NEWSLETTER

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Reconstruction & Insolvency Newsletter

Welcome to our December Reconstruction & Insolvency newsletter

This quarter we have included news on:

- voting power: conflicts of interest and COIs
- liquidators' fees
- NAB class action update
- *Commissioner of Taxation v Park*
- the information gathering powers of ASIC and the ATO.

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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Voting power: conflicts of interest and Committees of Inspection

As you would be aware, a Committee of Inspection (**COI**) may be required to consider a number of resolutions. Some of those resolutions may be in their favour, and others may not. In fact, some decisions put before a member of a COI may be in direct conflict with that member's own interests. In these circumstances, what rights does a liquidator have to disqualify that member from voting on the resolution?

While the *Corporations Act 2001 (Cth)* (**Act**) makes provision for the removal of a COI member by resolution of creditors and contributories, it is silent as to a member's ineligibility to vote on a particular resolution due to a conflict of interest.

However, members of a COI are elected by the general body of creditors. A member's role is to act on behalf of the body of creditors and to make decisions in the best interests of creditors as a whole. Accordingly, each member of a COI owes fiduciary duties to the body of creditors, and their duties are reflective of this relationship.

The duties of a member of a COI include the following:

- to actively consider whether a discretion should be exercised;
- not to act for their own benefit or for the benefit of a third person;
- to act for the equal benefit of those they represent;
- to act in good faith; and
- to avoid conflicts of interest and duty.

Accordingly, members are likely to be in breach of their duty to avoid conflicts of interest and duty, by voting in a resolution that is in the best interests of creditors as a whole, but against their own interests to such a degree that their ability to cast an unbiased vote may be compromised.

Where, for example, an outside party (like an employee of a creditor company) is asked to 'step in' and vote on the company's behalf (ie as a proxy), the employee assumes the role of the voting member, which can

expose the proxy to being in breach of their duty to act in the best interests of their employer and their duty to act in the best interests of the general body of creditors.

In circumstances where a liquidator perceives there may be a potential conflict, they may consider writing to the member in question reminding them of their fiduciary duties and drawing their attention to the perceived conflict. The member may then be invited to disqualify themselves from voting on the resolution, failing which the liquidator may propose a resolution removing the member from the COI.

Authored by: **Wayne Kelcey**, Cornwall Stodart

Recent Supreme Court decisions scrutinise liquidators' entitlements to costs, fees and remuneration

Two recent Supreme Court decisions in New South Wales have attracted substantial judicial comment regarding a liquidator's entitlement to payment of costs, remuneration and expenses incurred in the course of defending legal proceedings brought against the liquidator.

This article considers these two decisions and also takes a closer look at the rights of a liquidator and third party litigation funders to be indemnified from secured assets (in priority to the secured creditor) for costs and expenses incurred as a result of realising secured property.

Liquidators' costs of defending an entitlement to remuneration

In *Re RMGA Pty Limited* [2012] NSWSC 678, the New South Wales Supreme Court was asked to consider whether the liquidator appointed to RMGA Pty Limited (**Mr Clout**) was entitled to remuneration for his activities in respect of a dispute with a shareholder and director of the liquidated company (**Ms Gardner**). Ms Gardner had previously applied for a review of Mr Clout's remuneration under section 473 of the *Corporations Act 2001* (Cth) (**Act**) and initiated an inquiry into his conduct under section 536 of the Act (**Interlocutory Process**). Justice Barrett heard the Interlocutory Process and held that Ms Gardner had not established that Mr Clout's fees were 'excessive or not properly incurred', which may have indicated misconduct of a type contemplated by section 526 of the Act.

On 8 February 2010, Justice White ordered a stay of the winding up. In a further challenge to Mr Clout's remuneration, Ms Gardner claimed that Mr Clout was not entitled to:

- remuneration for the period following the stay of winding up other than for tasks incidental to completing his appointment;
- costs of his defence in respect of Ms Gardner's application under section 536 of the Act; or
- costs of pursuing recovery of remuneration amounts that were disputed by Ms Gardner.

