Pattison Consulting Pty Ltd

INCORPORATING

ABN 24 434 194 066
ACN 079 638 501

www.pattisons.com.au
pattisons@pattisons.com.au

MELBOURNE
Level 14
461 Bourke Street
Melbourne VIC 3000
T 03 9600 4611
F 03 9602 5007
DX 562 Melbourne

DANDENONG
Suite 2
71 Robinson Street
Dandenong VIC 3175
T 03 9792 5611
F 03 9792 5822

GEELONG
Level 2
83 Moorabool Street
Geelong VIC 3220
T 03 5222 7422
F 03 5222 5822

Insolvency Communique

JULY - SEPTEMBER 2007

Promised mortgages never signed

A private investment company had provided finance totalling $1.1 million to various corporate entities controlled by a property developer.

The loans were documented by way of various 'shareholder agreements.' The shareholder agreements included a promise to use 'best endeavours' to ensure that the investor would be provided with second mortgage security.

There were various delays in the preparation of the mortgages, and by the time the developments struck trouble the mortgages were still unregistered.

The investor took action against the property developer as well as an accountant and a real estate agent, all of whom had been designated as 'managers' in various shareholder agreements which they had signed.

The investor claimed that statements in the shareholder agreements, and statements made at other meetings about the status of the projects amounted to 'false and misleading representations' that gave rise to damages under the *Trade Practices Act.*

In *For the Good Times Pty Ltd v Coltern Pty Ltd* the New South Wales Supreme Court held that:

- There was no attempt to comply with the terms of the shareholder agreements, which were treated as 'mere bits of paper to be churned out when needed to assist…fund raising,' and the property developer was clearly in breach of those undertakings.

- The real estate agent and accountant knew that they were being held out as managers and members of a team that would bring the projects to fruition, but did nothing to make the projects succeed.

  Although the accountant had prepared mortgages in respect of three companies and handed them to the property developer, he had done nothing more.

- 'The majority' of the representations sued on by the investor were false and 'no sane person' would have invested funds without believing the representations to be true.

- Even if the loss was partly attributable to other factors such as under-capitalisation (as argued by the defendants) the defendants would be liable if the false and misleading conduct was a cause of the loss.

The Court ordered $238,000 in damages against the property developer in respect of a specific transaction, and ordered a further award of $1.9m for which the property developer, accountant and real estate agent would be jointly and severally liable.

Extension of decision period

The voluntary administration regime contained in the *Corporations Act* includes a very specific exception to the general moratorium against recovery action by creditors.

A creditor with security over all or substantially all of the assets of a company may enforce that security - but only if it acts within the ten business day 'decision period' which commences when the secured creditor is advised that an administrator has been appointed.

In *Australian Capital Reserve Ltd (Administrators Appointed) v High Tower Investments Pty Limited (Administrators Appointed)* administrators had been appointed to a large number of companies in a corporate group. Some of those companies held charges over other companies in the group to secure inter-company loans.

At a first meeting of creditors a resolution had been passed to replace the original administrators to avoid the possibility of actual or perceived conflicts of interest in respect of the 'lender companies.'

The 'new' administrators were therefore appointed after the decision period had already begun, leaving them with very little time to make a decision about whether to enforce the security or not.

If they did not act to enforce their security, then they would be prevented from doing so until the moratorium expired, but if they did enforce there was the possibility that they might trigger enforcement by other secured creditors - which could ultimately be to the detriment of creditors.

The new administrators considered the possibility of a contractual solution by which the borrower companies would promise to consent to the enforcement of security after the decision period had expired - but were concerned that a Court might reject a contract that restricted an administrator's discretion, and instead asked the Court to make orders to extend the decision period.

The Federal Court of Australia held that:

- ASIC had been advised of the application, and did not object, and no other secured creditors would be affected by such an extension.
- There was 'no doubt' that an extension of the decision period was required, and 'no doubt' that the Court had power to make such an order.

