NEWSLETTER

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Reconstruction & Insolvency Newsletter

Welcome to our first Reconstruction & Insolvency Newsletter

The newsletter will be distributed quarterly and will contain topical articles on legal issues and developments, as well as news of Cornwall Stodart's Reconstruction & Insolvency team.

This quarter we have included news on:

- rights of tenants and landlords in insolvency
- confusion over receivers' obligations with respect to leave and superannuation entitlements resolved
- unfair preference claims: preserving liquidators' entitlement to recover interest
- civil dispute resolution legislation.

Please don't hesitate to contact us if you would like more information on any topic, whether covered in this newsletter or not. We hope you find the newsletter informative and useful.

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*Click on image to view Paul's profile

Cornwalls' Reconstruction & Insolvency Team Member Profile

Paul Buitendag, Partner and Head of Reconstruction & Insolvency

Paul is experienced in commercial disputes generally, with a focus on reconstruction and insolvency. Before joining Cornwall Stodart, Paul was the Principal of his own firm in South Africa, where he practised broadly in commercial law. His clients value his depth of expertise in dispute resolution, and his ability to deliver commercial outcomes.

He advises liquidators, administrators, banks and creditors on proof of debt claims, as well as enforcing securities, unfair preferences, receiverships, commercial transactions, deeds of company arrangement and insolvent trading.

Paul's expertise extends to debt recovery, schemes of arrangement and liquidations. He is renowned for identifying cost effective and commercially sound alternatives to litigation.

In 2011 Paul became co-editor of the Lexis Nexis *Australian Corporation Law - Principles & Practice (External Administration)*, a quarterly loose-leaf volume.

Rights of tenants and landlords in insolvency

Two recent Victorian decisions have clarified the legal principles applied by the courts in relation to tenants' and landlords' rights in an insolvency administration:

1. Administrators commonly apply for extensions of the convening period for the purpose of extending the moratorium. Often, extensions of the moratorium aim to allow the administrators (or, through them, secured creditors and their appointed receivers) to effect a sale of a business, with its leasehold intact, as a going concern. However, the recent decision in *IMO Colorado Group Limited* [2011] VSC 552 should serve as a warning to administrators and receivers that the courts will not necessarily prevent landlords from re-entry onto premises leased by the company in administration.

We have recently initiated a series of mutual knowledge sharing seminars with a firm of insolvency practitioners. In discussions between our firms, it was identified that there is a lack of knowledge around what each firm does. The seminars are designed to provide a basic understanding on particular topics and it is expected that this sharing of knowledge and strengthening of relationships will enable our two firms to work together more effectively.

The first seminar was held on 7 March and our Head of Commercial Litigation, Wayne Kelcey, presented on the topic: 'Anatomy of a Legal Proceeding'. The feedback has been very positive and we look forward to continuing the series. We hope to introduce similar seminars with other insolvency practitioners with whom we have a significant relationship.

2. Often a liquidator of a landlord may wish to sell property unencumbered, including by any leasehold interests. Liquidators have wide powers to disclaim 'onerous property'. However, following *Willmott Forests Ltd (Receivers and Managers Appointed) (In Liq) & Ors* [2012] VSC 29, liquidators of landlords cannot disclaim a lease with the effect of extinguishing the tenant's leasehold estate or interest in land, due to the both contractual and proprietary nature of leases.

IMO Colorado Group Limited

Background

The landlords of Westfield Southland and Westfield Carousel, made application for leave of the court under section 440C of the *Corporations Act 2001* (Cth) (**Act**) to enforce their rights to possession of two retail premises within their shopping centres that were leased by the tenant, Colorado Group Limited (Administrators Appointed) (**Colorado**).

The Colorado group commenced administration on 30 March 2011, reportedly owing $440 million to primary secured lenders, $20 million to unsecured lenders and $13 million in employee entitlements. The group comprised 10 companies, of which Colorado was the main contracting entity, with stores located in both Australia and New Zealand.

In May 2011, Colorado had been granted an extension to the period within which the administrators were required to convene the second meetings of creditors of the entire group, until 3 February 2012.

The Colorado lease at Westfield Southland commenced on 3 April 2006, for a five year term. The parties undertook negotiations for renewal, but no subsequent agreement was reached. The term expired on 2 April 2011, a few days after administration commenced.