Justice Black held that there was no blanket limitation on a liquidator's right to recover remuneration in respect of work performed following the stay of the winding up of a company. His Honour held that the relevant question to be asked is whether each particular attendance claimed by the liquidator is one that was 'properly undertaken for a proper purpose' and therefore recoverable as costs of the liquidation[1]. With regard to whether the liquidator was entitled to the costs associated with defending the Interlocutory Process brought by Ms Gardner, his Honour held that Mr Clout's action was 'necessary in the practical sense' if he was to 'maintain and realise' his entitlement to remuneration.

Justice Black concluded that the costs and expenses associated with substantiating a claim of remuneration and defending an inquiry into the propriety of the liquidator's conduct were incidental

1 *Corporations Act 2001* (Cth) s 556(1)(a)

to the primary purpose of administering the winding up of the company. Therefore, the costs and expenses were recoverable from the assets of the company in accordance with the order of priority contained in section 556(1) of the Corporations Act.

Liquidators' costs of defending removal proceedings

The New South Wales Supreme Court has considered a further case regarding a liquidator's entitlement to reimbursement for costs and expenses incurred in the course of defending legal proceedings. *SingTel Optus Pty Limited & Ors v Weston (Costs)* [2012] NSWSC 1002 involved an application for the removal of the special purpose liquidator of One.Tel Limited (**Mr Weston**) by its creditors on grounds that included 'perceived problems with impartiality', excessive remuneration and inadequate control of expenditure (**Removal Proceedings**).

Chief Justice Bergin stated that the court's discretion to deny a liquidator a right of indemnity for costs and expenses incurred in the course of defending removal proceedings must be exercised with 'great caution and only in exceptional circumstances'. His Honour made it clear that the establishment of 'exceptional circumstances' would be dependent on proving that the liquidator acted unreasonably and improperly in maintaining a defence to the Removal Proceedings and not whether the defendant acted reasonably in the course of his or her appointment as liquidator of the company.

In this case, the plaintiffs submitted that Mr Weston's conduct was sufficiently 'odious' to displace the general rule that a liquidator is permitted to recover costs and expenses associated with defending legal proceedings brought against him or her in their official capacity. The plaintiffs claimed that Mr Weston had unreasonably maintained a defence on the basis of the facts that were proven in the Removal Proceedings, which included that the liquidator:

- made a claim for remuneration that he was not entitled to and which he had incorrectly certified as being properly incurred and payable;
- failed to remedy the overpayment of remuneration promptly and without delay; and
- conducted 'inappropriate investigations' that led to the accumulation of unnecessary costs and fees throughout the liquidation.

His Honour held that while Mr Weston had engaged in conduct that evidenced 'serious errors of judgment', the manner in which he maintained a defence to the Removal Proceedings was justifiable. His Honour stated that there were *'real and complex issues for decision in the removal proceedings having regard to the defendant's length of time in office and his wealth of knowledge and experience gained during that period'*.

Therefore, the maintenance of the defence was not *'so plainly unreasonable or undertaken in an unmeritorious, deliberate or high handed way'* to warrant a denial of the liquidator's entitlement to be indemnified for fees, costs and expenses properly incurred in the course of defending legal proceedings.

Liquidators' right to payment of costs, expenses and remuneration following the realisation of secured assets

The decision in *Re Newtronics Pty Ltd* [2011] VSC 349 (***Newtronics***) involved a novel factual scenario being considered in light of the well-settled legal principle that a liquidator may rank in priority to the rights of the secured creditor where the liquidator has 'cared for, preserved or realised' the charged asset[2]. In *Newtronics*, the liquidator commenced legal proceedings on behalf of Newtronics against Atco Controls Pty Ltd (**Atco**) and Atco's receivers. Newtronics claimed that certain 'letters of support' issued by Atco amounted to a contractual undertaking not to call upon its secured debt. Newtronics claimed that Atco's subsequent appointment of receivers was therefore ineffective.

The liquidator entered into an indemnity agreement with Seeley International Pty Ltd (**Seeley**) for the purposes of raising sufficient funds to pursue the litigation against Atco and its receivers. Seeley was the also the largest unsecured creditor of Newtronics. Newtronics established its case against Atco at the Supreme Court hearing but was unsuccessful against Atco's receivers (**First Instance Decision**). The liquidator brought an appeal against the decision. However, the parties reached a settlement agreement on the day the matter was due to be heard by the Court of Appeal. The terms of settlement included that the receivers make payment of $1.25 million to Newtronics.

