the return to creditors.

The Court listed some factors that needed to be considered when a Court exercises its discretion, namely:

- ◆ the length of the adjournment envisaged;
- ◆ the envisaged purpose of the adjournment; and
- ◆ the likely consequences of such an adjournment.

The Court found that the onus is on the administrator to show that there is a '*sufficient possibility, as distinct from mere optimistic speculation*' that an adjournment is in the interests of creditors.

The Court decided that it was in the interests of the creditors that the administrator be given a brief time (four days) to decide whether the company could continue trading, continue under administration, or whether it should be wound up.

Termination of deed of company arrangement.

Case Name:

Linen House Pty Limited v Rugs Galore Australia Pty Limited (subject to a Deed of Company Arrangement)*

Citation:

Unreported, Supreme Court of Victoria per Gillard J.

Date of Judgment:

2 June 1999

Issues:

- ◆ Termination of DOCA's
- ◆ Law s445D

This case concerned an application to set aside a DOCA on the ground that the information provided to creditors was misleading and deceptive. The application was made under section 445D(1)(a) of the Law.

At the time of its insolvency, Rugs Galore Australia Pty Limited (**RGA**) was owned by a similarly named company Rugs Galore Pty Limited (RG) and had two secured creditors – the National Australia Bank (NAB) and Pindos International Imports Pty Limited (Pindos). A number of unsecured creditors, one of which was Linen House Pty Ltd. RG, which was also insolvent, executed a DOCA that provided for payment of a small sum to its unsecured creditors while leaving the rights of two secured creditors intact.

Subsequently Mr Dowson the sole director of both companies, sold RG's business to RGA. RGA then executed a charge in favour of Real Enterprises Pty Limited (**Real Enterprises**), as well as an agreement which effectively gave Real Enterprises 80 per cent ownership of RGA.

The directors of Pindos included Messrs Lagas, Economou and Bourke. Real Enterprises was a \$2 company owned by Bourke's partner in an accountancy practice, a Mr O'Brien. The same practice provided services to RGA, Lindos and Real Enterprises. Acting under a floating charge over RGA's assets, Pindos applied to have RGA placed into administration.

Following an initial meeting with creditors, the administrator replaced Dowson as a director of RGA with the directors of Pindos, pursuant to s442A of the Law, and issued a report advising that a DOCA should be executed. The proposed terms of the DOCA were being pushed by Pindos and were not, at this stage, in the hands of the administrator, let alone the other creditors.

NAB was concerned that, having already supported RG's DOCA, it was now in a similar situation to RGA. The administrator assured NAB that Pindos would undertake daily management of the company and recommended that the DOCA be executed. NAB responded by demand that Pindos underwrite RGA's debt to the bank – a demand acceded to by Pindos.

Before meeting for a second time with creditors, the administrator issued a circular setting out a Pindos proposal, subsequently carried at the meeting, to provide funds for part-paying unsecured creditors, as long as they released RGA from all provable debts.

In doing so, the administrator failed to advise the unsecured creditors of:

- ◆ the close relationship between RGA's secured creditors (Pindos and Real Enterprises) and between the accountants of RGA and those companies;
- ◆ the relationship between the respective directors of those companies.
- ◆ the previous involvement of these companies in the business affairs of RGA;
- ◆ the motives of the companies making the DOCA proposal;
- ◆ the nature and effect of the agreement between RGA, Pindos and Real Enterprises; and
- ◆ the agreement brokered by the administrator between Pindos and the NAB.

In these circumstances, Linen House Pty Ltd applied to have the DOCA terminated.

The Court found that the object of Pindos in appointing an administrator and then executing the DOCA, was to enable Pindos, Real Enterprises and their respective directors to take over RGA. Effectively the administrators had assisted these companies to become the real beneficiaries of the DOCA by not revealing to the creditors the factors which were material to their decision.

In the Court's view, the investigative functions of the administrator "*were very important*" and obliged him to consider the conduct of the company's directors, offences which they may have committed, voidable transactions, personal liability of any officer of the company for company debts and reasons for the company's financial strife. As the extent of such investigations was the decision of the administrator, it was essential that he act impartially, independently, and in the interests of creditors.

The Court also found that the time limits set by Part 5.3A of the Law provided no excuse for the administrator to fail to conduct a proper investigation of the company's affairs. Indeed, the fact that the second meeting of creditors could be adjourned shows that time constraints are not intended to limit the thoroughness of investigations.

The Court noted a growing belief among administrators that because a DOCA might enable creditors to receive more money than in a winding up, there was no necessity to concern them with other matters. Their assumption was that money is the '*bottom line, and irrespective of how much, a receipt or something is better than nothing*'. This assumption was directly opposed to the rights of creditors outlined in Part 5.3A, which empowers them to decide on a company's future and take any number of other matters into their consideration. The creditors' right to decide must not be fettered by the opinion and '*information filtering*' of the administrator.

Finding that the administrator had not adequately informed creditors when making their decision, the Court terminated the DOCA executed by RGA under s445D.

The Court noted that such a termination may be made if false or misleading information is given to creditors, either by the company's officers via the administrator or by the administrator. The Court does not need to prove fault on the part of any person before it can terminate the DOCA.

Other issues up to the Court's discretion are delays and third party rights gained under the DOCA and whether creditors, even if provided with the accurate and true information, would still have voted in favour of executing a DOCA. That creditors might receive more under a DOCA than on a winding up is a relevant, though not decisive, factor. The weight attached to any of these factors will depend on the circumstances of the case.

This case has important implications for administrators in the completion of their duties and functions by confirming their investigative functions. The case sets a very high standard for administrators.

Getting an extension: buying time to start insolvency proceedings.

Case Name:

Green v Chiswell Furniture Pty Limited (in liq.)

Citation:

Unreported, Supreme Court of New South Wales per Austin J.

Date of Judgment:

23 June 1999

Issues:

- ◆ Voidable transaction
- ◆ Extension of time
- ◆ Law s588FF

This case concerned an application by a liquidator for an extension of time in which to commence proceedings for voidable transactions.

Section 588FF(1) provides that if a company's liquidator makes an application within three years of the "*relation-back day*", the Courts have certain powers to set aside and make other orders in relation to voidable transactions.

Section 588FF(3)(b) allows a Court to extend the three year limit for commencing proceedings in relation to a voidable transaction, if the liquidator applies to the Court within that three year period.

This case arose out of the insolvency of Chiswell Furniture. The key dates and events were:

- ◆ 1 May 1996: Martin Green was appointed administrator of Chiswell Furniture (16 May). A second meeting of creditors of Chiswell Furniture occurred on 28 May. They resolved that the company execute a DOCA.
- ◆ 16 October 1998: As administrator under the DOCA, Mr Green issued a report to creditors and convened a meeting of creditors on 13 November 1998. This was then adjourned to 30 November 1998.
- ◆ 30 November 1998: The creditors met and resolved to terminate the DOCA.
- ◆ December 1998: A secured creditor appointed receivers and managers to Chiswell Furniture (1 December). On 17 December, Justice Windeyer ordered a reconvening of the meeting of creditors to reconsider the winding up resolution and directed that, under s447A, the meeting of creditors held on 30 November 1999 should be treated as being adjourned until 21 January 1999.
- ◆ 21 January 1999: The reconvened meeting occurred and creditors resolved that the company be wound up.

The Court considered that the voluntary winding up of the company was '*taken to have begun*' on 1 May 1996. For the purposes of voidable transactions under s588FE(1) this was to be regarded as the "*relation-back day*".

The Court noted that s588FF(3) does not specify the criteria the Court should consider when deciding whether to grant an extension of time. To determine whether it was reasonable to allow the liquidator to commence proceedings in a period longer than three years, the Court had to establish why the proceedings had not begun within the period. The principal issue was to explain why the delay had occurred.

The Court cited with approval the following comments of Finn J from an earlier case¹

- (a) Ordinarily, the issues raised on an extension application are threefold:
 - (i) the explanation for the delay in bringing the proceedings;
 - (ii) a preliminary review of merits at the foreshadowed proceedings – that is, an investigation as to whether such proceedings should be so devoid of prospects that it would be unfair, by granting an extension, to expose the other party to the continuing prospect of suit;
 - (iii) whether the likely actual prejudice resulting from the grant of an extension is sufficiently substantial to outweigh the case for granting an extension;
- (b) Where the liquidator's purpose in seeking the extension of time is simply to put himself into a position where he can properly decide whether or not to bring proceedings, a preliminary inquiry into the merits of any consequent proceedings may not always be necessary.

In the present case there is no evidence of any prejudice that would flow from granting an extension and so that was not an issue.

The Court felt that the facts before it sufficiently explained the delay in bringing proceedings. From the day of his appointment the liquidator had had just over three months to commence proceedings or to apply to the Court for an extension. Moreover, the liquidator had been hampered in carrying out his investigations because the affairs of the company had been in the hands of the receivers since December 1998.

The liquidator had not proposed to commence proceedings immediately but had sought an extension of time to conduct appropriate enquiries and investigations and to obtain legal advice about whether or not to bring proceedings. He had also envisaged convening a meeting of creditors to consider proposals for funding in relation to prospective litigation.

On the basis of these facts, the Court granted a one-year extension of the time allowed for proceedings to commence.

This case sets a useful precedent for liquidators who may need to apply for an extension of time when the three year limitation period is approaching.

¹ in *Taylor v Woden Constructions Pty Limited*, unreported, Federal Court of Australia per Finn J, 23 August 1998.

Taking action against a company in liquidation.

Case Name:

In the matter of Addstone Pty Ltd; Ex parte Macks

Citation:

(1998) 30 ACSR 177, Federal Court of Australia per Mansfield J.

Date of Judgment:

23 December 1998

Issues:

- ◆ Proceedings against a company in liquidation
- ◆ Leave to commence proceedings
- ◆ Prejudice to liquidator
- ◆ Law s471B

This case concerned s471B of the Law, which provides that a party wishing to bring proceedings against a company being wound up must first obtain leave of the Court. Here, the Federal Court considered some of the factors which determine whether a party should be granted such leave.

The case involved a liquidator who brought proceedings against a legal practitioner who represented the group of companies in liquidation (*Emanuel Group*). An insurer underwrote the funding for the litigation. The insurer also underwrote the practitioner's professional indemnity insurance, which would indemnify the practitioner if the liquidator's action was successful.

The practitioner alleged that the insurer was acting in conflict of interest, breach of fiduciary duty, breach of good faith and breaches of various terms of the professional indemnity policy itself. The practitioner also sought to have the funding agreement between the insurer and the liquidator declared void. The practitioner sought leave of the Court, under s471B, to join Emanuel Group to the action against the insurer, and undertook that they would not enforce any orders made against the Emanuel Group, including costs orders, without further leave of the Court. The purpose of this undertaking was to ensure that if the practitioner did have an entitlement from Emanuel Group, then it would need to be proved in the liquidation so as to be treated equally with the entitlements of other creditors.

The Court held that if leave was granted, then the liquidator would be unable to prosecute the Emanuel Group and its creditors generally, severely prejudicing the insolvent company and its creditors, despite the proffered undertaking. This consideration weighed greatly against the application for leave. Arguments in favour of leave included the fact that it would be desirable to have Emanuel Group as party to proceedings so that they could be bound by its outcome and the fact that the conduct complained of was significant. Notwithstanding these factors, The Court refused the application for leave to proceed against Emanuel Group.

It was clear that a significant consequence of granting leave to proceed against Emanuel Group would have been that the liquidator would be unable to bring an action against the insolvent company and therefore, would be deprived of the opportunity of realising an asset which could be distributed to creditors.

A Court will be reluctant to grant a party leave to proceed against a company in liquidation under s471B if the result of leave would adversely affect a liquidator's prospect of realising company assets.

A taxing issue - priority of tax payments in a liquidation.

Case Name:

Deputy Commissioner of
Taxation v BJ Marron & Son Pty
Ltd (In Liq)

Citation:

Unreported, Supreme Court of
Victoria per Warren J.

Date of Judgment:

23 April 1999

Issues:

- ◆ Priority of payments in distribution of company property
- ◆ Priority of tax payments
- ◆ Law s564

This case involved an application by the liquidator of BJ Marron & Son Pty Ltd (Marron) for orders under s564 of the Law that two sums be paid to the DCT in priority to other creditors of the company.

Section 564 of the Law allows for the Court to make orders giving certain creditors an advantage over others where those creditors have provided an indemnity to the liquidator (such as for the costs of litigation) under which property has been recovered, protected or preserved.

Most creditors of Marron were very small but the largest was the ATO which had a relatively substantial claim. Prior to his appointment as liquidator, the provisional liquidator sought legal advice regarding potential causes of action. As a result of such legal advice the liquidator decided to pursue Marron's former solicitors over losses it suffered in an earlier real property transaction. Unfortunately, the liquidator did not have the funds to pursue the cause of action (which represented Marron's only significant asset) and creditors were unwilling to fight it. All, that is, except the DCT who agreed to indemnify the liquidator and meet all legal costs. The proceedings were ultimately successful.

The liquidator sought an order that he was entitled to pay the DCT's legal costs back to it in priority to the claims of other creditors. The liquidator also sought an order that he was entitled to pay the debt of \$22,833.15 owing by the company to the DCT in priority to other creditors. This would have the effect that after the payment of the liquidator's costs, the winding up, and these payments to the DCT, the remaining creditors would receive approximately 10 cents in the dollar. If the DCT had not provided indemnity to the liquidator, the liquidator would not have been able to fund the proceedings, and it is likely that the creditors would have received no return at all.

The Court considered that s564 should be applied liberally. Particular attention was given to the statement of Hayne J in *Re Ken Godfrey Pty Ltd (in liq)*:

"In my view, it is clear that at least in this case and perhaps more generally, creditors who put their own credit at risk by providing indemnity for costs or litigation to be pursued by a liquidator should receive more from the fruits of any successful action..."

The central consideration for the Court was the fact that the only contributor towards the proceedings was the DCT. If contributions had been received from other creditors, it is likely that the Court would have held that all unsecured creditors were entitled to receive a distribution equal to the amount that they would have received if the proceedings had not been pursued, with the DCT being entitled to all of the residual amount.¹

However, in the absence of other contributors, the 10 cents in the dollar windfall for unsecured creditors, as a result of the successful proceedings, and the liberal interpretation deemed necessary in the application of s564, the Court held that the DCT was entitled to receive more of the fruits of the successful proceedings than the other non-contributing creditors.