The Colorado lease at Westfield Carousel commenced on 4 October 2004, for a five year term. The term was extended twice, with the last extension expiring 17 May 2011. It was confirmed on 16 March 2011 that Colorado would not be offered another premises within the shopping centre.

Both Westfield Southland and Westfield Carousel had made other arrangements regarding the premises occupied by Colorado. Westfield Southland had entered negotiations with a prospective tenant to lease the Colorado premises at Westfield Southland, who was temporarily placed in another location within the shopping centre as a result of the administrators' hold over the property. Westfield Carousel arranged for the premises of Colorado at Westfield Carousel to be subdivided into two tenancies, and re-fitted to be leased to two new tenants. The subdivision and fit out had been postponed following the commencement of the administration.

The proceedings

The court was asked to consider the following issues:

1. notwithstanding the status of a lease agreement, whether tenants under administration are entitled to withhold possession of property from a landlord by virtue of s 440C; and

2. whether the interests of tenants under administration and the interests of creditors generally, outweigh the interests of landlords.

Section 440C of the Act provides that during the administration of a company, the owner or lessor of property that is used or occupied by, or is in the possession of, the company, cannot take possession of the property or otherwise recover it, except:

- with the administrator's written consent; or
- with the leave of the court.

Section 440C falls within Part 5.3A of the Act and its application must fall within the expressed objectives set forth in s 435A, namely that the business, property and affairs of an insolvent company are to be administered in a way that:

- maximises the chances of the company, or as much as possible of its business, continuing in existence; or
- if it is not possible for the company or its business to continue in existence, results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

The decision

Associate Justice Gardiner of the Supreme Court of Victoria held that:

- landlords bear the onus of proof of persuading the court that the leave should be granted, given they are the parties seeking it;
- leave should only be granted if it does not contradict the objective of the administration, in this case Part 5.3A. Both stores made up only a minor percentage of the undertakings of Colorado and there was no evidence to suggest such contradiction;
- the prohibition on landlords taking possession of property leased to parties under administration should be relaxed if the prohibition would be inequitable. In this case the leases had expired and so the goodwill of Colorado (interpreted as a feature of s 435A) diminished, while the prohibition under s 440C remained inequitable as against the landlords;
- it is necessary to balance the interests of the parties. In doing so, the benefit to unsecured creditors should not be at the expense of parties seeking to exercise proprietary rights. The creditors in this case would receive no benefit from rejecting the application for leave, whereas the plaintiffs would suffer ongoing financial loss;
- loss is assessable with regard to a non exhaustive list of factors including the: expected timeframe of the administration proposed by the administrators; ability to pay rent while in administration or after; impact on the financial position of the company. Applying these to the present circumstances - given the unsecured creditors were unlikely to receive dividends, current rentals were being paid by receivers, and the administrators' proposals would not include arrangements with the plaintiffs as a result of the expiration of lease agreements - the receivers and administrators were not successful in demonstrating a negative effect on the likelihood of Colorado entering into a deed of company arrangement if the leave were granted;
- assessing the probability of the suggested consequences, it was more probable than not that the losses faced by Westfield Southland and Westfield Carousel exceeded those of Colorado; and
- the conduct of the parties did not suggest unethical behaviour.

The loss to the plaintiffs was significant, in that it outweighed the loss incurred by Colorado, and was vital to the granting of leave. As the plaintiffs were unable to lease the premises to the intended new tenants, they were losing receivable income. The court agreed to grant leave to the plaintiffs in taking possession of their respective premises.

Willmott Forests Limited

Background

Willmott Forests Limited (**WFL**) follows Timbercorp, Great Southern and Enviroinvest in the recent spate of large agribusiness managed investment schemes collapsing. Like many of those schemes, WFL was the responsible entity/manager of several managed investment schemes that conducted agricultural operations on land either owned by WFL or leased by WFL from third parties. WFL entered into lease and licence agreements with the members of the scheme (known as 'Growers'), who had rights to grow and harvest trees on the land.

Upon their appointment, the liquidators of WFL entered into agreements to sell the freehold land, unencumbered by the Growers' rights. When the Growers refused to give up their rights, the liquidators obtained approval from the Federal Court to amend the scheme constitutions and other documents to enable WFL to terminate the Growers' rights and disclaim the lease and licence

agreements pursuant to s 568 of the Act. The Federal Court expressly left open the question of whether such a disclaimer would be effective to extinguish the Growers' leasehold estate or interest in the subject land. The liquidators applied to the Supreme Court for judicial advice on this question.