2 *Re Universal Distributing Company Ltd (in liq)* (1933) 48 CLR 171

The liquidator received and forwarded the $1.25 million settlement amount to Seeley pursuant to the terms of the indemnity agreement. In the meantime, Atco was successful in its appeal against the First Instance Decision and claimed that it was entitled to the $1.25 million settlement sum on the basis that the proceeds of the litigation were subject to a charge that it held over all Newtronic's assets.

The liquidator relied upon the long-standing principle in *Re Universal Distributing Co Ltd (in liq)*, to claim an equitable lien over the entirety of the settlement sum for the *'legal costs and expenses referrable to the preservation, realising and getting in of that settlement sum'* (***Re Universal Distributing* Principle**).

Atco denied that the *Re Universal Distributing* Principle was applicable and advanced the following arguments:

- the liquidator had not incurred any 'indebtedness' of which it may seek reimbursement because his expenses were funded by a third party creditor under an indemnity agreement;
- the equitable lien was displaced by the liquidator's statutory right to apply to the court under section 564 of the Act for approval of an asset distribution that favours an indemnifying creditor; and
- Seeley was unable to be subrogated to the liquidator's equitable lien because the terms of the indemnity agreement were silent on the issue of subrogation and instead expressly stated that the liquidator would utilise its statutory right under section 564.

Justice Davies rejected Atco's submissions and held that:

- the liquidator had an obligation to account to the indemnifying creditor for the costs and expenses of the litigation under the indemnity agreement and therefore incurred 'indebtedness' of a type contemplated by the Re Universal Distributing Principle;
- Seeley's right of subrogation to the liquidator's right of recoupment under the Re Universal Distributing Principle was a 'necessary incident of the contract of indemnification' and remained intact notwithstanding the liquidator's intended reliance on section 564 of the Act; and
- it was not unconscionable for the liquidator to rely on an equitable lien instead of an application under section 564 of the Act because the two rights 'co-exist' and are 'not mutually exclusive'.

Her Honour concluded that the costs and expenses associated with the litigation were properly incurred by the liquidator in furtherance of his duty to call in and realise the assets of the company. Accordingly, the liquidator was permitted to exercise a right of indemnity in the form of an equitable lien over the proceeds of the litigation and this entitlement was unaffected by the existence of an indemnity agreement between the liquidator and a third party.

In summary...

A number of recent cases have required the courts to balance a liquidator's right to recover costs and expenses of substantiating a claim for remuneration with the need to restrict unmeritorious claims for payment being made against the assets of a liquidated company. The cases discussed in this article indicate that liquidators will generally be entitled to recover costs and expenses associated with defending litigation (including removal proceedings) where they have acted reasonably and properly in connection with the relevant legal proceedings.

Further, a liquidator who obtains funding from an indemnifying creditor for the purposes of realising a chose in action remains entitled to an equitable lien in accordance with the *Re Universal Distributing* Principle, notwithstanding the concurrent operation of section 564 of the Act.

Authored by: **Natalie Ayoub** and **Lesley Naik**, Cornwall Stodart

NAB class action settled for $115 million

Following on from our update regarding the decision in *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in Liq) [2012]* FCA 1028, the NAB class action has been settled.

A class action of approximately 15,000 shareholders led by Maurice Blackburn against the National Australia Bank (**NAB**) began in November 2010, claiming losses on behalf of investors regarding Collateralised Debt Obligations (**CDOs**).

With no admission of liability, NAB has agreed to pay AUD$115 million in settlement of the proceedings, including interest and costs. The settlement will need to be approved by the Victorian Supreme Court.

In 2006, NAB had bought $1.2 billion in CDOs that comprised asset-backed securities, with a heavy exposure to the US subprime mortgage market. In May 2008, NAB was forced to write-down the value of the parcel of collateralised debt obligations by $181 million, followed by a second write-down of $830 million in July 2008.