Accordingly, the Court granted the orders under s564.

This case illustrates the benefits which can be available to unsecured creditors owed significant amounts of money in indemnifying a liquidator for the costs of proceedings designed to recover, protect or preserve company assets or moneys.

¹ As was held in *Allquip (WA) Pty Ltd (in liq) v Allan & Ors* (1997) 25 ACSR 765

Carrying on business during a liquidation.

Case Name:

Re Rico Pty Ltd

Citation:

Unreported, Supreme Court of New South Wales per Young J.

Date of Judgment:

30 November 1998

Issues:

- ◆ Carrying on of business during winding up of corporation
- ◆ Factors the Court will consider in relation to s420C order
- ◆ Law s420C

This case involved an application by the receiver of Rico Pty Ltd (Rico) for an order under s420C of the Law permitting him to carry on the business of the corporation during winding up.

The receiver had been appointed by the State Bank (the *Bank*) after it became clear that Rico would not be able to pay money owing to it. The Bank's appointment was subject to a charge over all of the company's assets and undertakings. This charge conferred wide powers to the receiver. Following VA, Rico went into liquidation.

The principal business of Rico was the design and construction of engineering plant and necessary equipment with Mt Isa Mines Ltd (*Mt Isa Mines*). The receiver had previously negotiated a continuing contract with Mt Isa Mines which made a large profit for Rico. The receiver wished to proceed with a second stage of that contract which would allow Rico to continue trading and provide for the continued employment of thirty employees. If the second stage were completed it would provide little benefit for unsecured creditors of Rico, but would benefit the secured creditors and employees.

The receiver sought the consent of the liquidator for the completion of the second stage, however the liquidator declined to give consent. The principal reason being his belief that if the second stage was not successful it could result in further claims against Rico. Despite the receiver having taken out insurance and the outcome of the second stage bearing little impact on unsecured creditors, the liquidator continued to refuse consent unless it could be shown that there was a benefit to the unsecured creditors.

Prior to this case, there had been no previous decision on the scope of s420C and prior to the introduction of the provision, authority suggested that a receiver's role as agent for the company ceased upon liquidation¹. The Court held however, that this previous authority appeared to be the reason for the introduction of s420C. In its consideration of the meaning and scope of s420C, the Court noted that the provision is located in Pt5.2 and is thus focused on the powers of receivers rather than the orderly liquidation of the company. In this way, the section is not directed towards liquidation per se.

In contrast, s420C is directed towards the situation when the liquidation has interfered with the proper conduct of the receivership. The Court recognised that both the liquidator and the public generally have the right to be involved in the decision as to whether the receiver's agency should continue.

The Court considered that whilst it is important to protect unsecured creditors of the company under the provision, in many cases it will also be important to consider the interests of the employees. It is unclear what factors the Court will take into account in determining whether the interests of the employees

are a relevant consideration. In the present case however, the Court held that the circumstances provided for the interests of the community generally, including the employees, to be a relevant consideration. The Court concluded that the second stage would provide substantial benefits to the thirty employees of the company, whilst having no material or substantial effect on the unsecured creditors.

Accordingly, the Court made the order under section 420C.

The Court found that the interests of employees must be taken into account, where a receiver makes an application under s420C of the Law but did not consider what specific factors should be taken into account. Accordingly, these will vary from case to case.

¹ *Re Leslie Homes (Aust) Pty Ltd* (1984) 8 ACLR 1020.

Payment of employee entitlements in a winding up.

Case Name:

Office-Co Furniture Pty Ltd
(Receivers and Managers
Appointed)

Citation:

Unreported, Supreme Court of
Queensland per de Jersey CJ.

Date of Judgment:

26 March 1999

Issues:

- ◆ Payment of employee entitlements
- ◆ Payments to be made in a winding up
- ◆ Law s433, s556 & s588

The receivers of Office-Co Furniture Pty Ltd sought a direction that they should pay those employees which had accrued both annual and long service leave, but had not taken it up, to the time of the commencement of the receivership.

Section 433(3)(c) of the Law relates specifically to receiverships and the payment of debts or amounts that are in the winding up of a company, payable in priority to other unsecured debts pursuant to s556 of the Law.

Section 556 determines those amounts that are *due* for the purposes of a company winding up and to be paid in priority to other unsecured debts and claims.

Section 588 has the effect of “*deeming*” the employment of employees as terminated as at the commencement of the winding up.

The Court held that although s433(3)(c) specifically refers to s556 in the case of receivership, s556 must also be read with s558 which specifically deems employment as terminated in cases of winding ups. The intent of s433 is then that similar priority be accorded in cases of receivership as with winding ups. So s558 applies, if indirectly, to cases of receivership since s558 operates on s556 and in turn on s433.

At the date of commencement of receivership the employees were allowed payment of their accrued annual and long service leave entitlements in respect of employment prior to the appointment of the receivers and managers.

Is the award of an arbitrator valid in relation to a company already in liquidation?

Case Name:

Doran Constructions Pty Limited
(in liquidation) v Beresfield
Aluminium Pty Limited

Citation:

Unreported, Supreme Court of
New South Wales per Brownie
AJ.

Date of Judgment:

21 May 1999

Issues:

- ◆ Companies in liquidation
- ◆ Validity of award against a company placed into liquidation
- ◆ Law s500(2)

This case considered the validity of an arbitrator's award in the context of a company in liquidation.

Section 500 (2) of the Law provides that:

"After the passing of the resolution for voluntary winding up no action or other civil proceedings shall be proceeded with ... against the company except by leave of the Court and subject to such terms as the Court imposes."

The company passed a resolution for the winding up of a company prior to the publication of two relevant arbitrators' awards. After the second of those awards was published a receiver was appointed to the company.

The company argued that there was a pre-condition requirement which needed to be satisfied under s500(2) that the arbitrator must obtain the leave of the Court before proceeding with the arbitration. Therefore, as the awards were published after the company voted for liquidation, the awards were nullified by the provision in the Law.

His Honour found that:

"I do not think it is relevant but I really cannot imagine that the liquidator would not want to know what the arbitrator thought, or that any Judge, if asked at that stage, would have failed to grant leave to proceed to publish the award. It would, of course, be necessary to obtain leave to enforce the award. ... It does not seem to me that the legislative intention disclosed was that an act taken in contravention of section 500(2) would, by virtue of those circumstances alone, be a nullity."

His Honour held that the awards of the arbitrator were not nullities by reason solely of the fact that there had been a resolution passed for the voluntary winding up of the company before the awards had been published.

This case will be of much significance to liquidators of companies placed into liquidation whilst awards on judgments are pending.

What's a "super-added statutory quasi-trust"?

Case Name:

Environmental Agency v Stout

Citation:

[1991] 1 All ER 746, High Court of England & Wales, Chancery Division per Neuburg J.

Date of Judgment:

20 April 1999

Issues:

- ◆ Liquidation
- ◆ Priority for payment of debts
- ◆ Outstanding legal claims
- ◆ Law s500(2)

In this case the High Court of England and Wales delivered a concerning decision dealing with priorities for the payment of debts where a company in liquidation had environmental claim against it. The relevant provisions required rehabilitation or remediation of a site and had been incorporated into the environmental licence or mining lease issued in favour of the insolvent company.

In this case Mineral Resources Limited (*Mineral Resources*) had been issued with a waste management licence pursuant to the *UK Environmental Protection Act*. Mineral Resources was later placed into liquidation, and the liquidator sought to disclaim the licence. The Court held that having regard to the legislative scheme set up by the *Environmental Protection Act* and the *Insolvency Act*, the liquidator could not disclaim the licence.

One of the arguments which was advanced by the liquidator in favour of allowing him to disclaim the licence was that the Environmental Agency would be entitled to prove in the liquidation for any loss or damage which it suffered as a result of the disclaimer, namely the loss of the right given by the *Environmental Protection Act* to enter upon the subject land, to rectify any environmental problems and to recover the cost of that work from the licence holder.

In respect of that argument, it was held that the Environmental Agency had not suffered any loss or damage and, therefore, could not prove in the liquidation. This was because:

- ◆ the Environmental Agency was not under any duty to carry out the necessary rehabilitation and remedial work; and
- ◆ the only loss suffered by the Environmental Agency was the loss of the right to recover the cost of work which it might in the future (though it may not) have chosen to carry out at its own expense.

In essence, it was held that it was not the Environmental Agency but the general public which had suffered the loss arising from the degradation of the environment.

The Court distinguished the facts before it from a breach of a standard commercial lease. It was said that in the normal circumstances of the lease, the damage to the property was a detriment suffered by the other party to the lease, namely the landlord whose own property had been affected. This was not the case, it was held, with the breach of a waste management licence as it was not the land of the Environmental Agency which was affected.

If the reasoning contained in the decision with respect to the proof of debt issue is followed, then many environmental liabilities may not be capable of proof in an administration or liquidation of an insolvent company.

However, this did not leave the Environmental Authority without a remedy. The Court held, on public policy grounds, that the assets of Mineral Resources were held on a “*super added statutory aspect of the quasi trust*” for the purpose of complying solely with waste management licence. The consequences of this “*super added statutory aspect of the quasi trust*” are significant from the point of view of liquidators and secured and unsecured creditors.

Liquidators

The concern raised by the liquidator was that if the assets of the company in liquidation were held on trust for the purpose of complying with the duties imposed pursuant to a waste management licence, there would be no satisfactory basis upon which the liquidator could recover his fees or costs.

The Court recognised that such a consequence “*raised a general point of concern*” because if it was known that liquidators could not recover their reasonable costs and a reasonable rate of remuneration in respect of ensuring that the company complied with the licence, nobody would be prepared to accept an appointment as a liquidator of a company that held such a licence.

The substantial public policy considerations against such an outcome were addressed by the Court by allowing the liquidator to recover the costs associated with compliance with the licence. At 764 it was stated:

“In a case such as the present, a waste management licence is beneficially the property of the company and remains so after the liquidation if it cannot be disclaimed. Thus, if the liquidator negotiated a transfer of the licence, it could not, I think, be seriously suggested that he could not recover his reasonable costs and remuneration in connection with that transfer. Furthermore, if the liquidator could not disclaim the licence, it would be a necessary part of his task as liquidator of the company to ensure, so far as possible in light of the financial situation of the company, that it complies with its obligations under the licence.”

On this basis, it was held that the liquidator could receive his fees and disbursements incurred in complying with the licence from the property of the company without being in breach of the super added statutory quasi trust. However, the decision is silent in respect of costs which were incurred which did not relate directly to comply with the licence.

Secured Creditors

Whilst the decision does not expressly consider the position of secured creditors, it could be argued on the basis of the reasoning of the Court that secured creditors would not be entitled to have recourse to the company’s assets to the extent that such assets were held on trust for the purpose of complying with the environmental obligations of the company. Clearly, if this were to be the case, such environmental liabilities could seriously prejudice the position of the secured creditors.

Unsecured Creditors

The fact that the costs of complying with an environmental licence would rank ahead of unsecured creditors was conceded by the Court. The prejudice to unsecured creditors however was rationalised upon alternative grounds. In the event that the creditors were substantial institutional creditors, it was said that they should not be concerned because they would be used to adapting to the changing requirements of society and the Law. Further, in the case of smaller, less sophisticated creditors including creditors otherwise entitled to priority, the Court stated:

“Unpalatable as it might be for small unsecured creditors to be prejudiced, it is not particularly surprising, in the present climate, that the public interest in protecting the environment should rank ahead of their interests”

As a result, the Court ordered that the liquidator must not apply any of the assets of the company by way of payment or distribution to any creditors except if:

- (a) full provision had been made out of the assets of the company for the costs of discharging the company’s present and future obligations under the licence; or
- (b) the licence has been terminated in accordance with the provision of the *Environmental Protection Act*.

This decision has not yet been considered further in any jurisdiction. It is suggested that there may be deficiencies in the reasoning of the Court (except possibly in so far as it relates to the proof of debt issue). Accordingly, if it became necessary to argue the merits of the decision, it is likely that there would be reasonable prospects of persuading a court that the decision should not be followed in Australia. Australian Environmental authorities are no doubt reading the judgment with great interest.

All creditors must be treated equally.

Case Name:

Katingal Pty Ltd v Amor

Citation:

Unreported, Federal Court of Australia per Burchett J.

Date of Judgment:

26 March 1999

Issues:

- ◆ Application by a creditor in relation to company property
- ◆ Constructive trust
- ◆ Law s471B

This case involved Flexible Pty Limited (*Flexible*) who sought to have the assets of another company, Australasian Memory Pty Limited (*Australasian Memory*), which was in liquidation, declared to be held on constructive trust. Flexible alleged a manager and director of Flexible and a shareholder in Australian Memory, Mr Amor, transferred business opportunities, goodwill and assets from Flexible to Australasian Memory.

However, Australasian Memory was in liquidation with more liabilities than assets. This meant that if the assets of Australasian Memory were held in trust exclusively for Flexible, the creditors of Australasian Memory would have their already very small dividend reduced to nothing.

The Court refused to grant leave for Flexible to pursue this action as it considered the action had little chance of success. The Court held that if a constructive trust were declared, the assets of Australasian Memory could not be considered separately from the liabilities it had incurred as it regarded a constructive trust as an adaptive, equitable remedy for Flexible's loss, rather than as an institution that must be applied wholesale without regard for equitable principles. This concept was seen as compatible with the interests of innocent third party creditors whose just claims to the assets of the business should be taken into consideration.

This case indicates that where a company is in liquidation the Court is reluctant to place its assets under a constructive trust in favour of another company as this would cause great detriment to the creditors of the company in liquidation.

Matters to be considered when terminating a winding up.

Case Name:

Intag International Limited (in liquidation); Westpac Banking Corporation v Intag International Limited

Citation:

Unreported, Supreme Court of New South Wales per Santow J.