- In the circumstances it was appropriate to link the decision period with the period in which the second meeting of creditors would be convened.

The new administrators' request for an extension of the decision period was successful.

Taking possession of property

In *Pattison v Wates & Anor* a bankruptcy trustee asked the Federal Court to make orders requiring two bankrupts to vacate their family home.

The trustee had assessed the value of the property and formed the conclusion that there would be equity in the property after allowing for a debt owed to a secured creditor, and had commenced negotiations with the bankrupts to allow them to purchase the property from the estate.

The Federal Magistrates Court held that:

- Although there was no specific provision of the *Bankruptcy Act* the general powers set out in sections 77(g) and 30 were sufficient authority for the Court to act.

- 'Somewhat unusually' there was general agreement about the ownership of the property and general agreement that there had been 'extensive though not fruitful negotiations' between the parties.

- However, the parties had been unable to agree on the amount required to discharge the creditors' claims and achieve annulment of the bankruptcy.

- It was likely that there would only be a 'modest' net equity in the property after allowing for the expenses of sale - but sufficient to justify the orders sought by the trustee.

The trustee was successful, however the Court extended the period in which the property be vacated to 30 days, instead of the 14 days originally sought.

Liability as trustee

In *Direen v the Deputy Commissioner for Taxation* a debtor asked the Federal Magistrates Court of Australia to set aside a bankruptcy notice for $71,688.

The debtor argued that there was a distinction between her personal capacity and her capacity as a trustee of the family trust.

She pointed to the fact that each 'entity' had a separate tax file number, and had different GST withholding and reporting obligations. She also pointed to section 254 of the *Income Tax Assessment Act 1936*, which referred to a trustee's obligation to make returns and be assessed on the profit of a trust in a 'representative capacity only,' with 'each return and assessment…separate and distinct from any other.'

The Federal Magistrates Court held that:

- A trust was not a legal personality, but instead a 'collection' of the duties, disabilities, rights and powers in relation to specific property held in trust.

- A trust could not exist independently of the trustees or the beneficiaries who were involved in the trust relationship, and could not own property or enter into contracts.

- 'Without hesitation' the debtor's defence was 'fundamentally flawed' and should not succeed.

Liquidator's compromise

Bauhaus Pyrmont Pty Ltd (in liquidation) in the matter of Wily as Liquidator dealt with a liquidator's request that the Court confirm the proposed settlement of an insolvent trading claim.

After completing a preliminary investigation the liquidator of a company arranged for examination summonses to be issued to the former directors. Their response was an application to have the summonses set aside and the liquidator removed.

While the liquidator was developing his claim, a director of the company providing litigation funding was acting in a way that the Court described as 'very unhelpful to the liquidator's task.' This included sending letters to the solicitor for the former directors that were 'at the least robust, but have been described as rather threatening.'

When the liquidator learned of the letters his solicitors wrote to the director and asked him to cease. When the liquidator learnt of further letters he wrote to the director, this time requiring him to 'cease all further communications with [the solicitor]' and anyone else concerning the affairs of the company.'

In the mean time, a preliminary hearing about the examination summonses lead to a judgement which included a critical finding that 'there were reasonable grounds for inferring…that the liquidator shared…[the director's] improper purpose of using the examination proceedings to embarrass the former directors in a public forum.'

A few months later the liquidator terminated the funding agreement and commenced negotiations with the former directors which led to a proposed settlement by them paying $425,000 which would effectively be absorbed by legal costs.

The New South Wales Supreme Court held that:

- The Court was normally 'reluctant' to give directions about commercial matters but it would sometimes be appropriate, for example where a liquidator's proposed decision might be the subject of criticism as being 'unreasonable or mala fides.'

- There might have been a perception that the liquidator 'was in cahoots' with a man 'acting quite inappropriately' however the facts before the Court 'should dispel that perception.'

  In fact, the liquidator tried 'in very difficult circumstances' to pursue actions in the creditors' best interests whilst 'having his very actions white-anted' by the litigation funder.