The position at law

Section 568 empowers liquidators to disclaim certain property of the company, including contracts, land burdened with onerous covenants and property that is difficult to sell. Liquidators cannot disclaim a contract (except an unprofitable contract or a lease of land) without approval of the court. Section 568D(1) provides that the effect of a disclaimer is to terminate the company's rights, interests, liabilities and property 'for or in respect of' the disclaimed property, but the rights of other parties are not affected 'except so far as is necessary in order to release the company or its property from liability'.

Counsel for the liquidators submitted that the effect of a disclaimer of a lease is that the tenant's leasehold estate ceases to exist.

The decision

Justice Davies in the Supreme Court of Victoria rejected this submission, stating that:

> *'[it] fails to give due regard to the position in law that a lease creates both contractual and proprietary rights. A lease is a contract between the parties but a lease is also the grant by the landlord of an estate in land in the tenant, which is a different estate in land to the landlord's freehold estate. The leasehold interest is a legal estate of which the tenant is the owner.'*

Her Honour held that a disclaimer of a lease by the liquidator of a landlord would only terminate the rights, interests, liabilities and property of the landlord, but would not bring the lease to an end for all purposes. Importantly, the tenant's proprietary rights in the land would continue to subsist. Unless a resolution was reached by 15 January, the conditions precedent for the sale of land would not be met and the sale would fall through. The liquidators would then face a new round of negotiations with the Growers to give up their rights.

The decision is a significant victory for tenants, and may cause difficulties for liquidators, particularly where the subject company has a sizable property portfolio or recalcitrant tenants. Liquidators should review carefully the property portfolio of companies to which they are appointed and be mindful that they are unable to evict tenants merely by disclaiming the lease as onerous.

Conclusion

The above decisions clarify the rights between landlords and tenants where one party becomes insolvent. The decisions in effect may preserve the pre-existing proprietary rights of parties to a lease during an insolvency administration.

(Please **click here** for an article written by Jamie Bedelis - Senior Associate and member of our Commercial Property team - on a recent decision of the Victorian Civil and Administrative Tribunal (**VCAT**), where VCAT found that a landlord was entitled to terminate a lease upon the bankruptcy of the tenant's guarantor.)

Authored by: **Jarrod Munro**, Cornwall Stodart

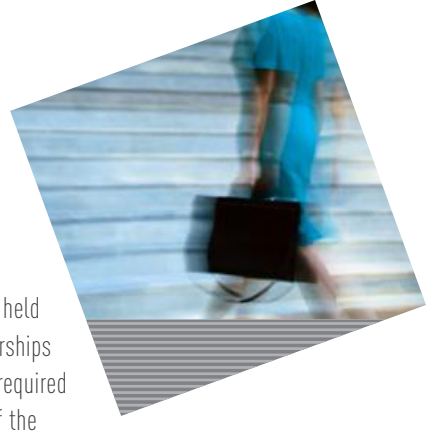
Confusion over receivers' obligations with respect to leave and superannuation entitlements resolved

Background

It is essential that receivers consider their obligations and liabilities with respect to employee entitlements. The *Corporations Act 2001* (Cth) (**Act**) requires receivers to pay employees various entitlements in priority to the charge holder – and, in certain circumstances, makes them personally liable to meet those entitlements. Receivers who fail to pay certain employee entitlements may be guilty of an offence under the Act and be personally liable to pay compensation.

The legal position

It is settled law that receivers of companies that 'trade-on' throughout the appointment are required to pay employees – their



wages, any payments in lieu of notice and any redundancy payouts – in priority to the claims of a secured creditor under a floating charge. However, until recently, uncertainty existed as to the extent of a receiver's liability with respect to employees' annual leave, long-service leave and superannuation entitlements, where employees continued their employment after the appointment of a receiver. The Federal Court decision of *White v Norman*[1] has confirmed as good authority the reasoning of Finkelstein J in *McEvoy v Incat Tasmania Pty Ltd*[2] and Barker J in *Re Vickers, in the matter of Challenge Australian Dairy Pty Ltd* (***Re Vickers***),[3] which clarified the obligations of receivers with respect to these entitlements.