Date of Judgment:

29 June 1999

Issues:

- ◆ Termination of liquidation
- ◆ Law s436B

This case considers the circumstances in which Court terminates the liquidation of a company using section 482(1) of the Law.

The case involved Intag International Limited (*Intag*), which was placed into liquidation. With the leave of the Court, the liquidator was appointed as administrator via an application made under s436B(2). Two weeks later, the creditors authorised the execution of a DOCA following the emergence of a salvage proposal. The liquidator applied to the Court to terminate the winding up, arguing that the best return to the unsecured Intag creditors would be achieved if the DOCA was implemented. This could only occur if the liquidation was terminated.

The Court considered the circumstances in which such an order ought to be given. Santow J held that the following things should be considered:

- ◆ the solvency of the Company must be sufficiently assured;
- ◆ the Court must consider whether such a termination will be conducive or detrimental to commercial morality and the interests of the public at large;
- ◆ in doing so, it will be appreciated that the interests of the public at large and commercial morality are best served by precluding the return from liquidation of companies whose solvency is still questionable or whose past insolvency is the result of mismanagement when no adequate steps have been taken to correct it; and
- ◆ it is important to have adequate assurance that the restored company has arrangements in place to correct for the future those causes of its past failure. It is therefore not enough merely to look to solvency though that is a necessary condition of terminating liquidation.

The Court imposed several obligations on the company relating to the receipt of certain payments envisaged by the DOCA and to the appointment of directors and independent financial controllers. If these were not satisfied, the company would automatically return to liquidation through a self-executing order.

This case provides a good indication of when the Court will terminate the liquidation of a company.

Winding up a foreign company.

Case Name:

Re New Cap Reinsurance Corporation (Bermuda) Limited & The Corporations Law

Citation:

Unreported, Supreme Court of New South Wales per Young J.

Date of Judgment:

3 June 1999

Issues:

- ◆ Winding up a foreign company
- ◆ Appointment of a provisional liquidator
- ◆ Request for assistance from a foreign court
- ◆ Law s581

The Bermudian liquidator of a Bermudian company succeeded in having a provisional liquidator appointed to the company's assets in Australia.

The Supreme Court of Bermuda appointed a provisional liquidator to New Cap Reinsurance Corporation (Bermuda) Limited (*New Cap Bermuda*). The provisional liquidator in turn sought to have the Supreme Court of NSW appoint a joint provisional liquidator to the Australian assets of New Cap Bermuda. New Cap Bermuda was not registered in Australia as a foreign corporation.

The first question before the Court was whether it had jurisdiction to appoint a provisional liquidator to the company. Given that New Cap Bermuda was not registered in Australia, the answer to this question depended on whether the company carried on business in Australia.

The Court held that when seeking the appointment of a provisional liquidator it was only necessary to establish a *prima facie* case that the company carried on business in Australia. His Honour found that this test was satisfied in the present case because New Cap Bermuda had invested funds in Australia, had issued letters of credit to Australians and held insurance policies over risks in Australia.

The second question was whether the Court should exercise its jurisdiction to appoint a provisional liquidator to New Cap Bermuda. The Court indicated that it would not appoint a provisional liquidator as a matter of course. It was necessary to show that there was sufficient ground for the appointment such as, for example, the fact that the assets of the company were in some degree of jeopardy.

In reaching the conclusion that it was appropriate in this case to appoint a provisional liquidator, the Court emphasised s 581 of the Law and the importance of international cooperation in cases of cross-border insolvency. Section 581 provides that the Court may assist the courts of countries like Bermuda which have jurisdiction in a foreign winding up. The Court said:

"In recent years, the problem of corporations in trouble which have assets around the world has become an increasing problem. Winding up law is still basically a fairly local affair, but when there are troubles with the company or group of companies which have assets throughout the world, then special action has to be taken to ensure as much as possible that the worldwide public is protected. To this end the courts throughout the world and particularly courts in Australia must obey the philosophy of s581 of the Corporations Law and facilitate as much as possible the control of assets throughout the world".

In this case, this spirit of international cooperation was crystallised in the form of a letter of request issued by the Supreme Court of Bermuda. Citing an English decision as support, the Court held that where a foreign court sought assistance from an Australian court, the Australian court ought to give the assistance requested unless there was some compelling reason not to do so.

This case indicates the extent to which an Australian Court can act to assist an international insolvency administration.

Looking into the liquidator's mind - access to a liquidator's affidavits

Case Name:

Emanuel Investments Pty Ltd (in liquidation); Elliot v Macks

Citation:

Unreported, Supreme Court of South Australia per Master Burley.

Date of Judgment:

24 June 1999

Issues:

- ◆ Discharge of liquidator's examination
- ◆ Access to liquidator's affidavit
- ◆ Law s596B

This case considered the standards applicable where an examinee seeks orders to discharge a liquidator's examination and/or to gain access to the liquidator's affidavit relied on in support of his application for examination and production.

The liquidator of the Emanuel Group obtained orders pursuant to s 596B of the Law for the examination of various parties. Emanuel Investments and others applied to the Court to inspect the liquidator's affidavit in respect of the examinations. Gaining access to the liquidator's affidavit provides the proposed examinees not only with warning of the topics involved in the examination but also with the armory to have the examination orders discharged.

The order can be discharged if it is shown that the liquidator has not made out all of the statutory requirements involved for such an examination or is not acting legitimately in bringing the application for the examination (referred to as an abuse of process). To gain access to a liquidator's affidavit it is necessary to convince the Court to exercise its discretion to make such an order.

The Court commented on the desirability of not forewarning the proposed examinee of the subjects upon which the examination is proposed. The Court discussed the standard which the applicant must surpass in order that the Court should exercise its discretion. That standard was found to be:

"where the Court is of the opinion that it will or may be unable fairly and properly to dispose of the application if part of the evidence is withheld from the person against whom the order is sought."

One of the applicants' arguments was that considerable duplication would occur between the proposed examination and production of documents now and discovery which would occur later. This duplication would increase costs and cause significant delay in the progress of the case.

The Court, however, found that these matters did not provide a basis for granting leave to examine the liquidator's affidavit. It went on to find that these matters were more relevant to the application to discharge the production and examination orders.

The Court denied the applicants access to the affidavit on the basis that they had not satisfied it if they had an arguable case in relation to the production orders sought.

In relation to the examination orders, the Court allowed the applicants access to only the relevant parts of the liquidator's affidavit due to an alleged breach of an undertaking made by senior counsel for the liquidator. This breach involved failing to give the applicants notice of the making of the application and failing to depose on oath that there was a permissible purpose.

As a result of this case the hurdle still seems quite high before the Court will be prepared to grant access to a liquidator's affidavit in support of an examination and production order.

What guides a liquidator: fiduciary duties or the corporations law?

Case Name:

Coats v Southern Cross Airlines Holdings Limited (in liquidation)

Citation:

(1998) 16 ACLC 1393,
Queensland Court of Appeal per
Fitzgerald P, MacPherson JA and
Thomas J.

Date of Judgment:

12 June 1998

Issues:

- ◆ Duties of Liquidators
- ◆ Legal rights of shareholders against directors
- ◆ Law ss447(2), 476, 479(3), 533 & 535(1)

In this case the Court was asked to extend the duty owed by liquidators to creditors and contributories to a duty to inform shareholders of potential legal rights they may have against officers of the company in liquidation.

A liquidator had determined that the shareholders had an arguable claim against the former officers of the company in liquidation and wished to advise creditors by letter of this, despite the fact that doing so would cost over \$5,000. The liquidator's opinion was that the letters could be seen as defamatory so he sought orders from the Court that it was in order to send the letters.

At first instance, the Judge found that the fiduciary duties owed by a liquidator to the shareholders required that the liquidator protect the shareholders and that the duty to inform the shareholders of the potential action.

The Court of Appeal unanimously overturned the earlier judgment. The Court, pragmatically, preferred the Law as a guide to the role of the liquidator, rather than the concept of the fiduciary relationship, which was called "*obscure*" and "*elastic*" in this context. The Court adopted the view that the functions and duties of liquidators are determined by their role of realising the company's assets and distributing the proceeds. Consequently, providing information to contributories when it is not necessary for the winding up, particularly when it was to assist contributories in relation to private claims, is not part of the role of a liquidator. If it were, the scope of the liquidator's duties would be greatly expanded and could extend to investigating the material facts of the case on behalf of the contributories in relation to private claims.

While this judgment could be interpreted as indicating that the concept of a fiduciary duty is becoming outmoded as a guide to conduct of a liquidator, it is submitted that the better view is that Courts tend to view fiduciary duties as prohibitive (rather than entailing a positive duty) and a dim view is taken of any attempt to extend fiduciary duties beyond this.

When to appoint a provisional liquidator.

Case Name:

ASIC v DW & IM Tapping Pty Ltd

Citation:

Unreported, Federal Court of Australia per Marshall J.

Date of Judgment:

1 December 1998

Issues:

- ◆ Appointment of provisional liquidator
- ◆ Law s472

In this case the Federal Court considered an application by ASIC that a provisional liquidator be appointed to D W & I M Tapping Pty Ltd (*Tapping*) under s472(2) of the Law.

The main issue was whether or not it was in the creditors best interests for the voluntary administrator to be replaced by a provisional liquidator. Unlike an administrator, a provisional liquidator would have an obligation to investigate the affairs of Tapping. This was important as it was suspected that the directors were in breach of a number of their duties and that a number of loans made by Tapping were improper. In such circumstances the Court held that it was critical that the affairs of the company be thoroughly investigated by a liquidator.

Accordingly, the Court appointed a provisional liquidator to Tapping pursuant to subsection 472 (2) who was imbued with the powers provided pursuant to the Law and who assumed possession of the property of Tapping.

This case illustrates that creditors' interests will dictate the need for an appointment of a provisional liquidator, which is when the company's affairs are so parlous as to require the supervision of the Court.

The independence of liquidators.

Case Name:

Unifor Office Systems Aust Pty Ltd v Brewer Partnership Pty Ltd

Citation:

(1999) 17 ACLC 642, Supreme Court of New South Wales, Equity Division per Hodgson CJ in Eq.

Date of Judgment:

2 March 1999

Issues:

- ◆ Administration
- ◆ Application for winding up a company in administration
- ◆ Position of the liquidator
- ◆ Law s440A

A winding-up summons was filed and two registered liquidators were appointed joint and several administrators of the Brewer Partnership Pty Limited (Brewer).

Offices Systems Australia Pty Limited (*Unifor*) was a creditor of Brewer, claiming 20% of the unsecured debts. Evidence was presented to the Court which showed a long history of attempts by Unifor to recover its debts from Brewer.

The onus is on the debtor company to satisfy the Court that continuance in administration is in the interests of the creditors. The views of creditors are also of some importance in deciding whether or not to dismiss the application. Brewer relied on evidence that 80% of the creditors had given their proxies to the administrators in favour of continuing with the administration. The creditors had not been given a choice as to whether they preferred administration or winding up, but were merely notified of the administration of the company, not the pending winding up proceedings.

It is the Court's preference, rather than a matter of law, that administrators should not be chosen by the directors or other principals of the insolvent company, but should be chosen by independent persons with no prior connection or interest in the company, as this would most likely be in the interests of creditors. Here, while the administrators themselves were independent parties, they were selected by the directors of the company, a fact which runs counter to the general approach of the Court.

An order was made to wind up the company as the Court was not satisfied that the requirements of s440A(2) of the Law had been made out.

While it may be the case that director appointed administrators are independent of interests in or connection with the Company, Courts are keen to preserve the actual and perceived independence of administrators.

A liquidator's bills should look like a lawyers.

Case Name:

Re Solfire Pty Ltd (in liquidation)
(No 2)

Citation:

[1999] 2 Qd.R.182, Supreme
Court of Queensland per
Shepherdson].

Date of Judgment:

14 May 1998

Issues:

- ◆ Liquidator's costs
- ◆ Provision of bill to members
- ◆ Law s477, s473, s477(3) & s477(6)

In this case members applied to have the remuneration of liquidators reviewed under the Law. The Supreme Court of Queensland ordered the liquidators produce a Bill of Costs for their expenses (including legal expenses) comparable to that required by a solicitor to a client.

The two sole shareholders applied to have:

- the fees claimed by the liquidators reviewed; and
- the Bill of Costs of the liquidator's solicitors reviewed.

The Court found that the Court had jurisdiction under the Law to review the remuneration of both provisional liquidators and (upon application by members with an aggregate shareholding of at least 10%) liquidators. A liquidator's remuneration includes the fees of any solicitors engaged by the liquidator.

The Court did not have sufficient information to review the remuneration in the present case. It stated that when the remuneration of a liquidator is to be reviewed, the liquidator should provide to the Court a document similar to a Bill of Costs in taxable form provided by solicitors to their clients. This should include the following information:

- identity, grade and charge out rate of each person engaged;
- tasks;
- date; and
- amount of time spent.

A scale of charges compiled by a reputable professional body could also be useful. In addition, the Court stated that any resolution passed by members regarding a liquidator's remuneration would not preclude a member from applying for review of the liquidator's remuneration under the Law.

The Court ordered that the liquidators furnish an itemised account of their costs and expenses and that if agreement could not be reached, the Court would review the remuneration.

The liquidators received a one-line bill from the solicitors but did not seek an order to have an itemised Bills of Costs produced. Under the *Companies (Queensland) Rules* 1985, a liquidator has discretion as to whether to require a Bill of Costs from an engaged solicitor.

However, if it is a “*proper case*” for such a demand, a Bill of Costs must be demanded. Such a “*proper case*” would include one in which the solicitors’ bill is rather high and given in one line. The Court ordered the solicitors engaged by the liquidators to provide itemised Bills of Costs in taxable form, and that if agreement could not be reached, the Court would review the legal costs.

This case is a good reminder to both liquidators and their lawyers to properly record and document their time and to provide proper particulars in their accounts.

Useful guidelines for the removal of a liquidator.

Case Name:

Citrix Systems Inc v Telesystems Learning Pty Limited
(in liquidation)

Citation:

(1998) 28 ACSR 529, Federal Court of Australia per Moore J.