- There were no grounds for doubting the prudence of the liquidator's conduct or his judgment in settling the proceedings.

Insolvent Transactions

In *Welcome Homes Real Estate Pty. Limited & Ors v Ziade Investments Pty. Limited & Anor* the New South Wales Supreme Court of Appeal was asked to consider whether the granting of two mortgages were insolvent transactions.

A company involved in property development had provided mortgages to commercial lenders, and then later, two further mortgages to a group of lenders associated with the sole director's father ('the family mortgagees'). When the borrower defaulted the commercial lender tried to enforce it's security. When that failed, the commercial lender obtained an order to wind up the company.

The liquidator investigated the granting of the mortgages and obtained orders declaring them void. The family mortgagees then appealed.

The family mortgagees said that in deciding that no reasonable person would have granted the mortgages the Court had failed to take into account family relationships and a history of assistance from father to son. They pointed out that the mortgages were not prepared by lawyers, and said that the non-contemplation of future advances were not 'powerful indications' that future assistance would not be provided.

The New South Wales Court of Appeal held that:

- In considering whether a reasonable person would have granted the mortgages it was relevant to consider family relationships and a history of assistance. However the family relationship was also a reason for careful scrutiny.

  In this case, 'a track record of assistance' and preparedness to assist did not outweigh the 'gross imbalance of…benefits and burdens identified by the primary judge.'

- On the evidence the Court's conclusion about insolvency was 'amply justified.'

The appeal was refused.

Competing claims

In *Whitton as Trustee of the Estate of John Emmanuel Rose v Regis Towers Real Estate Pty Ltd (In Administration)* the Federal Court of Australia Court of Appeal was asked to consider two competing claims.

The trustee of a bankrupt estate claimed that the bankrupt had artificially interposed a company into his dealings, and claimed that assets held in the name of the company should be treated as assets of the estate. The administrator of the company claimed to be a creditor in the bankruptcy for the amount recorded on the company balance sheet.

Each of the claims had been earlier pursued unsuccessfully, and each insolvency practitioner had appealed.

The Federal Court held that:

- The trustee's inference that the debtor was insolvent some six years before he became bankrupt was 'much too tenuous' and due to 'guesswork and speculation.'

- The debtor had intended to make his investment in conjunction with a partner. The company had been incorporated at his partner's suggestion, and whilst he was the sole shareholder and director that was because she had withdrawn from the arrangement.
- Section 1305 of the *Corporations Act* provided that company books were 'prima facie evidence of any matter stated or recorded in the book.'

- However, the books of the company were insufficiently reliable to prove the administrator's claim, and the trustee was correct to reject it.

  In those circumstances section 1305 did no more than provide evidence that 'an unknown person formed an opinion on an undisclosed basis that…a figure should appear in the accounts.'

Neither appellant was successful.

Missing loan agreement

In *Sobey v Nicol & Davies, in the Matter of Mercorella*, the Federal Court of Australia Full Court was asked to consider questions around the claimed existence of a loan to a solicitor who had operated an unregistered managed investment scheme.

The receivers appointed to the assets of the scheme asked the Federal Court to make a determination about the ownership of a surplus left after a mortgagee sale, which had been claimed by an investor who said he had lent $750,000 to the solicitor, secured by an equitable mortgage over the property.

By the time of the hearing the investor had not complied with the Court's directions to file an interlocutory application and supporting affidavit. His solicitors presented a medical report that explained that he had been heavily medicated to alleviate extreme pain from hip replacement surgery and unable to

provide instructions, and sought an adjournment. The primary judge refused the adjournment, holding that the investor's claim was capable of being established by documentary evidence – including a copy of a loan agreement which the investor had claimed had been signed - and that there had not been an appropriate explanation why that documentary evidence had not been presented to Court.