Re Vickers

Facts

In *Re Vickers*, Challenge Australia Dairy (**CAD**) went into receivership but the receivers continued to operate parts of the business and retained a large proportion of employees. Many of these employees had been with the company for a long time and had accrued a significant amount of leave and superannuation entitlements, which they continued to accrue throughout the receivership. These entitlements were potentially a significant liability for the receivers, who sought directions from the court to determine whether they were required to pay the employees their entitlements in priority to the charge debt pursuant to ss 433, 556(1) and 558(1) of the Act.

The applicable law

Section 556(1) provides that, in a winding up, employee entitlements that are 'due' on or before the start of the administration rank ahead of claims by a secured creditor under a floating charge. Section 558 then provides that entitlements of employees of a company in liquidation have the same priority as if the employees' services had been terminated at the commencement of the winding up. Accordingly, in a winding up, priority is afforded to certain entitlements of employees who continue with the company after the commencement of the winding up. Section 433 provides (among other things) that employee entitlements 'that in a winding up [are] payable in priority to other unsecured debts' must be paid out in priority to the claims of a secured creditor under a floating charge. This provision applies to receiverships, but it does not refer expressly to s 558.

It is settled law that receivers are required to pay as a priority any employee entitlements that become due and payable on or before the date of appointment of the receivers. The difficulty for the receivers (and the court) in *Re Vickers*, was that conflicting authority existed as to whether s 558 applies to receiverships; and therefore whether entitlements accrued by the retained employees that had not fallen 'due' by the date of the receivers' appointment were required to be paid as priority payments.

The conflicting authorities

In *Re Office-Co Furniture Pty Limited*,[4] de Jersey CJ held that s 558 applies to receiverships such that employees whose employment is terminated during the course of a receivership are entitled to a priority out of the floating charge assets for entitlements accrued prior to the appointment of the receivers. Entitlements accrued after the appointment of the receivers were not entitled to any priority.

By contrast, Finkelstein J in *McEvoy* held that s 558 does not apply to receiverships and, accordingly, that receivers are required to pay employee entitlements out of the floating charge assets only to those employees whose employment was terminated on or before the date of appointment of the receivers (or had otherwise become 'due' prior to this date).

The decision

Barker J in *Re Vickers* considered these two obviously inconsistent decisions and stated:

> *'One can readily see the force of the practical analysis provided by de Jersey CJ in Re Office-Co Furniture. In so many cases, a receivership does spell an end to a company. It would seem odd, if not unfair, that there should be two different sets of rules concerning payment of entitlements upon a winding up and in a receivership. Nonetheless, I feel persuaded by the analysis provided by Finkelstein J in McEvoy, particularly having regard to the legislative history of s 443, and consider the better view is that s 558(1) does not apply to receivership.'*

As a consequence of s 558(1) not applying to receiverships, the accrued leave and superannuation entitlements of the retained CAD employees did not have any priority under s 433.

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[1] *White v Norman; Re Forest Enterprises Australia Ltd (recs and mgrs apptd) (in administration)* [2012] FCA 33.

[2] (2003) 130 FCR 503.

[3] *Re Vickers, in the matter of Challenge Australian Dairy Pty Ltd (Administrators Appointed) (Receivers and Managers Appointed)* [2011] FCA 10.

[4] [2000] 2 Qd R 49.

Additional considerations

The receivers also sought a ruling on whether they were personally liable for employee entitlements accrued during the course of the receivership under s 419. Section 419 provides that a receiver is liable for debts incurred by the person in the course of the receivership for 'services rendered, goods purchased or property hired, leased, used or occupied'.

The court in *Re Vickers* accepted that the appointment of a receiver out of court does not of itself terminate a contract of employment, and that the receivers of CAD had not personally adopted the employment contracts of the retained employees, nor had they entered into any new contracts or arrangements. Accordingly, the court made declarations that the receivers were not personally liable for any employee entitlements that accrue under pre-existing contracts of employment. Hence receivers should take care when adopting, changing or renegotiating contracts of employment or taking on new staff because in doing so, they may become personally liable for employee entitlements under s 419.

Conclusion

As a result of *Re Vickers* and, more recently, *White v Norman*, the decision in McEvoy appears to be accepted as good authority. However, in each of these cases, the court expressed some hesitancy in reaching the conclusion that s 558(1) does not apply to receiverships. As Barker J observed in *Re Vickers*:

> *'It may well be that if this express issue concerning priority payments in the case of a receivership were to be raised with Parliament for the first time, it would agree with the outcome found by de Jersey CJ in Re Office-Co Furniture.'*

Receivers should be aware of their obligations with respect to employee entitlements to ensure they do not inadvertently incur personal liability by their actions – and in this regard should take particular care when adopting, changing or renegotiating contracts of employment or taking on new staff.