Date of Judgment:

31 August 1998

Issues:

- ◆ Voluntary winding up
- ◆ Liquidator's conduct
- ◆ Independence of the Liquidator
- ◆ Law s459B

Citrix Systems (Citrix) sought an order under s459B of the Law that Telesystems Learning Pty Limited (Telesystems) be wound up.

The issues in question were whether the Court ought to make such an order in circumstances:

- ◆ where the insolvent company was already being wound up voluntarily; and
- ◆ where the order would be principally for the purposes of displacing the voluntary liquidator with a liquidator appointed by the Court.

Telesystems' liquidator allegedly failed to investigate the possibility of insolvent trading and had also allegedly failed to explain the reasons behind the reduction of a debt owed by Telesystems, of which Citrix was the major creditor. The liquidator's association with Telesystems commenced approximately five weeks prior to his appointment as voluntary liquidator.

The Court may make an order to wind up a company in insolvency even if the company is already being wound up voluntarily. The power of the Court to appoint a liquidator indirectly arises when such an order is made. The Law equally confers a power on the Court to remove a liquidator undertaking a voluntary winding up.

The Court may remove a liquidator and appoint another '*on cause shown*'. Cause is shown for removal whenever the Court is satisfied that it is for the better conduct of the liquidation or, put another way, it is for the general advantage of those interested in the assets of the company that a liquidator be removed. A liquidator must have no interest in any matter which he or she is required to investigate, "*and be seen to be*", independent of any such matter. The Court held that the liquidator's indifference to Citrix's stated concerns and his prior involvement with Telesystems were evidence that he was not diligently pursuing Citrix's interests as a major creditor. The Court agreed that the question should be whether there would be a reasonable apprehension by any creditor of lack of impartiality on the liquidator's part in the circumstances, by reason of prior association. It was held that Citrix's belief that the liquidator would not act independently was indeed reasonable.

Orders were made *inter alia* that Telesystems be wound up and a new liquidator be appointed.

This case is a useful indicator of the sort of conduct that will result in the removal of a liquidator by the Court.

The liquidator's interest and independence - what comes first?

Case Name:

Ultra-Tune Australia Pty Limited
v McCann

Citation:

(1999) 30 ACSR 651, Supreme
Court of Victoria per Hansen J.

Date of Judgment:

25 March 1999

Issues:

- ◆ Funding of litigation by a company liquidation
- ◆ Remuneration of Liquidator
- ◆ Conflict of interest
- ◆ Law s503, s504, s512, s532, s536 & s556

In this case the Victorian Supreme Court held that a legitimate financial agreement between litigants and a liquidator to fund litigation, and an arrangement where 30% of the liquidator's fees were deferred (thereby giving them a vested interest in the proceedings) did not amount to circumstances in which the liquidator's "independence has or appears to have been compromised, or where there is an actual or potential conflict of interest or other actual or apparent irregularity in the conduct of the liquidator".

The Court refused to make an order to remove the liquidator taking into account the lack of funds for a new liquidator, the complexity of the case and the current liquidator's knowledge.

In June 1994, UTSA Pty Ltd sold its business to Ultra Tune Australia Pty Ltd (*UTA*). In October of that year, Mr Michael McCann and Mr David Scott were appointed as administrators of UTSA, and were subsequently appointed as joint liquidators. A large amount of litigation followed, mainly between the liquidators and UTA, concerning the efficacy of the sale of UTSA to UTA. In June 1995, UTSA's causes of action were assigned by agreement to the Titan Corporation (*Titan*). As a result of this litigation, and the events surrounding it, UTA sought orders in the Supreme Court of Victoria for removal of the liquidator and that they pay to UTSA an amount of \$350,838.85.

The Court noted the general principle that a Court may remove a liquidator if it is in the interests of a liquidation to do so. An appropriate case may be one in which the liquidator's "*independence has or appears to have been compromised, or where there is an actual or potential conflict of interest or other actual or apparent irregularity in the conduct of the liquidator*".

The Court examined financial payments made by Titan to the liquidator which were alleged to have resulted in a conflict of interest and a lack (actual or perceived) of independence on the part of the liquidator. The Court rejected these submissions. It held that the remuneration was the result of a legitimate arrangement entered into because UTSA did not possess the funds necessary to meet the costs of the litigation and the liquidator's fees. To hold otherwise would be to negate the liquidator's primary responsibility to further the processes of liquidation, through prosecuting litigation, for the benefit of the creditors and shareholders.

The Court then examined an arrangement by which 30% of the liquidator's fees were deferred. It was alleged that this gave the liquidator a vested interest in the outcome of the litigation to such an extent that there was a conflict of interest between the liquidator's desire to succeed in the case, and the creditors' interests in settlement.

The Court again held that there was no conflict of interest. To succeed the UTA would need to have provided evidence that there was a conflict between the liquidator's arrangement and a result which the UTSA creditors may have favoured. There was no evidence of such a conflict. Nor was there any evidence that the liquidators did not consider the interests of the UTSA's creditors and shareholders.

The Court also took into account UTSA's inability to fund the costs and expenses of a new liquidator, the weight and complexity of the case, and the liquidator's knowledge of it, were also relevant factors. On balance, and mindful of the realities of the situation the Court refused to make an order for removal. In the particular circumstances it was not in the best interests of the liquidation of UTSA that the current liquidator be removed from office despite the existence of the arrangements in question which in different circumstances could lead to an actual or perceived lack of independence.

This case is yet another example of how Courts are increasingly granting latitude to liquidators to exercise their powers in the best interests of the liquidation.

It's a liquidator's prerogative to change his or her mind after all!

Case Name:

Re Tietyens Investments Pty Limited

Citation:

Unreported, Federal Court of Australia per Weinberg J.

Date of Judgment:

31 March 1999

Issues:

- ◆ Liquidator's powers
- ◆ Liquidator's ability to withdraw support form compromise
- ◆ Law s477 & s479

In this case the Federal Court held that in circumstances where a debt compromise agreement was executed by creditors and a liquidator, the liquidator was entitled to withdraw its support from that agreement following receipt of legal opinion which considered that entry into the agreement would not be in the creditors' best interests.

Following a dispute with a creditor in relation to a development contract for Tietyens Investment Pty Limited (*TI*) one remaining asset (equity in a retirement village), *TI*'s liquidator agreed to enter into a debt compromise agreement. The Agreement had the effect of giving the Creditor a sum of money and providing for mutual releases from liability. The Agreement was said to be subject to Court approval under s477(2A) of Law. Under that section a liquidator is prohibited from compromising a debt to a company which is greater than the prescribed amount (\$20,000) without the Court's approval. The Agreement also provided for Senior Counsel's opinion which was received following all parties' (including the liquidator's) execution and which indicated that the creditor's liability could be as much as the entire outstanding \$34 million owed to creditors. The liquidator subsequently withdrew its support for the Agreement and made 2 applications to the Court in the alternative:

1. seeking the Court's approval of the compromise of debt pursuant to s477(2A) of the Law; and
2. seeking directions from the Court under s479(3) of the Law in relation to the compromise.

Courts have the power to give directions to protect liquidators from liability in the event that they proceed with a compromise.

The creditor also brought an application for declaratory and injunctive relief primarily to test whether it had standing to be heard in the liquidator's applications. Weinberg J held that the creditor had standing. His Honour found that ordinarily the creditor would not have standing primarily because the issue of whether the authority to compromise needed to be given was a personal matter for the liquidator. Weinberg J found that the question of standing was at the Court's discretion and that because of the sudden and complete change in the liquidator's views it would be given.

The Court held that the claim against the creditor was **not** a debt but a claim where a third party is liable for another party's breach of trust if it assists or procures that breach of trust in circumstances where its conduct, given its actual circumstances and state of mind, is seen to be objectively dishonest. Accordingly, the liquidator's application under s477(2A) was dismissed.

Section 479(3) provides that a liquidator may apply to the Court “*for directions in relation to any particular matter arising under the winding up*”. In directing that the liquidator, being satisfied in reliance upon a Senior Counsel’s advice that it would not be in the best interests of TI’s investors to implement the Agreement, may act on that advice and not implement the Agreement, the Court made the following points:

- ◆ the Court’s inquiry is not in the nature of a commercial decision;
- ◆ the Court will not generally interfere unless there are good grounds for doubting the prudence of the liquidator’s conduct;
- ◆ the *Spedley*¹ principles are applicable. Under those principles an authorisation was allowed because there was evidence that “*full regard was had to the competing legal and commercial considerations*”;
- ◆ the fact that the liquidator considered the issues were mainly legal and not commercial was significant;
- ◆ the fact that the liquidator was an experienced liquidator and litigator was also significant;
- ◆ the liquidator had sufficient information before it to reach a conclusion as to whether entering into the compromise was in the best interests of the investors: in doing so the liquidator had considered Senior Counsel’s opinion, defences to the Moses Group’s cross claims, and recovery possibilities if successful. Ultimately, the liquidator had declined to support the Agreement in the exercise of its commercial judgment; and
- ◆ in those circumstances it was not necessary to prepare a cost benefit analysis, nor to seek advice from Counsel more removed from the parties.

Accordingly, the Court ordered that the liquidator could rely on Senior Counsel’s advice and refuse to implement the Agreement, notwithstanding that that advice was received after the Agreement was executed by all parties.

This case raises questions of certainty for parties entering into debt compromise agreements. Creditors should be aware that such agreements are open to attack by a liquidator who at a later date is of the opinion the agreement is not in the best interests of the liquidation.

¹ *Re Spedley Securities (in liq)* (1992) 9 ACSR 83

Is your security safe from a preference claim?

Case Name:

Noel Guthrie as the Liquidator of ULT Limited (Receiver Appointed) (in liquidation) v Bank of Western Australia Limited

Citation:

Unreported, Supreme Court of Western Australia per White J.

Date of Judgment:

21 December 1999

Issues:

- ◆ Debenture deed
- ◆ Preference payments
Law s556 & s566

This case concerned an application by the liquidator of ULT Limited (ULT) challenging the Bank of Western Australia's (the Bank) charge over ULT's property.

ULT gave the bank a charge over all its assets and undertakings by a debenture deed for all moneys then owing or to become owing in the future. ULT subsequently filed a Variation Deed to increase the maximum prospective liability under the charge and to grant an additional floating charge over all of its assets and undertakings.

The liquidator submitted that the Variation Deed gave the Bank a preference over ULT's other creditors as its effect was to increase the security given by ULT to the Bank under the Debenture. The liquidator submitted that the notice of debenture was a notice to the world at large and that, if it was incorrect (as it was following the Variation Deed), the result must be that the Debenture was void. Alternatively, the liquidator submitted that if the Notice was correct, then the Bank was limited in its security to an amount not exceeding the amount the "*present of liability*" for which the debenture had been stamped plus the maximum prospective liability referred to in the notice. Finally it was argued that the Bank's floating charge on ULT's property created by the Variation Deed was invalid on the ground that it was created within six months prior to ULT's winding up and was therefore void under s566.

However, the Court held that the maximum prospective liability did not place a limit on the total amount secured or to be ultimately recoverable under the security. It did not preclude the parties from making and accepting advances in excess of the maximum amount and such advances would still be secured and recoverable. The Variation Deed did not create a preference in favour of the Bank. The parties were entitled to state in the Notice whatever maximum prospective liability figure they pleased without in any way affecting the validity of the Debenture. The amount stated as maximum prospectively liability could therefore have no effect upon the security as between ULT and the Bank but only on the Bank's security vis-à-vis a subsequent chargee if the amount advanced was greater than that stated in the Notice.

The Court also held that the relevant charge was the original debenture and not the Variation Deed. As this had been created more than 6 months before the winding up, it was not void under s566.

The case is useful in that it clarifies the functions of notices of security in relation to preference payments.

Awareness is not just a matter of personal perception.

Case Name:

Anthony Milton Sims v Celcast Pty Ltd

Citation:

Unreported, Full Court of the Supreme Court of South Australia per Cox, Mullighan and Williams JJ.

Date of judgment:

5 May 1998

Issues:

- ◆ Defence to voidable transactions
- ◆ Objective and subjective awareness
- ◆ Law s588FG

The appellant sought a decision to quash the trial judge's finding that Celcast Pty Ltd (Celcast) was entitled to rely on the defence under 588FG(2) of the Law which provides a defence to a voidable transaction when the relevant person acted in good faith and had no reasonable grounds to suspect insolvency.

The appellant brought proceedings in the District Court seeking a declaration that a payment of certain money made by Leal Pty Ltd (*Leal*) to Celcast was an unfair preference, an insolvent transaction, and a voidable transaction. The appellant also sought payment of this amount from Celcast to Leal in accordance with s588FF. There was no dispute that Leal was insolvent at the time of the payment and that the payment was an insolvent transaction. However, the trial judge found that Celcast was entitled to rely on the defence provided by s588FG(2) and dismissed that action. Section 588FG(2) provides a defence to voidable transactions where the person made the transaction in good faith and had no reasonable grounds to suspect insolvency. This final element has both a subjective and objective element.

The Court considered the nature of the subjective and objective in the context of a suspicion of insolvency and assessed whether a subjective test must be satisfied independently of an objective test. The Court was aware that if a difference was not found between the tests of suspicion, less diligent directors would receive greater protection than mere diligent directors as the latter would have greater subjective awareness, knowledge and appreciation of the company's financial affairs. Accordingly, the Court held that the tests are concerned with different types of suspicion. The subjective test will be assessed by the Court with reference to the conclusion which ought to have been reached by a particular creditor by a process of deduction given the particular steps taken, such as research or monitoring. In this sense, it accommodates subjective factors.

The Court held that the objective test is directed towards the conclusion of suspicion of insolvency which an objectively reasonable person would have arrived at had they been placed in the relevant creditor's circumstances. A suspicion of insolvency consists of an actual feeling of apprehension or mistrust but without sufficient evidence to be certain of that fact. The '*circumstances*' referred to in this objective test allow the Court to look at a collective cumulative mass of information available, rather than a narrow focus on a few individual pieces of information. Therefore, although some subjective factors can be taken into consideration in determining the limits of the relevant '*circumstances*', the test is primarily objective. A hypothetical objective reasonable person is unlikely to be wearing '*rose coloured glasses*' nor to allow personal perceptions to cloud reasonable commercial judgment. In short, the fact that a less diligent creditor employs a flawed process of monitoring debtors will not avail it of the defence under s588FG(2) if a reasonable person in its circumstances would have read the situation differently.