On 24 August 2012, the Supreme Court of Victoria ordered the publication of notices in national newspapers to open the class action to all investors who held shares in NAB between 1 January and 25 July 2008. The court also directed NAB to write to 230,000 shareholders, advising them of the opportunity to join the class action. Over two-hundred and fifty institutional and retail investors are currently members of the class action. The matter was scheduled for trial in December 2012.

During April and May 2008, Paul Buitendag (Head of Reconstruction & Insolvency at Cornwall Stodart) and external consultant and forensic accountant David Collett, delivered a presentation predicting the potential effects of the developing Global Financial Crisis (**GFC**) and how litigation of this nature would impact Australia.

Authored by: **Jacinta Atkinson** and **Paul Buitendag**, Cornwall Stodart

The Commissioner of Taxation's right to garnish proceeds from the sale of secured property under section 260-5 of the *Taxation Administration Act 1953* (Cth)

Introduction

The recent Federal Court decision in *Commissioner of Taxation v Park and Anor* [2012] FCAFC 122 (**Park**) affirms the imperative for receivers and trustees of bankrupt estates to proceed with caution when voluntarily releasing security for the purposes of facilitating the sale of secured assets by the mortgagor to a third party. The decision highlights the result of an unintended substitution of a proprietary right for a personal covenant, which is perilous for creditors given the latter class of legal right is so often proven valueless in the context of an impecunious debtor.

The facts

In Park, the Commissioner of Taxation (**Commissioner**) sought payment for outstanding tax of $75,508.64 owing to the Commonwealth. The taxpayer (**Mrs Bassili**) had entered into a contract for the sale of land which was subject to two registered mortgages in favour of the National Australia Bank and Instyle Developments Pty Ltd (**Instyle**). The Commissioner issued a notice on the purchasers under section 260-5 of Schedule 1 of the *Taxation Administration Act 1953* (Cth) (**Act**) requiring payment of a portion of the purchase price, being monies owing to the taxpayer by the purchasers, to be made directly to the Commissioner in satisfaction of Mrs Bassili's debt (**Notice**). The Commissioner informed the purchasers that he was 'enforcing his entitlement ahead of earlier secured creditors'[1].

A statement of adjustments was prepared in anticipation of settlement under the contract of sale. The statement revealed that not only was the combined value of the secured debt in excess of the purchase price, the interjection of the Commissioner's asserted priority left an additional shortfall of $75,508.64, which was to be borne entirely by Instyle as second mortgagee. Unsurprisingly, Instyle initially refused to release its security; however, it eventually discharged its mortgage on the condition that $325,613.66 (being the maximum amount payable to Instyle) was paid into the trust account of its solicitors, Warlow Scott. The matter proceeded to settlement on 23 February 2010.

1 *Commissioner of Taxation v Park and Anor* [2012] FCAFC 122, [9]

The Commissioner brought proceedings to recover the amount claimed in the Notice, ultimately appealing against the decision of the Federal Magistrate, which ruled that Instyle was entitled to retain $75,508.64 which had subsequently been paid into court. In the case before the Full Court of the Federal Court, Justices Jessup and Katzmann (Justice Siopsis in dissent) held that the Commissioner's statutory right to issue a notice under s 260-5 of the Act was not to be subordinated to a party's security rights in the property and the Commissioner was entitled to payment of $75,508.64 in priority to the second mortgagee.

The Appeal decision

Their Honours rejected the Federal Magistrate's reliance on an analogy between the circumstances of the present matter and those which follow the crystallisation of a floating charge over the debts due to a company. In the latter scenario, the debts previously owing to the taxpayer are instead deemed to be owing to the chargee (or receiver) following crystallisation of the charge, thus rendering a section 260-5 Notice incapable of attaching to those debts. However, the court found that this reasoning was not amenable to application in respect of Torrens system land, which permits security interests to be granted only in the land itself and not to monies owing to a taxpayer.