On appeal the investor told the Court that his now former solicitors had lost the original mortgage. He sought permission to provide some of the missing information, including an affidavit from a witness to a claimed meeting held between the investor, his lawyer, and the solicitor at which the now missing loan agreement had apparently been signed. The investor also provided affidavits from a solicitor who said that he had drafted a loan agreement, and another solicitor who claimed to have witnessed the signing of the mortgage, as well as copies of bank statements which showed that two cheques for a total amount of $750,000 had been presented and honoured.

The receivers argued that if the Court was prepared to authorise additional evidence, they would also ask to introduce answering evidence, which included transcripts from public examinations in which key witnesses had apparently denied the existence of the loan.

The Full Court held that:

- None of the 'additional' evidence was 'fresh evidence' – events occurring or documents created since the date of the original hearing – and the explanation for the evidence not being adduced at first instance was 'unsatisfactory and…disputed.'
- The fragment of the mortgage provided to the Court appeared to provide past consideration.
- The investor had not been able to provide an accounting to even establish that he was a creditor, and the receivers could show that some $8,000,000 had been paid to him.

The Court refused to accept the additional evidence, noting that it was not clear that the additional evidence - even if accepted - would demonstrate an entitlement to the surplus.

Return of bankrupt's passport

A bankrupt asked the Federal Magistrates Court to order the return of his passport so he could attend his parents' 50th wedding anniversary celebration.

The celebration was planned to occur after the standard three year term of bankruptcy would ordinarily expire, however his trustee had lodged an objection to discharge which had extended the term. The trustee claimed that the bankrupt had failed to properly disclose particulars of his income, and had also issued a notice of income contribution requiring the bankrupt to pay $23,477.97.

The bankrupt argued that the trustee had invoked an 'extraordinary construction of the definition of income,' and had asked the Inspector-General in Bankruptcy to review the calculation. The Inspector-General did reduce the bankrupt's contribution liability but only by a small amount, and the bankrupt then filed an application for a further review by the Federal Court.

Before that application had been determined, in *Lockwood v Vince* the Court held that:

- The trustee accepted that the proposed visit was genuine and that the bankrupt was likely to return to Australia as promised.
- Assuming the bankrupt would return as promised, it could not be said that the visit would hamper the administration of the estate.
- Although 'the income identified by the trustee would only be regarded as income by the application of some complex and fairly obscure legislative provisions' it was appropriate to consider the application on the basis that the income contribution as assessed was payable until set aside by the court.
- There was no general rule that a trustee *must* insist on prior payment of any outstanding income contribution before consenting to travel – although a trustee might do so in the circumstances of a particular case.
- The bankrupt had not acted dishonestly, and there was no allegation that he had acted 'less than properly.'

The bankrupt's passport was returned.

Appointment of provisional Liquidator

Emmacourt Pty Ltd v Jewels of Australia Pty Ltd dealt with an application for asset protection orders and the appointment of a provisional liquidator, brought by a shareholder and director concerned about the conduct of the company's business.

By the day of the hearing, undertakings had been given to Court and overpaid moneys had been repaid. The other directors said that the overpayment – in breach of previous court orders to preserve the status quo – was inadvertent, and due to a misunderstanding of those orders.

The other directors argued that there was no longer any need for an asset protection order or the appointment of a provisional liquidator, and that appointing a provisional liquidator would have an 'unnecessary and damaging impact' on the commercial viability of the company.

The Federal Court held that:

- The Court would generally not appoint a provisional liquidator unless there was 'a reasonable prospect' that a winding up order would ultimately be made.

- The application was brought to address a potential dissipation of assets, and there was no evidence that the company was insolvent.

- Evidence from the director responsible for the overpayment was 'unsatisfactory,' particularly in light of his legal qualifications and lengthy business experience.

- The overpayment was relatively small and not likely to put the assets in jeopardy.

- After balancing the evidence from experts, the Court could not conclude that the appointment of a provisional liquidator would not cause 'serious and irreparable harm to the business.'