Allen Allen & Hemsley

In relation to the circumstances in question, the Court held that there were a number of developments in the business relationship between Leal and Celcast which would have raised a suspicion of insolvency in an objectively reasonable person. In particular the dishonouring of a number of cheques made out by Leal and overdue indebtedness on numerous occasions ranging between 90 and 120 days indicated that Leal was insolvent.

However as Leal had been a long standing customer of Celcast, Celcast's officers were generous in their assessment of the financial position of Leal, thus allowing personal perceptions to cloud commercial judgment. In this sense, they were blind to the facts in front of them. An objectively reasonable person presented with such information would have had a suspicion that Leal was not able to pay its debts and would have had reasonable grounds to look into the possibility of Leal's insolvency. The Court held that the trial judge was in error in making allowance for Celcast's officers subjective analysis of the information presented to them when considering the objective test. Accordingly the appeal was allowed as Celcast could not be afforded the protection of the defence in s588FG(2) as it's assessment of the situation did not meet the objective test.

This case confirms the differences between subjective and objective tests of reasonableness in the context of defences to voidable transactions.

Relating to the relation back period.

Case Name:

Olsen v Nodcad Pty Limited

Citation:

Unreported, Supreme Court of New South Wales per Austin J.

Date of Judgment:

23 April 1999

Issues:

- ◆ Relation-back day
- ◆ Moving relation-back day by appointment of voluntary administrators
- ◆ Law s 9 (definition of "relation back day"), s513A & s588FE

In this case the Court held that the relation back day for the purposes of determining whether a payment was an unfair preference under s588FA of the Law (and therefore a voidable transaction under s588FE) was the date on which an order for the winding up of the company was made, and not the earlier date of filing an application to wind up the company.

Nodcad Pty Ltd's liquidator sought to avoid a payment of \$69,850 to Robert Moore & Associates. Nodcad and others had claimed that they were beneficially entitled to certain moneys held by MLC Investments Limited, and in response the defendants of which MLC was one, made an application by way of cross-claim for an order that Nodcad be wound up. Nodcad went into VA and an administrator was appointed.

Under s588FE(2) of the Law, the application of Part 5.7B Division 2 to the transaction depends on whether the payment occurred during the 6 months ending on the relation back day.

Section 513A states that:

*"if the Court orders under section ... 459B... that a company be wound up, the winding up is taken to have begun or commenced: ...
(a) if immediately before the order was made, the company was under administration – on the section 513C day in relation to the administration;"*

The question for the Court was, where an application to wind up a company was filed and an administrator subsequently appointed and then a winding up order made, whether the relation back day for the purpose of determining whether a payment is an unfair preference under s588FA is:

- (a) the earlier date on which the **application for the order for the company to be wound up was made** (pursuant to section 9(a) of the Law), or
- (b) the (later) date on which an **order for the winding up of the company** was made

Pursuant to section 9, the relation back day would have been the day on which the application for the winding up order was filed if s513A(e) applied. However, the Court held that because immediately before the winding up order was made Nodcad was under administration, s513A(b) and not s513A(e) applied.

The Court therefore concluded that the relation back day was the day on which the order for the winding up of the company was made. That is, the relation back day was held to be the s513C day in relation to the administration. The Court reached this conclusion on the basis the winding up order itself terminated the administration, and consequently immediately before the winding up order was made, Nodcad was still under administration. The impugned payments were therefore not held to be voidable transactions pursuant to s588FE of the Law because they were not made during the 6 months ending on the relation back day.

This case shows that insolvency practitioners should note that a Court order to wind up a company under administration brings the administration to an end and that the relation back day accordingly will be the date on which the order to wind up the company was made, and not the date upon which the application for an order to wind up the company was made.

Tax liabilities and preference payments.

Case Name:

Sands & MacDougall Wholesale Pty Limited (in liquidation) v Commissioner of Taxation

Citation:

Unreported, Supreme Court of Victoria per Nathan J.

Date of Judgment:

26 November 1999

Issues:

- ◆ Status of Sales Tax Payments - whether unfair preferences or voidable transactions
- ◆ Reasonable grounds to suspect insolvency
- ◆ Law s588FA, s588FE, s588FF & s588FG

During the 6 month period prior to its winding up, the liquidator of Sands & MacDougall Wholesale Pty Ltd (SMW) alleged that 6 payments made to the ATO in respect of sales tax were both unfair preferences (pursuant to s588FA) and voidable transactions (s588FE and 588FF).

Section 588FA defines a preferential payment as occurring when, in respect of an *unsecured debt*, a creditor receives from a company more than it would receive in respect of such debt if the transaction was set aside and the creditor was required to prove for the debt in the company's winding up. One of the requirements of a preferential payment is that it is in respect of an unsecured debt. The ATO argued that when one had regard for the scheme of the Sales Tax Legislation which provides for the tax to be ultimately paid by the retailer (as opposed to the final wholesaler as was SMW), the final wholesaler was effectively paying nothing but was simply acting as a conduit passing on to the Commissioner moneys payable by the purchaser. Accordingly, no "*debt*" arose as between the final wholesaler (SMW) and the ATO.

The Court unanimously rejected this argument and held that the liability of a wholesaler to pay sales tax to the Commissioner is clearly to be characterised as a "*debt*".

The ATO argued that it was entitled to rely on the preferential payment defence contained in s588FA(3). Under this section a payment will not be considered preferential if it forms part of a continuing business relationship between debtor and creditor. The key ingredient of this provision is that a creditor is continuing to supply goods or services to the company on a credit basis in return for the debtor reducing past indebtedness (ie, there is a continuing business relationship between the parties). The ATO argued that by virtue of it providing a continuing disposition to agreeing to alternative payment plans by SMW of sales tax owed by it, it was providing value which constituted a continuing business relationship. The Court emphatically rejected this argument and concluded that no contract existed between the parties and that on no view could they be considered to be trading partners. The impugned payments were in no way connected to the subsequent supply by the ATO of goods or services.

The final issue was whether the ATO could rely on s588FG(1) which required it demonstrate that no reasonable grounds for suspecting SMW's insolvency existed and that a reasonable person in the Commissioner's position would have had no grounds for such suspicion.

The liquidator argued that:

- ◆ the ATO was aware of the company's continued late payments of sales tax;
- ◆ representatives of the ATO had engaged in conversations with SMW's credit controller on the specific topic of SMW's doubtful solvency; and
- ◆ the ATO had access to SMW's tax returns which clearly demonstrated financial hardship.

The Court ruled that the ATO did have reasonable grounds for suspecting SMW's insolvency and was thus deprived of the defence of s588FG(1).

The Court ruled in favour of the liquidator and ordered the ATO to repay each of the impugned payments, together with interest, pursuant to s588FF(1)(a) of the Law.

This case shows that even the ATO, given the right circumstances, may be on the end of a preference claim and lose.

Preference payments: the "running account" doctrine.

Case Name:

Julzar Pty Limited v Rodgers

Citation:

Unreported, Supreme Court of New South Wales per Young J.

Date of Judgment:

17 March 1999

Issues:

- ◆ Unfair preferences
- ◆ Running account doctrine
- ◆ Law s588FA

This case considered whether a liquidator could recover moneys paid by the company (*Cypain*) to a trade creditor as preference payments within the meaning of s588FA of the Law.

In deciding the case, the Court was obliged to consider whether Cypain was insolvent at the time the payments were made and whether the relevant trade creditor (*Julzar*) could rely on "*the running account doctrine*" contained in s588FA(3) to reduce its indebtedness to the liquidator.

Using a commercially realistic cash flow test of insolvency, the Court held that as most of Cypain's assets were stock in trade which were proving difficult to sell, Cypain was insolvent.

The main issue was whether Julzar could rely on what has become known as the "*running account doctrine*" contained in s588FA(3). The essential feature of this doctrine is that it anticipates a continuing relationship between the parties with an expectation that further debts will be incurred. In this sense, the transaction in question forms part of the business relationship between the parties by which the indebtedness of one party to the other is increased and reduced from time to time.

In determining whether the particular transaction forms part of a "*running account*" the Court will examine the business relationship between the parties to determine if it usually proceeds on the basis that the creditor will continue to supply goods or services to the debtor as long as the debtor complies with credit arrangements. In essence a payment is not preferential in nature if the business effect of the transaction is that the creditor is continuing to supply goods on credit to a greater value than the payments received, despite the fact that such payments are applied against past indebtedness.

The Court accepted that Julzar did not consider that it had an on-going business relationship with Cypain for the majority of the relevant insolvent period. In fact goods were only supplied by Julzar for a fraction of the period during which it was receiving Cypain's "*insolvent*" payments. For the period during which goods were supplied an on going business relationship was established and the running account doctrine was applied. Julzar's indebtedness to the liquidator was reduced by the appropriate amount.

This case clarifies the features of the nature of the "*running account*" doctrine and the circumstances in which it may be utilised by creditors and attacked by liquidators.

The effect of agency on preferential payments.

Case Name:

Merchant and Partners (Sydney) Pty Ltd v Halse (Joint Liquidator of Woods Advertising Pty Ltd) (in liquidation)

Citation:

Unreported, Full Court of the Supreme Court of Western Australia per Pidgeon, Wallwork and White JJ.

Date of Judgment:

10 October 1999

Issues:

- ◆ Preference payments
- ◆ Preferential payments in context of quasi-agency relationship
- ◆ Law ss 565 & 1305

This case considered preferential payments under s565 of the Law in the context of an quasi-agency relationship.

The respondent was the liquidator of an advertising company (*the Company*). The Company was not accredited under the relevant media agency accreditation schemes. As such in order to procure advertising with media groups for two of its existing clients, the Company requested the appellant, also an advertising company but one which was accredited, to place advertisements for those clients. The advertising was undertaken and the appellant invoiced the two clients, Bakewell Foods and Persian Carpet Museum directly. However, the invoice to both of these parties was forwarded to the Company. The Company would then send out its own invoice to its clients and attach the appellants invoice.

Prior to the Company becoming insolvent, Bakewell paid its account directly to the Company. The Company used the funds provided by Bakewell to satisfy other debts and, upon receiving a query by the appellant as to the whereabouts of the payments, undertook to pay the amount as soon as possible. Persian Carpet Museum, being unable to pay its account, agreed to partially satisfy its debt by delivering rugs to the Company. The Company managed to pay the appellant the money owing from Bakewell as well as managing to sell the rugs through a number of different sales. The last sale of rugs and the payment in respect of the Bakewell debt both occurred in the relation back period and the liquidator, at first instance, succeeded in requiring that those monies be paid back.

The question before the Court was whether the appellant had contracted with Bakewell and Persian Carpet Museum or whether the Company had made the contracts with the Company. If the contracts were made between the appellant and Bakewell and Persian Carpet Museum then the disputed sums were not preferential payments as found by the Master.

On the evidence Wallwork and White JJ found that the relationship between the Company and the appellant was an agency relationship.

In coming to this conclusion, their Honours considered that the fact that the invoices were made out individually to Bakewell and Persian Carpet Museum, a letter from the Company to the appellant referred to a debt of Persian Carpet Museum to the appellant rather than the Company and affidavit evidence provided by the Manager of the appellant established that an agency relationship existed. Weight was also given to the fact that the appellant did not take out trade credit insurance with respect to the Company because it did not have the intention of allowing the Company to incur a debt to it.

This conclusion was reached despite the fact that the Company had the debt recorded in its books as debt it owed to the appellants and that s1305 of the Law provides that entries in a book kept by a corporation are prima facie evidence of any matter stated or recorded in the book. They also held that the Master may not have given sufficient weight to the fact that the respondent had the onus of proof to establish the existence of a debtor/creditor relationship.

The Court held that the quasi – agency relationship was one which did not lead to payments being regarded as preferences. However, the decision is not an invitation for companies to enter into “agency” style relationships for the sake of convenience for the Court will examine them thoroughly.

Preferences: defining payments made in the ordinary course of business and in good faith.

Case Name:

Sheahan v Fabienne Pty Ltd

Citation:

(1999) 17 ACLC 1600, Full Court of the Supreme Court of South Australia per Doyle CJ, Duggan and Debele JJ.

Date of Judgment:

27 August 1999

Issues:

- ◆ Preference payments
- ◆ Payment made in ordinary course of business and in good faith
- ◆ Law s565

In this case the Court considered whether certain payments made should be saved from being preference payments in accordance with s565 of the Law because they were made in the ordinary course of business and in good faith

The creditor was Fabienne Pty Ltd (*Fabienne*). Fabienne carried on an automotive engineering business. The debtor, now in liquidation, was Bosun Pty Ltd (*Bosun*), a motor vehicle dealer. For a period of over eight years a significant proportion of Fabienne's business was the repair and service of Bosun's vehicles. During this period both businesses grew. Payments were made to Fabienne on a running account.

Fabienne's terms of trading were stated to require payment of accounts within seven days. However, the Court accepted that most of its debtors, including Bosun, did not adhere to those terms and took substantially longer. Over the eight year period Bosun paid its accounts between five to fourteen weeks after receipt of the invoice. No cheques of Bosun were dishonoured until the end of July 1990 when a cheque dated 19 July 1990 was dishonoured.

In dismissing the appeal the Court identified a number of factors that must be considered when determining whether certain payments are made in the ordinary course of business and in good faith. It agreed that there are instances where one cannot readily determine whether a particular transaction or series of transactions is in the ordinary course of business and, aside from the fact that creditors generally wish to have debts paid promptly, it cannot be said that there is any ordinary course of business as to the time within which debts should be paid. Accordingly, what is considered "usual" between the parties in any particular case can only be determined by having regard to what are the usual terms of dealing or trading and the particular terms on which the debtor and creditor have been trading.

In ascertaining whether a payment has been made in good faith, the Court found that it is necessary to consider both subjective and objective elements. A suspicion of insolvency, or reasonable ground for suspecting so, will negate a finding of good faith.