Authored by: **Graeme Scott** and **Lachlan Currie**, Cornwall Stodart

Unfair preference claims: Preserving liquidators' entitlement to recover interest

Background

Often creditors will seek to resist a claim for interest on the basis of an allegation that a liquidator did not provide supporting evidence promptly.

Recent decisions in the Federal Court and the Victorian Supreme Court are a timely reminder for liquidators of the legal position regarding the awarding of interest in successful claims against creditors and the approach open to judges when exercising their discretion.[1]

The basis for awarding interest is on the premise that the creditor had the use and benefit of the money (up to the date of the court's order) and accordingly the creditor has derived an advantage from retention of the sum beyond the date of the liquidator's demand until the date of the court order.[2]

Further, state and federal legislation provide for an award of interest following a successful claim.[3] These provisions are similar in language and effect and confer on the court a discretionary directive to award interest following a successful recovery of debt.

The effect of this is that liquidators have a prima facie entitlement to receive interest unless a debtor shows 'good cause' why interest should not be awarded.[4]

'Good cause...to the contrary'

What courts will deem to be sufficient to constitute 'good cause... to the contrary' will turn on the facts and circumstances of the particular case.

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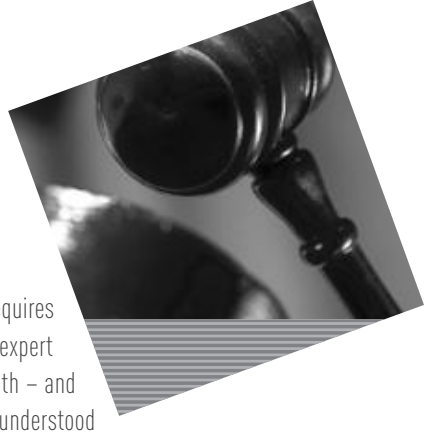
[1] *Kazar (Liq.) v Kargarian; Re Frontier Architects Pty Ltd* [2011] FCAFC 136; *PGA Group Pty Ltd v Idameneo Ltd* [2011] VSC 420; see also: *Greig and Anor v Commissioner of Taxation and Ors(No 2)* [2010] QSC 265; and *Kallis Enterprises Pty Ltd and Ors v Baloglow and Anor (No 3)* [2007] NSWCA 98.

[2] *Noxequin Pty Ltd & Anor v Deputy Commissioner of Taxation* [2007] NSWSC 87 per Barrett J [38].

[3] *Supreme Court Act 1986* (Vic) section 58; *Federal Court of Australia Act 1976* (Cth) section 51A.

[4] *Supreme Court Act 1986* (Vic) section 58(1).



This being said, 'good cause' as to why interest should not be awarded is difficult to show except in exceptional circumstances.[5] In one Supreme Court case, a delay of ten years between when the debt was payable to the date of judgment was considered excessive. However, in reviewing the facts, the judge also found that at certain times during the period, delay was not unreasonable and therefore awarded interest for a period of three years preceding judgment.[6]

Often a creditor will argue that a liquidator is not entitled to interest (or only at a lesser rate or shorter time period) because, for example, the liquidator was tardy in progressing an unfair preference claim or providing the creditor with information to support the liquidator's claim.

However, in *Kallis Enterprises Pty Ltd and Ors v Baloglow and Anor (No 3)* [2007], the NSW Court of Appeal accepted that mere 'delay is ordinarily not a reason for refusing or reducing the inclusion of interest', noting from the evidence at trial, it was obvious that the liquidator had a difficult task in piecing together what had occurred and what action to take.[7]

Further, the Federal Court last year noted that a reasonable amount of time needs to be afforded to applicants in order to investigate whether an action can and should be brought, especially when the claim is brought by a liquidator. It was held that absent any truly blameworthy conduct causing an excessive delay, the general rule is that interest will be awarded for the period commencing from the date of any demand until the time of judgment.[8]

Notwithstanding the above, creditors may still be successful in arguing that a delay has been unreasonable – and if they are able to demonstrate this, the court may use its discretion to deny an application for interest, partially suspend the applicable time period, or award a lesser rate of interest than the maximum allowed.