In the course of rebutting the various arguments put forward by the respondents, the court also held that:

- on the proper analysis of the accrual of rights in the process of delivering good title, the purchasers never owed any money to the mortgagees and they were not under any obligation to *'give effect to the terms of the vendor's security'*[2];
- the execution of an unconditional contract for the sale of unencumbered title to the property where such title was not in fact held by the registered proprietor did not give rise to an equitable charge over the proceeds of sale in favour of the mortgagees; and
- it was erroneous to conclude that the Commissioner's right to garnish monies under section 260-5 of the Act altered vested security interests because Instyle's mortgage could only ever have been affected by either the repayment of the secured monies or the voluntary release of its security.

With regard to the cause of the second mortgagee's compromised position, their Honours stated at [114]:

> *'if there is a discernible point at which Instyle's position was compromised by the sequence of events which occurred on 23 February 2010, it was when it released its mortgage over the property'*.

Implications for secured creditors, receivers and trustees of bankrupt estates

Secured creditors, trustees and receivers should be mindful that the voluntary release of a mortgage to facilitate the sale of property will not result automatically in an entitlement to a portion of the proceeds of sale. A debtor's personal obligation to apply the proceeds of sale towards discharging their debt may also prove illusory where the debtor's liabilities exceed the value of their assets. Furthermore, secured creditors must consider the prospect that the debtor has an outstanding taxation liability owing to the Commonwealth that may be subject to a Notice under section 260-5 of the Act. A valid Notice issued to the purchasers of charged property may, in practice, enable the Commissioner to rank in priority to a registered mortgagee.

In many cases, where a debtor is in default, the advisable course of action will be to enter into possession of the property and exercise a statutory power of sale. In all cases, secured creditors and their representatives should give due consideration to their options when presented with a request to discharge a security interest in property.

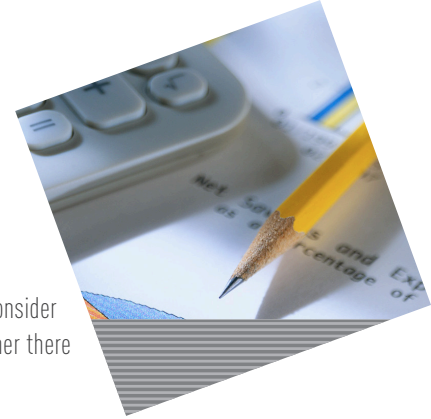
Authored by: **Lesley Naik** and **Michael Kohn**, Cornwall Stodart

Information gathering powers of ASIC and the ATO

Introduction

Over the past 12 months, the Australian Securities and Investments Commission (**ASIC**) and the Australian Taxation Office (**ATO**) have stepped up their enforcement activity, targeting company directors, liquidators and auditors. Both agencies have broad investigative powers and, in particular, may compel individuals to

[2] Ibid [106]



attend examinations to answer questions and to produce certain documents. Directors and accounting professionals should be aware of their rights and obligations when served with notices from these organisations.

Powers of ASIC and the ATO

In addition to their informal investigative powers, the *Australian Securities and Investments Commission Act 2001* (Cth) (**ASIC Act**) grants ASIC the power to:

- compel a body corporate (or an eligible person of a body corporate, such as a director) to produce documents in relation to the business affairs of a company (section 30); and
- require a person to appear for examination to give information relevant to a matter it is investigating (section 19).

The power of ASIC investigators to require the production of books may be exercised only upon satisfaction of any one of the following purposes:

- the performance or exercise of any of the Commission's functions and powers under the Corporations legislation;
- ensuring compliance with the Corporations legislation;
- investigation of an alleged or suspected contravention of the Corporations legislation (or any other law that concerns the management or affairs of a body corporate or managed investment scheme) or involves fraud or dishonesty and relates to a body corporate, managed investment scheme or financial products; and
- pursuant to a formal investigation.

The powers of ASIC are very wide. However, if the investigation falls outside the scope of ASIC's statutory authority, the notice for production may be challenged.