The period over which Bosun had been delaying payments of Fabienne's accounts for increasing periods of time coincided with the time when Bosun had opened a new workshop and commenced to do some repairs itself. Bosun had purchased a new workshop, fitted it out and commenced employing a number of people. The Court found that these steps are not indicative of a cash flow problem. It further found that a reasonable person would have concluded that it suggested that the business was successful and expanding.

In finding that the payments were received in good faith the Court held that Fabienne's state of mind about Bosun's cash flow problems might be characterised as a suspicion of insolvency. But it was no more than that because Bosun was paying Fabienne in a very similar manner to the pattern of payments over a long time. Furthermore, the increase in the account can be attributed to the increase in business, despite Bosun opening up its own workshop. As such the Court found that there was no objective reason to indicate a want of good faith or preference.

This decision clarifies the position at law as to what will constitute a good faith payment. The decision also and provides guidance as to the criteria to be used when considering whether a payment is made in the ordinary course of business.

Fixed & floating charges - securing against preference claims.

Case Name:

Wily v Rothschild; Wily v
Rothschild Australia Limited

Citation:

(1999) 17 ACLC 1643, Supreme
Court of New South Wales per
Windeyer J.

Date of Judgment:

10 September 1999

Issues:

- ◆ Security provided by fixed and floating charges
- ◆ Preference Claims
- ◆ Variable payments
- ◆ Code s368 & s451

This case considered whether certain fixed and floating charges were sufficient in their terms to provide security to a lender to avoid preference claims made by the liquidator pursuant to s451 of the Code. The proceedings also considered whether a payment was void against a liquidator under s368 of the Code as having been made after the commencement of the winding up and a set off claim.

AUR obtained finance by arranging “*gold loans*”, where money is made available to the borrower, a calculation is made of how much gold that amount of money would buy at the then spot price and the loan is repayable by payment of that amount of gold together with an amount to represent interest called ‘gold fees’. Depending on fluctuations in the gold price this arrangement can work to the benefit of the lender or the borrower. AUR entered into two gold loans with the bank and granted fixed and floating charges to the Rothschild Australia Limited (*the Bank*).

By June 1990 the price of gold had fallen significantly from the 1988 price. AUR could then purchase gold at a relatively low price and deliver that gold to the bank in satisfaction or part satisfaction of hedging contracts which resulted in a considerable profit to AUR. AUR settled the first gold loan (the *First Transaction*) and paid an amount into “*blocked account*” with the Bank in the name of AUR which was applied to the second gold loan and other purposes (the *Second Transaction*).

On the same day as it applied to reduce the second gold loan the directors of AUR resolved to apply for its winding up and for the appointment of the provisional liquidator. A few days later the Bank sent AUR notice of default in respect of the gold loans and a week later appointed receivers and managers. The liquidator argued that:

- (i) the payment received by the Bank satisfying the First Transaction was a preference; and
- (ii) the Second Transaction was:
 - (a) made after the commencement of the winding up and void against the liquidator under s368 of the Code; or
 - (b) made before the commencement of the winding up and was a preference; or
 - (c) made before or after the commencement of the winding up and was void.

The Bank argued that it held security over the funds applied to buy the gold which was delivered to it in repayment of the gold loans and that in any event there was no preference as it had a right of set off.

Both charges were fixed and floating charges but had crystallised prior to the two transactions.

The Court held that AUR had entered into the hedging contracts for the purposes of its mining operation and the payments for the gold loans were for the same purpose. The gold purchased in that manner was therefore covered by the charges and the First Transaction was not a preference.

The Second Transaction involved the use of funds standing in the blocked account. The Court held that if it was possible to have security over that account, those funds also constituted property rights and interests acquired or contracted to be acquired from time to time for the mining purposes and thus were subject to the charges. However the money in the blocked account was deposited with the Bank in an account in the name of AUR which meant that the Bank was holding the money on AUR's behalf and effectively owed AUR the money held in the deposit account. This raised the question of whether it was possible for a deposit holder to hold security over a debt which it owed to the depositor. In answering this question, The Court held that the Bank was found not to have had security in the money standing in the blocked account. In making this finding Windeyer J followed the decision in *In Re Chargecard Services Limited* [1987] Ch 150, a position that has now fallen out of favour in the United Kingdom.¹ This meant that the Bank could have received a preference as a result of the Second Transaction unless a set off operated. The Court therefore needed to consider the set off point in relation to the Second Transaction.

The difficulty with the set off point was that there was no evidence as to the timing of the Second Transaction in comparison to the winding up other than that they both took place at some time during the same day. If the winding up commenced before the Second Transaction took place, an automatic set off would have taken place at the commencement of the winding up resulting in a balance due one way or the other. However, if the winding up commenced after the Second Transaction occurred, had the Second Transaction not occurred, set off would have been available with the result that the payment could not have given the Bank a preference over other creditors. A preference at that time could only have occurred if, at the time the Bank received credit from AUR, it had notice of any act or omission of AUR which would give ground for an application to wind AUR up under s364 of the Code. The Court could find no evidence that the Bank had any knowledge that AUR was unable to pay its debts at the time it received credit from AUR being the date on which the money was placed into the blocked account. As there was no evidence that the Bank had any such knowledge The Court found that it had received no preference by reason of the Second Transaction. The Bank was found to have received no preference under the First or Second Transactions.

The case is an important consideration of the need to have clearly drafted security documents and to envisage, at the time of drafting those documents, the potential use of property or funds by the borrower. It also confirms that the Court is most likely to find that it is not possible to hold security over a deposit where the purported chargee is obliged to repay that deposit to the purported chargor.

¹ See *Bank of Credit & Commerce International SA* [1998] AC 214 per Lord Hoffman.

Charges and preferences.

Case Name:

Wily v St George Partnership
Banking Ltd

Citation:

Unreported, Full Court of the
Federal Court of Australia per
Wilcox, Sackville and Finkelstein
JJ.

Date of Judgment:

29 January 1999

Issues:

- ◆ Preference payments
- ◆ Fixed and floating charge
- ◆ Law s565

This case concerned an appeal by the liquidator of Space Made Pty Ltd (*Space Made*), against a decision of a trial judge who held that payments made by Space Made to a creditor bank, did not have the effect of giving this bank a preference, priority or advantage.

On 20 July 1988 Space Made created a charge over its property in favour of the bank. This charge was fixed on certain property and floating on all other property. In February 1991 the bank agreed to a scheme which would reduce Space Made's indebtedness to it. This involved the bank lending two associated companies \$900,000 who would then lend it to Space Made which would apply it to reduce its indebtedness to the bank. Three consecutive payments of \$900,000, \$100,000 and \$112,000 were made from Space Made to the bank. In July 1991 Space Made was wound up and the liquidator sought to recover those payments on the basis that each payment was void as against the liquidator in accordance with s 565(1) of the Law. The trial judge rejected that argument at first instance.

The Full Court held that because a floating charge does not specifically affect any asset until it crystallises into a fixed charge, it is not capable of conferring a proprietary interest prior to crystallisation. The test for determining whether a particular interest is proprietary is whether the holder of the interest is able to enforce the interest against third parties. In this respect, whether a floating charge prior to crystallisation confers a proprietary interest in the chargee over the chargor's assets will depend on whether the chargee has enforceable rights against third parties in respect of those assets. In the current case, the Court held that the appropriate time for comparing the position of Space Made's creditors when the payments were made was on the basis of their likely position in the case of winding up. Accordingly, at the time Space Made was wound up the bank's floating charge would have crystallised and become fixed. Hence, the property which was the subject of the charge would not be available for distribution to other creditors. In this way, the payments could not be regarded as preferential payments as any payment out of property that is not available to meet the debts due to the other creditors does not confer a preference on the recipient.

This case provides comfort to the holders of floating charges who receive payments prior to liquidation from the chargee in whole or partial satisfaction of their indebtedness.

Recovering unfair preferences.

Case Name:

G&M Aldridge Pty Ltd v Walsh (as liquidator of Thompson Land Ltd) (Receivers and Managers Appointed) (in liquidation); Elecraft (Australia) Pty Ltd v Walsh; K & v Plumbers Pty Ltd v Walsh; Barden-Steedeck Industries Pty Ltd v Walsh

Citation:

Unreported, Victorian Court of Appeal per Winneke P, Phillips, and Buchanan JJA.

Date of Judgment:

12 November 1999

Issues:

- ◆ Recovery of Unfair Preferences
- ◆ Misapplication of property the subject of a fixed charge
- ◆ s122 BA
- ◆ Code s451

This case concerned an appeal by four companies which submitted that moneys paid to them by an insolvent company were not unfair preferences. The appellants argued that there could be no preference because the property in question was not available otherwise to the unsecured creditors generally. This was because the fund from which the moneys were drawn to pay the appellants were the subject of a fixed charge in favour of a bank.

The appellants were four contractors who performed work on the construction of a shopping complex in Melbourne. The shopping complex was owned by a company called Thompson. Thompson engaged Construction Engineering Pty Ltd (**Construction**) to be the construction managers for the project. The appellants entered into a contract with Construction as an agent of Thompson to perform work on the shopping centre. When the appellants submitted their final claims for payment they discovered that Thompson was insolvent and unable to pay their claims. Thompson subsequently acknowledged that the amounts were owing to these appellants and agreed to make an immediate part payment, or a deposit, on account of what was owing and also gave security for the payment of that balance in a number of units which Thompson held in a trust fund. As a result of these arrangements which were put in place on 15 March 1990, each of the four appellants received a portion of the monies owing to it by Thompson.

The appellants submitted that they had received no preference, priority or advantage over other creditors both when these deposits were paid and when security was given over the units.

The appellants first argued that the money from which the deposits were paid was in fact trust money being held by Construction on behalf of Thompson. In this way, the appellants sort to argue that the money belonged beneficially to them. However the Court rejected this submission.

The appellants then sought to argue that the payments made on 15 March 1990, and by implication the giving of security over the units on the same day, did not constitute a preference, priority or advantage over other creditors. They argued this on the basis that the money from which the deposits were paid were the subject of a fixed charge over all the assets of Thompson in favour of a bank. The Court acknowledged that the property the subject of the charge had crystallised and become fixed, and not floating when Thompson had become insolvent. This was prior to 15 March 1990. However, the Court rejected this submission.

The Court stated that once the floating charge had crystallised and become a fixed charge, the bank had obtained a proprietary interest in the assets of Thompson including any monies and any units over which Thompson purported to give security to the appellants. Accordingly, Thompson lacked the capacity in law to alienate such property inconsistently with the bank charge when it had become fixed. Yet this is exactly what it purported to do and in doing so breached its contract that it had made with the bank in relation to the fixed charge.

In this regard, the appellants submitted that the charge having crystallised and having become fixed over the assets of Thompson, the assets that were distributed to the appellants were not available assets in the winding up in so far as unsecured creditors were concerned. However, the Court held that the misapplication of this property by Thompson did not mean that the property in question was not available to meet the debts due to the other creditors. In fact, such misapplication constituted a preference.

This case highlights that monies paid to unsecured creditors out of property which is the subject of a fixed charge can still constitute an unfair preference and be set aside by the Court.

Disclaimer of onerous property.

Case Name:

Real Investments Pty Limited (in liquidation); Transmetro Corporation Limited v Real Investments Pty Limited

Citation:

Unreported, Supreme Court of Queensland per Chesterman J.

Date of Judgment:

23 April 1999

Issues:

- ◆ Unprofitable contracts
- ◆ Disclaimed by liquidator
- ◆ Law s568 & s568(1)

This case involved an application by Transmetro Corporation Limited for orders setting aside a notice issued to it by the liquidator of Real Investments Pty Limited (*Investment*). This notice disclaimed a contract between Transmetro and Investments on the basis it was unprofitable.

The contract in question was described as “Management Agreement and Sublease” between Investments, Transmetro and Ballville (another company which went into liquidation at the same time as Investments). The contract concerned the subdivision and development of land by Transmetro and the leasing of some of the sold developed properties by Transmetro to Ballville. These would then be subleased by Ballville back to Transmetro. However, many of the developments were never sold and thus the lease and sublease could not occur.

As the liquidator had not sought the requisite Court’s leave to disclaim the contract, it was first necessary for the Court to determine that the contract was in fact “*unprofitable*”. The term “*unprofitable*” is not defined by the Law. The Court decided that the purpose of the disclaiming provisions was to enable a liquidator to rid the company of “*burdensome financial obligations which might otherwise continue to the detriment of those interested in the winding up*”. The Court decided that the term “*unprofitable*” includes both “*bad bargains*” and contracts that cannot be satisfactorily carried out by a liquidator. In this respect, the contract must give rise to prospective liabilities. Contracts which are financially disadvantageous may be unprofitable, as well as contracts which delay the winding up because they require performance over a substantial period of time and involve expenditure which may not be recoverable.

The Court found that the contract in question was unprofitable because it obliged the liquidator to maintain a course of action over a long period in which liabilities would be incurred with no guarantee of return and Ballville was also in liquidation and thus unable to perform its obligations under the contract.

Because the contract was unprofitable, the liquidator did not require the Court to disclaim it.

The liquidator was also required to show that to disclaim the contract would not involve a disproportionately beneficial result from Transmetro than it would a detrimental result for Investment’s creditors.

The Court found that there was no such disproportionate result and accepted that the disclaimed contracts would have no effect on Investment's creditors as they would receive no dividend in any event. The immediately ascertainable consequences of disclaimer had no substantial effect on Transmetro, even though it was denied the opportunity to restructure the contract. A disproportionate result did not occur.

The final question was whether the Court should exercise its discretion to set aside the liquidators disclaimer. The Law gives no indication of the factors to be considered by the Court in exercising such discretion.

Accordingly Transmetro's application failed and the liquidators disclaimer was validated.

This case provides a useful consideration of factors that liquidators should take into account when disclaiming unprofitable contracts.

Re Wakim and the Corporations Law

THE UNCONSTITUTIONALITY OF CROSS-VESTING MATTERS TO THE FEDERAL COURT OF AUSTRALIA

On 17 June 1999 the High Court in a 6:1 majority decision (Kirby J dissenting), ruled in *Re Wakim; Ex Parte McNally & Anor* ((1999) 163 ALR 270 (***Re Wakim***)) that the conferral of State (but not Territory) jurisdiction on federal courts under both the general and corporations cross-vesting schemes was constitutionally invalid.