For example, in *Jonas (as liq of MGT Damorr Knitting Mills) v Rocklea Spinning Mills (No 2)* [2003], the Victorian Supreme Court exercised its discretion to suspend interest accruing during certain periods as a result of a trial date being vacated due to the liquidator's extremely late production of a large number of documents necessary for the trial.[9]

Preserving the claim for interest

In order to preserve the claim for interest, we would recommend that the liquidator send a letter of demand at the earliest opportunity.

Liquidators should also ensure that there is no unreasonable delay in the production of documents.

Authored by: **Adrian Lasky** and **Natalie Ayoub**, Cornwall Stodart

Civil dispute resolution legislation

Over the last 12 months there have been significant legislative developments across state and federal jurisdictions that affect the way civil proceedings are conducted in Victorian and federal courts.

The Victorian Act and overarching obligations

The *Civil Procedure Act 2010* (Vic) (**Victorian Act**) commenced on 1 January 2011. It introduced a number of 'overarching obligations' that apply to all civil proceedings heard and issued in a Victorian court (that is, the Magistrates Court, the County Court and the Supreme Court). The Victorian Act requires all parties to the dispute (including expert witnesses and funders) to comply with – and also certify that they have read and understood – these obligations.

Overall, the Victorian Act seeks to ensure that parties conduct themselves appropriately by only pursuing claims and defences that have a proper basis, negotiating settlements where possible, avoiding delays and keeping costs to a minimum. By way of example, parties are under an obligation to disclose documents to the other side that are critical to the resolution of a proceeding at the 'earliest reasonable time' after they become aware of the document in their control.

There are consequences if parties do not act in accordance with the overarching obligations. For example, costs may be ordered against a party, or a claim or defence may be struck out by the court.

The Federal Act and 'genuine steps' requirement

The *Civil Dispute Resolution Act 2011* (Cth) (**Federal Act**) came into effect on 1 August 2011 and imposes obligations on prospective

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[5] *Kazar (Liq.) v Kargarian; Re Frontier Architects Pty Ltd* [2011] FCAFC 136, per Foster J at [75].

[6] *PGA Group Pty Ltd v Idameneo Ltd* [2011] VSC 420, per Davies J.

[7] *Kallis Enterprises Pty Ltd and Ors v Baloglow and Anor (No 3)* [2007] NSWCA 98.

[8] See comments in *Kazar (Liq.) v Kargarian; Re Frontier Architects Pty Ltd* [2011] FCAFC 136 at [68].

[9] *Jonas (as liq of MGT Damorr Knitting Mills) v Rocklea Spinning Mills (No 2)* [2003] VSC 366.

litigants to take genuine steps to resolve a dispute before proceedings are commenced in either the Federal Court or Federal Magistrates Court.

Unlike the Victorian Act, the Federal Act has a more limited purpose. It aims to 'ensure that, as far as possible, people take genuine steps to resolve disputes before certain civil proceedings are instituted'. If dispute resolution is unsuccessful and proceedings are issued, each party must file a 'genuine steps statement' to the effect that genuine steps have been taken to resolve the dispute.

While the Federal Act does not prescribe what genuine steps must be taken by parties (instead allowing parties to decide what steps are appropriate in the circumstances), it does provide examples of 'genuine steps' that could be taken by a party. Examples include attempting to negotiate with the other party with a view to resolving some or all the issues in dispute, providing relevant information and documents to the other party to facilitate resolution of the dispute and considering whether the dispute could be resolved by an alternative dispute-resolution process.

Under the Federal Act, as is the case under the Victorian Act, the court is able to take into consideration what genuine steps were taken by the parties (and whether those steps were appropriate) when exercising its discretion to award costs.

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The Victorian Act initially required parties to engage in 'pre-litigation requirements' (this has since been repealed).

However, while there is no legislative requirement to engage in pre-litigation requirements, we have found that in appropriate cases pre-litigation steps may be utilised to expedite the settlement of matters (without the need to issue proceedings) and to minimise costs. Indeed, our experience is that, by providing the other side with an evidence pack (which also contains an analysis of the evidence) relied on to support a claim as early as possible, meaningful settlement negotiations can be engaged in, often resulting in settlement prior to any proceedings being issued – or where proceedings have been issued, we have been able to obtain orders consenting to judgment without proceeding to a contested hearing.

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