The Commissioner of Taxation also has extensive search and interrogation powers. These are contained in sections 263 and 264 of the *Income Tax Assessment Act 1936* (Cth) (**ITAA**). Section 263 provides that the Commissioner is authorised to have full and free access to all buildings, places, books, documents and other papers for any purpose connected to the ITAA. These powers have been expansively interpreted and even apply to third parties who are not the taxpayer whose affairs may be the subject of review. Section 264 of the ITAA is an inquisitorial power that gives the Commissioner power to require any person, whether a taxpayer or not, to furnish the Commissioner with such information as the Commissioner may require. This includes requiring the person to attend and give evidence before the Commissioner concerning the person's or any other person's income or assessment and may require that person to produce all books, documents and other papers whatsoever in that person's custody or control. These powers have also been used by the ATO as a form of pre-issue discovery, which is not usually permitted in tax litigation.

The focus of investigations by ASIC and the ATO may be different (having regard to the different regulatory functions of both organisations) and, as a general rule, you are required to comply with notices for production/examination. Failure to comply with a valid notice may result in a fine and/or imprisonment.

However, the time and costs of compliance may be significant and, in certain circumstances, there may be grounds to challenge a notice from the ATO/ASIC. Accordingly, if you receive a notice from the ATO/ASIC and are concerned about what you may be required to do and/or produce, you should consider whether the notice is valid or whether there may be grounds to object.

Examples of grounds for objection

Examination:

A notice for examination may be set aside if reasonable grounds do not exist for the suspicion or belief that an individual can give information relevant to a matter that ASIC is investigating or proposes to investigate. A suspicion for the purpose of this section must be more than merely conjecture, surmise or speculation, but can be based upon or take into account matters not admissible in evidence, including hearsay. In other words, the examination power cannot be used as a 'fishing expedition'.

Further, the notice must set out the identity of the inspector, the general nature of the matter being investigated, and certain rights of the examinee. A notice may be set aside if the nature of the matter is not described with sufficient particularity. For example, an ASIC notice that referred only to 'an investigation into the affairs of [named person] covering the [stated] period' was successfully challenged as not stating the general nature of the investigation (as required by section 19 of the *ASIC Act*) (*Johns v Connor* (1992) 35 FCR 1).

The privilege against self-incrimination or the potential exposure to a penalty is not a ground to object to the disclosure of information to ASIC or the ATO.

Further, a notice for the production of documents may be set aside if it does not identify with sufficient particularity the documents sought. For example, a notice that attempts to specify books by reference to general statutory duties, namely 'all books required to

be maintained by the Corporations Act' is likely to be struck down because there is no provision in the Corporations Act that specifies precisely what books have to be kept (*MacDonald v ASC* (1993) 116 ALR 514).

Similarly, the notice must specify a time and place for production of the specified books. A notice that fails to include these details is invalid.

Penalties

ASIC may prosecute for a failure to attend an examination or produce documents without 'reasonable excuse'. A reasonable excuse may include any matter for the court to consider an adequate reason for non-compliance (such as the fact that a document is covered by legal professional privilege).

Similarly, the ATO can prosecute taxpayers who refuse to meet with a tax officer to answer questions, who fail to provide documents or information or who obstruct authorised officers when using their information gathering powers.

Non-compliance with a notice from the ATO or ASIC may result in a fine of up to $110,000 or two years' imprisonment or both. Destroying, concealing, altering or removing documents or providing false testimony attracts greater penalties.

Conclusion

If you have received a notice from ASIC or the ATO requiring your attendance at an examination or the production of documents and you are concerned about what you may be required to do and/or produce, we recommend that you seek legal advice as to whether there may be grounds to challenge the notice.

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

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Jarrod Munro, Senior Associate

Jarrod began his legal career in Perth, Western Australia, where he worked for around four years. He has also practised for a short time in Queensland, and is admitted to practise in New South Wales. In 2007 Jarrod was admitted to practise law in Victoria and, since then, has worked almost exclusively in the area of commercial litigation. His focus is on insolvency and bankruptcy, retail and commercial leasing disputes, intellectual property and debt recovery disputes.

Jarrod has particular expertise in the legal issues surrounding statutory demands, having acted for parties both applying for and resisting applications to set aside statutory demands on many occasions.

In 2011 Cornwall Stodart became responsible for reviewing and updating the *Lexis Nexis Australian Corporation Law – Principles & Practice (External Administration)* loose-leaf volume on a quarterly basis. Jarrod is one of the co-authors involved in this process.

Jarrod is the co-chair of our Young Business People Committee.