The general cross-vesting scheme was established in 1987 by the passing of legislation by the Commonwealth and each of the States and Territories which, subject to a few exceptions, vested the jurisdiction of each participating Court in every other Court forming part of the scheme. The participating Courts are the Supreme Courts of the States and Territories, the Family Court of Western Australia, the Family Court of Australia, the Federal Court of Australia, and, to a limited extent, the lower State courts.

The corporations scheme was established in 1991 by the enactment of the Law by the Commonwealth and each State and Territory. Under the scheme the civil jurisdiction of each State and Territory over matters arising under the Law was conferred upon the Federal Court and upon every other State and Territory Supreme Court. The effect of the decision in *Re Wakim* is that both the general and corporations cross-vesting schemes are invalid in so far as each purports to give Federal Courts jurisdiction to exercise State judicial power.

New South Wales, Victoria, Queensland, Western Australia, South Australia and Tasmania have all passed remedial legislation in the form of the *Federal Court (State Jurisdiction) Act*. The effect of this legislation is to minimise the impact of the *Re Wakim* decision in past and current proceedings by validating decisions made by the Federal Court under the cross-vesting schemes and allowing such judgments to be enforced in the same way as judgments from the relevant Supreme Court.

Under the present regime, all actions concerning corporations and insolvency matters which relying on provisions of the Law must be commenced in the Supreme Court of the relevant State. If such proceedings are currently being heard in the Supreme Court, an application should be made for a relevant order that the Federal Court had no jurisdiction to hear the matter and referring the matter to the relevant Supreme Court.

However, the State remedial legislation is the subject of a constitutional challenge in South Australia on the basis that the judicial integrity of the Federal Courts will be compromised if they are required to treat otherwise invalid decisions as their own. It is likely that constitutional challenges will be brought in other State jurisdictions.

In addition, it is possible that the Commonwealth Law as a whole will be struck down on a constitutional basis and either reliance will have to be made on each State's version of the Law, or each state will have to refer its corporations power to the Commonwealth. The current position of cross-vesting in relation to the Law scheme is in question.

Insolvency practitioners should pay particular regard to the developments in to the validity of the legislation pursued by the states seeking to air the results of *Re Wakim*. Practitioners should also carefully follow other Constitutional challenges to the Corporations Law.

Legislative developments

A New Tax System (Goods & Services Tax) Act 1999 (CTH)

The *A New Tax System (Goods & Services Tax) Act 1999* was passed by the Commonwealth Parliament in June 1999 as part of a suite of legislation which will bring far reaching reform to the Australian tax system. The GST regime, when it commences on 1 July 2000, will touch virtually every aspect of business. Furthermore, it will impact upon legal arrangements which predate 1 July 2000 but which will continue afterwards.

Overview of the Legislation

A number of Acts bring into being the GST:

- ◆ the principal Act is the *A New Tax System (Goods & Services Tax) Act 1999* (**the GST Act**) which sets out the machinery provisions for the application and calculation of the tax; and
- ◆ the *A New Tax System (Goods & Services Tax Transition) Act 1999* phases out certain indirect taxes, such as sales tax and explains the application of GST during the transitional period.
- ◆ three formal Acts, *A New Tax System (Goods & Services Tax Imposition-Customs) Act 1999*, *A New Tax System (Goods & Services Tax Imposition-Excise) Act 1999* and *A New Tax System (Goods & Services Tax Imposition-General) Act 1999* are designed to guarantee compliance with the Australian Constitution in the imposition of the new tax.
- ◆ the *A New Tax System (Goods & Services Tax Administration) Act 1999* and *A New Tax System (Indirect Tax Administration) Act* effect amendments to the *Taxation Administration Act 1953*. This Act is of importance in determining the Commonwealth's rights of recovery of the GST, its application to incapacitated entities which include insolvent companies, rights of set-off and the like.
- ◆ amendments to the *Trade Practices Act 1974* resulting from the *A New Tax System (Trade Practices Amendment) Act 1999* provide price controls for a period of 3 years following from June 1999 and grant the ACCC broad powers of enforcement in relation to those price controls.

GST Principles

GST is a tax on a person making a taxable supply. It is not “collected” from the recipient. “Taxable supply” is broadly defined to include any supply:

1. made for consideration;
 2. made in the course or furtherance of a business enterprise;
 3. connected with Australia; and
 4. by a person registered or required to be registered under the GST legislation (s9-5 GST Act).
- “Supply” is defined as any form of supply whatsoever including:

- (a) a supply of goods;
- (b) a supply of services;
- (c) a provision of advice or information;
- (d) a grant, assignment or surrender of real property;
- (e) a creation, grant, transfer, assignment or surrender of any right;
- (f) a financial supply;
- (g) an entry into or release from an obligation:
 - (i) to do anything;
 - (ii) to refrain from an act; or
 - (iii) to tolerate an act or situation;
- (h) any combination of any 2 or more of the matters referred to in paragraphs (a) to (g).

The reference to “*releases*” and to “*consideration*” means that settlements of disputes and of legal proceedings may well be caught by GST.

GST is to be levied at each step along the chain of transactions in the production and marketing of “*goods and services*” as defined by the GST Act until the particular good or service reaches the consumer. Although the tax is collected by suppliers, it is the consumer or end user who will ultimately bear the tax. This is achieved by the provision of credits to persons making taxable supplies for GST purposes in relation to the amounts paid on the inputs to the production or marketing of the good or service.

In those circumstances the supplier will only be obliged to pay the net amount of GST to the ATO. In circumstances where the input tax paid exceeds the GST liability on supplies, the supplier will be entitled to a refund. Input tax credits are only available however for what are termed “*creditable acquisitions*”. Creditable acquisitions are defined in Division 11 of the GST Act and in summary, are available where the goods or services are acquired for the purpose of carrying on a business enterprise.

There are a number of categories of supply which are GST-free, although the supplying entity is entitled to input tax credit on any creditable acquisition that relates to that supply. The principal GST-free supplies are as follows:

- (a) medical services;
- (b) food (subject to further qualifications);
- (c) exports;
- (d) child care;
- (e) education;
- (f) farm land; and
- (g) sale of an enterprise as a going concern.

There is a second ground of exception from the GST: where a supply is input taxed. However, the distinction between input tax supplies and GST-free supplies is that the supplying entity is not entitled to input tax credits for creditable acquisitions made. The principal categories of input taxed activities are financial supplies including loans, superannuation, life insurance and bank accounts, and the supply of residential premises (including rent).

Obligations to Remit GST

Division 27 of the GST Act provides for the remittance of GST based either on quarterly or monthly periods. For enterprises with an annual turnover of \$20 million or more, monthly periods must be adopted.

Only entities with an annual turnover of less than \$500,000 may account for GST on a cash basis (the government proposes to increase this threshold to \$1 million). Otherwise Division 29 of the GST Act requires entities to account for GST on:

- (a) the earlier of the issue of an invoice for the supply in question; or
- (b) the receipt of any consideration in connection with the supply.

If these time limits are enforced by the ATO, then poor debtor management may result in an obligation to remit GST before payment is received. There will also be pressure upon businesses to ensure that they obtain the proper documentation from suppliers so that they are in a position to claim input tax credits. Absent that documentation, suppliers will be obliged to remit the GST in full.

INSOLVENCY ISSUES

Priority of GST in Insolvency Administrations

Under the old regime created by s221P *Income Tax Assessment Act 1936* (Cth) there was some question as to whether the ATO would seek to improve its priority position in respect of unpaid GST. The ATO has not sought to do so with the new regime.

GST is to have no better priority than any other unsecured creditor save for some provisions which seek to impose limited trust obligations upon insolvency practitioners in favour of the ATO.

Section 55 *Taxation Administration Act (TAA)* obliges a liquidator of a company or a person who, in the capacity of receiver or receiver and manager appointed pursuant to a debenture, takes possession of assets of the company to provide notice of his or her appointment to the ATO within 14 days thereafter.

The ATO is then obliged to notify the insolvency practitioner of what is called the “*notified indirect tax amount*” which covers the outstanding GST and any penalty the company is liable to pay.

Significantly, the section then provides a prohibition upon the distribution of the company’s assets (save for payments to secured creditors or preferred creditors under s556 of the Law) until such time as notice is received from the ATO. The obligation not to distribute such funds is potentially inconsistent with a liquidator’s obligation to deal with assets under his control promptly, although assuming that the ATO does act promptly to notify the practitioner of the notified indirect tax amount, that should not cause a problem in practice.

Upon receiving notice from the ATO, the insolvency practitioner is obliged to set aside sufficient assets to pay the pro-rata value of the ATO’s claim. The TAA constitutes the practitioner as trustee of those funds to be paid to the ATO and further, if the practitioner fails to make that payment to the ATO then he will be personally liable to pay that amount. The practitioner will also be guilty of an offence.

In the context of a liquidation, it is difficult to envisage how the liquidator can set aside assets to pay the ATO in circumstances where the total value of assets available to pay ordinary debts and the value of the ordinary debts may not be known for some time, perhaps for years. Whilst the legislation does not easily bear this interpretation, it might be interpreted to mean that the liquidator need only set aside those assets when he or she is in a position to determine the value of the assets and the value of the creditors’ claims and make a distribution.

Further, in the case of a receivership, where the secured creditor has been paid in full and where upon his retirement the receiver is to hand the company back to the directors, s55 of the TAA will oblige the receiver to hold separate and to pay to the ATO sums due for GST. That is notwithstanding that his appointor’s security may have been discharged.

Potential Liability of Insolvency Practitioners for GST

The principal liability for the payment of GST is upon the supplier. To assist in the recovery of GST due to the ATO, the ATO has the right to direct third party debtors of the company to pay some or all of the debt to the ATO (s34 TAA). There is also a provision that appears to make directors, officers and agents of a company potentially liable for unpaid group tax.

Section 57 of the *TAA* provides as follows:

"Liability of directors, etc of a company

1. Any notice, process or proceeding that may be given to, served on or taken against the company or its public officer under an indirect tax law may, if the Commissioner considers it appropriate, be given to, served on, or taken against an entity (the representative) who is:
 - (a) a director, secretary or other officer of the company; or
 - (b) an attorney or agent of the company.
2. The representative has the same liability in respect of the notice, process or proceeding as the company or public officer would have had if it had been given to, served on or taken against the company or public officer.
3. The section does not, by implication, reduce any of the obligations or liabilities of the company or public officer."

The explanatory memorandum to the *A New Tax System (Goods & Services Tax Administration) Act* does not shed any light upon the intention of the legislature although the fact that it does not state that directors and officers shall be liable for unpaid GST may be a clue. Further, there is no mechanism as applies in respect of group tax whereby directors may become personally liable for group tax only after the receipt of a notice from the ATO and only in respect of group tax that becomes due in the future.

Provisions with the same or very similar wording appear in other Australian taxation statutes. An example is the existing s121 of the *Sales Tax Assessment Act 1992 (Cth)*.

The Full Court of the Federal Court of Australia considered the proper construction of such a provision in *Reynolds v Deputy Commissioner of Taxation (ACT)* (1999) 84 ATC 4689; 15 ATR 1073 (**Reynolds**). The majority (Lockhart J, Neaves J concurring) held that such a provision did not operate to impose a personal liability upon a director or officer of a company to pay tax payable by the company nor to make a director or officer of the company liable for the company's acts or defaults.

Their Honours so held on the basis that:

- ◆ the ATO had in fact disavowed any suggestion that the provision operated to impose a personal liability upon a director or officer of a company to pay tax payable by the company in view of the High Court judgment in *Lean v Brady* (1937) 58 CLR 328;
- ◆ it would be oppressive and unjust to allow the ATO to decide whether any and if so which directors or officer, attorneys or agents of the company should be prosecuted for an act or default of the company or its public officer and which would, in effect, allow the ATO to proceed in the Courts against a wide class of persons who had little or no involvement in the relevant conduct of the company or its public officer;
- ◆ the proper function of such provisions is to allow the ATO to ensure that companies and their officers observe their statutory duties under the relevant Act but that such duties do not refer to the payment of tax but to an act of responsibility in connection with returns, assessments and other ancillary matters; and
- ◆ a Court should only hold otherwise where compelled to do so by clear and unequivocal language.

Notably, in his dissenting judgment Blackburn J held that:

- ◆ the provision (which was identical to s57 of the *TAA 1953*) although draconian, was quite clear and rendered directors and officers of the company liable to the same penalties as the company - including the payment of tax payable by the company; and
- ◆ Blackburn J found that although the provision may be harsh and even regrettable the court ought apply the legislation in accordance with its clear purpose and that it was not for the court to speculate why the legislature chose such a "*drastic method*" for the protection of revenue.

Enquiries made of the ATO indicate that the ATO intends to proceed on the basis that the section does not impose personal liability upon officers or directors. However, the issue remains far from certain.

Turning to the provisions of the position of an insolvency practitioner, s82A(1) Law defines “*officer*” to include a receiver and manager, a voluntary administrator, an administrator of a DOCA and a liquidator appointed in a voluntary winding-up. Whilst receivers who are not managers, Court appointed receivers and Court appointed liquidators are not regarded as officers, they may be caught if they act as agents for the company. On this basis, insolvency practitioners may well be rendered liable for GST if the section is found to impose personal liability. Assuming that the ATO did seek to advance the construction that imposes personal liability upon directors and officers, there must be some doubt about the validity of taxation legislation which gives the ATO power to arbitrarily determine whether or not entities other than the principal entity are liable for tax. In addition to the point made by the majority in *Reynolds* there may be an argument based on *Giris Pty Limited v The Commissioner of Taxation* (1969) 119 CLR 365 and *Vale Press Pty Limited v The Commissioner of Taxation* (1992) 34 FCR 238 that this law does not conform with s51(ii) of the Constitution of the Commonwealth and is therefore invalid. Having dealt with unpaid GST which has accrued in the past what about GST incurred during trading after an appointment of an insolvency practitioner? The *GST Act* obliges enterprises to register with the ATO for GST purposes where they are conducting an enterprise with a projected turnover at or above \$50,000 per annum.