The Court declined to appoint a provisional liquidator, but – unusually – awarded costs to the unsuccessful applicant.

Was a Statement of affairs lodged?

In *Nicols v Geekie & Anor* a Bankruptcy trustee asked the Federal Magistrates Court for assistance in the administration of the bankrupt estates of a husband and wife.
The trustee's realisation of assets had generated a fund sufficient to pay known creditors in full, leaving a surplus which would ordinarily be paid to the bankrupts. However in the absence of any details from the bankrupts about their creditors it was possible that there might be additional creditors unknown to the trustee.

The trustee asked the Court to make two orders: the first to authorise to a dividend notwithstanding the absence of the statements of affairs; the second to

Ordinarily such claims are pursued by the directors, or a liquidator if appointed. However section 237 of the *Corporations Act* allows shareholders to apply for leave to initiate legal action on behalf of their company.

Before granting leave the Court must be satisfied that there is a serious question to be tried and that it is 'probable' that the company will not itself bring the proceedings. The application must be brought in good faith and must be in the best interests of the company.

The Court held that:

- Although the specific provision appeared to require an applicant to seek leave before commencing proceedings, this did not restrict the Court from making an order after an action had commenced.

- The Company had not had any directors since 2004 and did not have any assets, so it was probable that it would not itself bring proceedings.

- The applicants were prepared to indemnify the Company for costs and any adverse costs order

authorise the trustee to withhold payment of the surplus until the statements of affairs were received.
In fact the bankrupts had prepared and delivered the statements of affairs forms (which details a bankrupt's assets, liabilities and income) however the trustee had formed the view that they were so deficient that they should be treated as not having been received at all.

The Court held that:

- The statements of affairs were incomplete, at least as regards a listing of creditors.

- There were no reported decisions in which the relevant provision of the *Bankruptcy Act* had been applied to a filed but incomplete statement of affairs.

- The forms submitted had specifically referred to the possibility of deficiencies, and had noted problems caused by the absence of accurate records and difficulties experienced with an adviser. Other annotations expressed a willingness to discuss the information and provide further assistance to the trustee if required.

- In the circumstances it could not be said that the bankrupts had 'refused' to complete a statement of affairs.

The trustee's requests were refused.

Claim against receivers

In *South Johnstone Mill Ltd v Dennis and Scales* the Federal Court was asked to deal with some preliminary issues concerning a claim brought by a group of shareholders concerned that two receivers had sold company property at undervalue.

and there was no suggestion of any collateral purpose, so the good faith condition was met.

- There was sufficient undisputed evidence demonstrating both that there was a serious question to be tried, and that the likely claim was sufficiently large that it was in the best interests of the company to pursue it.
- Even assuming that all the evidence relied upon by the shareholders in their claim against the Bank which appointed the receivers was admissible, there was no evidence which allowed an inference that the Bank had directed or interfered with the Receivers' activities.

The shareholders were successful in obtaining leave to a full trial against the receivers – but not against the bank that had appointed them.

Important note

The information contained in this newsletter is by way of general comment only and is not intended as a substitute for specific advice that addresses your particular circumstances. You should seek specific advice before acting.

Pattisons Management Team

Paul Pattison	Director
Russell Harris	Associate Director
Malcolm Howell	Associate Director
Shaun Rowland	Senior Manager
Sophie Zapantis	Senior Manager
Antonia Kokkinis	Manager
Maurice Stolfa	Manager
Cynthia Van Zyl	Manager

- **Level 14, 461 Bourke Street**
  Melbourne, Victoria 3000
  Telephone 9600 4611, Fax 9602 5007

- **Suite 2, 71 Robinson Street**
  Dandenong, Victoria 3175
  Telephone 9792 5611, Fax 9792 5822

- **Level 2, 83 Moorabool Street**
  Geelong, Victoria 3220
  Telephone 5222 7422, Fax 5222 5822

www.pattisons.com.au

pattisons@pattisons.com.au