Division 147 of the GST Act requires representatives of incapacitated entities to register themselves. Failure to do so results in the commission of an offence under the *TAA*. Although the legislation is not explicit, it does appear that it is the intention of the GST Act to fix the insolvency practitioner with the obligation to pay GST incurred after his appointment notwithstanding he may be acting as agent of the company.

There are also obligations on insolvency practitioners winding-up businesses for non-residents. Section 58 of the *TAA* obliges agents undertaking such tasks to notify the Commissioner of their instructions and fixes the agent with personal liability for notified GST in circumstances where the agent does not remit those funds to the Commissioner.

Sale of Assets – Going Concern v Breakup

It may be that the GST legislation will influence the way in which insolvency practitioners seek to dispose of assets to maximise the value received. This possibility arises because the supply of a “*going concern*” is GST-free assuming that the supply is for consideration, the recipient is registered or required to be registered and the supplier and the recipient have agreed in writing that the supply is of a going concern.

A supply of a going concern is defined as an arrangement under which:

- "(a) *the supplier supplies to the recipient all of the things that are necessary for the continued operation of an enterprise; and*
- (b) the supplier carries on or will carry on the enterprise until the day of supply (whether or not as a part of a larger enterprise carried on by the supplier)."*

Assuming that those criteria are met, then there will be no need for the vendor to add GST to the price of a company’s business sold as a going concern. The explanatory memorandum does not make clear the purpose for this exemption. It might be read as beneficial legislation that is intended to seek to encourage the preservation of businesses and therefore employment. It also eases a cash flow problem which would otherwise strike the purchaser while he waited for his refund or input tax on acquisition of the business.

Where assets are sold as individual items as opposed to as part of a business enterprise, GST will be payable on the price of those items, although ultimately the GST paid by the purchaser may be offset by tax credits, a purchaser will have to finance the GST which, on a large sale, may be significant. In those circumstances purchasers may be prepared to pay more for a going concern than the sum of its parts. For that reason there is likely to be an incentive to seek to sell businesses as a going concern where possible. This incentive on its own is unlikely to be decisive in the decision to trade on and seek to sell as a going concern, but it will be a relevant factor to take into account.

Settlement of Disputes and Legal Proceedings

Although the GST is called a goods and services tax, potentially its application is much wider than that. As noted above, the definition of “supply” also covers the following:

- (a) provision or advice or information;*
- (b) a creation, grant, transfer, assignment or surrender of any rights; or*
- (c) an entry into or release from an obligation to:*
 - (i) to do anything;*
 - (ii) to refrain from an act; or*
 - (iii) to tolerate an act or situation."*

The reference in paragraph (c) to the entry into a release suggests that a releasor may be responsible for the payment of GST upon that release. This is likely to have an impact upon the settlement of disputes by insolvency practitioners and generally. In circumstances where the consideration paid for the release is not grossed up for GST the releasor bears the GST on the amount paid for that release.

EXAMPLE

Party A gives up its right to make a claim in consideration of the receipt of payment. Party A will be making a supply and will be liable to pay GST. The party making the payment, party B will (assuming that both parties are registered businesses for GST purposes) be entitled to an input tax credit and as a consequence, the cost to that party grossing up the payment for the GST effect is offset. If however, there is a failure to gross up the amount of the payment to be made by B to A, then potentially A will be left with the obligation to pay the tax in circumstances where, particularly if the company is no longer trading, it may not have or be unable in the future to obtain input tax credits to offset that payment.

In certain circumstances, there will be consideration for the release expressed in the agreement and the GST payable will be easily determinable. In other cases, there may be a more difficult task of establishing the market value of the release. In order to avoid arguments with the ATO it may be wise to value the release in the settlement agreement, bearing in mind of course the Division 165 anti avoidance provisions.

Price Controls and the ACCC

The amendments to the *Trade Practices Act* instituted by *A New System (Trade Practices Amendment) Act 1999* are relevant to insolvency practitioners where they trade businesses at any time up until 1 July 2002.

The legislation is designed to ensure that the adjustments to prices which occur as the result of reduction in the rate of wholesale sales tax the introduction of credits for fuel, the introduction of the GST and other tax charges, properly reflect those changes and are not used as an opportunity to drive higher profits. The ACCC has publicly stated in its GST Guidelines that:

Prices should not increase by more than the amount of a tax rise and should fall by at least the amount of any tax fall in any market.

The ACCC has further indicated that it would expect to see price changes to immediately follow reductions into wholesale sales tax rate and any increases in price as a result of GST should reflect no more than the 10% tax rate together with possible increases in compliance costs.

The ACCC has indicated that price rises beyond those that reflect changes to the tax rates may only be justified if costs (other than GST), have increased or there has been a demonstrable increase in demand for the product. The effect of the Act is to amend the price exploitation provisions of the Trade Practices Act 1974 (Cth) in regard to misrepresentations made about the effect of the New Tax System changes. The provisions include relevant misleading and deceptive conduct and false misrepresentations, both express and implied. Insolvency practitioners should take these provisions into account when advising clients as to such matters as persons involved in a contravention are also caught.

The enforcement provisions are worthy of note, fines may be levied upon profiteers at \$10 million for a company and \$500,000 for individuals including officers of the company. Further, upon the provision of a notice of breach under the amended Act, there is a reversal of the onus of proof in Court which requires the company to demonstrate that its price increases were justifiable based on the criteria set out in the Act.

The GST operates in relation to post-1 July 2000 supplies. Insolvency practitioners should keep up to date with legislative changes and Court interpretations of the various provision as cases come before the Courts after 1 July 2000.

CORPORATIONS LAW

The Corporate Law Economic Reform Program

The *CLERP Bill* was passed by the Commonwealth Parliament on 20 October 1999 and commenced on 13 March 2000. The *CLERP Act* amends the Law in four main areas:

- ◆ director's duties;
- ◆ fundraising;
- ◆ takeovers; and
- ◆ accounting standards.

Of most interest to insolvency practitioners are the new provisions relating to directors duties.

The business judgment rule

The "*business judgment*" rule seeks to provide company directors protection from breaches of their duties of care and diligence (both under the Law and in the common law) in relation to honest, informed and rational business judgments.

In order that a director may claim the protection of the rule, the following criteria must be met:

- ◆ the decision must be made in good faith and for a proper purpose;
- ◆ the director must not have any material personal interest in the matter;
- ◆ the director must inform him or herself about the subject matter of the decision to the extent he or she believes reasonably appropriate; and
- ◆ the director must believe rationally that the decision was made in the best interests of the corporation.

The rule's operation is limited to the business operations of the corporation and does not extend to those situations where shareholders allege oppression, there is a breach of the Law relating to takeovers, a misleading statement in a prospectus, insolvent trading or other areas where specific rules apply to director's behaviour.

Statutory derivative actions

Shareholders and directors have the right to bring action in the name of the company where the company is unable or unwilling to do so. This abolishes the common law rule enabling members and directors to bring such actions.

Former members of the company, present or former members of related bodies corporate and former directors are also able to bring such actions.

In all cases the leave of the Court is required to bring the action.

Revision of general statutory rules

The statutory duty of directors to exercise due care and diligence in the conduct of the company's affairs is now referable to the standard of the reasonable person in the circumstances of the director or officer concerned. Any breaches of this duty will give rise to civil penalties only.

The statutory duty to act honestly has been recast as a duty to act in good faith in the best interests of the corporation and for a proper purpose.

Recognition of the right to rely and delegate

Directors are recognised to rely on information and advice provided by experts, including employees. Any such reliance must be done in good faith and after making an independent assessment of the advice or information. The directors may also delegate their powers, subject to the company constitution, to the following persons:

- ◆ a committee of directors;
- ◆ a director;
- ◆ an employee; or
- ◆ any other person.

Indemnification of directors and officers

A company may not now indemnify a director or officer for legal expenses incurred:

- ◆ in defending proceedings in which the person was found to have a liability for which the company may not indemnify (ie. a wilful breach of duty to the company or an improper use of inside information or the position of director);
- ◆ in defending criminal proceedings in which the person is found guilty;
- ◆ in defending proceedings brought by ASIC or a liquidator decided against the director; and
- ◆ in proceedings for relief which are denied by a Court.

Also, directors and officers have no statutory right to the books of the company for the purpose of conducting legal proceedings.

Wholly owned subsidiaries and conflicts of interest

A director of a wholly owned subsidiary acting in good faith in the best interests of the company will be taken to act in good faith and in the best interest of the subsidiary if:

- ◆ the constitution of the subsidiary expressly authorises the director to do so; or
- ◆ the subsidiary is not insolvent at the time that the director acts, or as a result of the director's act.

Practitioners should familiarise themselves with the amendments introduced by the CLERP Act, particularly where they are considering proceedings against directors for breaches of duty.

OTHER DEVELOPMENTS

Protection of Employee Entitlements in Corporate Insolvencies

The extent to which the Law provides for the protection of the entitlements of employees of insolvent corporations became a high profile legal, political and social issue during the period 1998-1999.

This followed the much publicised Oakdale Collieries and National Textiles cases which, before specific government intervention, resulted their employees facing the very real prospect of their millions of dollars of accrued employee entitlements not being paid.

The current legal position

Under the Law and the BA employees are placed ahead of all other unsecured creditors, including the ATO and ordinary trade creditors. The Law presently provides that any shortfall in employee entitlements should also be met prior to claims made by the holder of a floating charge. In essence, that floating charge is rated as having a lower priority than employee entitlements. Despite this, but subject to the considerations above, if a business is hopelessly insolvent and its assets are either non-existent or fully secured, then employees are only marginally better off than the pool of unsecured creditors. The increase in high profile insolvencies and changes to the Commonwealth's policy arising out of its July 1999 Ministerial Discussion Paper led to Workplace Relations Minister Peter Reith's announcement of a national scheme on 8 February 2000.

The proposed national scheme for employee entitlements protection

The proposed national scheme will be backdated to 1 January 2000 to cover employees dismissed due to employer insolvency and outstanding employee entitlements being paid out of a specifically set up fund. The intention of the scheme is to provide a safety net for employees in that they will be entitled to a maximum of twenty-nine weeks pay for unpaid entitlements made up as follows:

- ◆ up to four weeks unpaid wages, annual leave accrued in the last year and redundancy pay;
- ◆ up to five weeks pay in lieu of notice; and
- ◆ up to twelve weeks long service leave.

A \$20,000 cap will exist on the amount an individual may receive from the fund, which will be financed by the Commonwealth and State governments.

The Commonwealth has also announced that it will introduce legislation to amend the Law to:

- ◆ introduce a new offence penalising any person entering into an arrangement or transaction which has the purpose including avoiding payment of employee entitlements; and
- ◆ strengthen the existing insolvent trading and related party provisions so that directors can be found in breach if they give a financial benefit to a related party or enter into an uncommercial transaction causing the company to become insolvent and to allow a court to order payment of some or all of an insolvent company's outstanding employee entitlements by any person whom the court is satisfied has been involved in transactions or arrangements which have the purpose of avoiding payment of those employee entitlements.

The proposed scheme does not alter the priorities currently available to employees in recovering their accrued entitlements as against other unsecured creditors. To this extent the status quo prevails. Practitioners should familiarise themselves with amendments in this area if and when they become law.

TRANS-TASMAN DEVELOPMENTS

Personal Property Securities Act 1999 (NZ)

The *Personal Property Securities Act 1999 (NZ)* was passed in New Zealand during 1999. The Act makes a number of fundamental changes to the law relating to debtors and secured creditors and priorities between competing secured creditors. The Act is based on similar legislation in Canada and the US. It will come into force on a date to be appointed by the Governor-General.

The new regime will apply to every transaction which creates a security interest in personal property, which is effectively all property other than interests in land. It will apply to security created by any legal entity, including individuals, companies, trusts and associations. It will repeal a number of Acts including the *Companies (Registration of Charge) Act 1993* and the *Motor Vehicle Securities Act 1989*, replacing the various registration regimes with an internet-based personal property register.

The New Rules

Two concepts that are fundamental to the operation of the Act are those of “*attachment*” and “*perfecting a security interest*.” “*Attachment*” occurs in respect of a security interest upon value being given by the secured party and the debtor having rights in the collateral. A security interest is ‘perfected’ when a “*financing statement*” (a separate form with specific information requirements) is lodged or the creditor takes possession of the property. The financing statement may relate to multiple security agreements. The security documents themselves cannot be registered. To amend a financing statement, a “*financing change statement*” is required to be lodged.

The financing statement may be registered before or after attachment or a security agreement is made. If beforehand, upon attachment the “*security interest will be perfected as at the date of registration*.” Therefore, it is important to register an interest as soon as possible. The Act also contains special rules where goods subject to a security interest are affixed to other goods (*accessions*), and where goods subject to a security interest are processed or commingled with other goods to form a product or mass (*commingled goods*).

Existing Security – Transitional Arrangements

In order to maintain priority after a 6 month transitional period provided for in the legislation, secured creditors will need to perfect existing security interests. Existing security will need to be re-registered before the end of that period to ensure it retains its priority under the new scheme.

Enforcement

In relation to personal property other than consumer goods, the Act prescribes default provisions to apply to the enforcement of security interests. In particular, note the following.

- ♦ as the legislation is currently drafted, ***only the secured party with priority over all other parties*** is entitled to take possession of and sell the collateral; and
- ♦ the parties may contract out of the enforcement provisions only to the extent that it does not affect the rights of third parties.

This Act will be critical to lenders in New Zealand. It will be interesting to observe whether similar legislation is enacted in Australia.

ACCC	Australian Competition & Consumer Commission (formerly the Trade Practices Commission)
ASC	Australian Securities Commission (superseded by ASIC)
ASIC	Australian Securities & Investments Commission
ATO	Australian Taxation Office
BA	<i>Bankruptcy Act 1966</i> (Cth)
CLERP	The Corporate Law Economic Reform Program
Code	<i>Companies Code</i> (repealed) (replaced by the <i>Corporations Law</i>)
DCT	Deputy Commissioner of Taxation
DOCA	Deed of Company Arrangement
GST	Goods and services tax
Law	<i>Corporations Law 1989</i>
VA	Voluntary Administration under Part 5.3A of the <i>Corporations Law</i>
*	Case is the subject of an appeal

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