



**BUSINESS ADVISORS & INSOLVENCY SPECIALISTS**

# *Insolvency Communique*

SEPTEMBER – OCTOBER 2006

## **Dispute over amount secured by mortgage**

A minority shareholder in a company commenced legal action to wind up the company, set aside arrangements securing a debt owed to a company associated with the majority shareholder, and restrain the appointment of a receiver.

The shareholder also sought orders that would require a director to indemnify two of the office-holders for liabilities incurred by them as guarantors of the company.

In a preliminary hearing, the New South Wales Supreme Court was asked to allow the minority shareholder to apply for a winding up order, and also to authorise its directors to pursue legal claims in the name of the company.

In *Sub Rosa Holdings Pty Ltd v Salsa Sudada Production Pty Ltd* the Court held that:

- Provisional liquidators appointed to the company had advised the Court that they were not in a position to determine the solvency of the company.

This was because they needed guidance from the Court about the status of the loan account and the validity of the charge - which were questions already before the Court.

- The plaintiffs were clearly entitled to dispute the validity of the charge.

The critical question was whether the Court should grant injunctions to prevent enforcement prior to the outcome of that dispute.

- Although the plaintiffs argued that the debt secured by the charge was nil, it was 'unlikely' that a final hearing would arrive at the same conclusion and there was at least a question to be tried on that issue.

- The plaintiffs had not justified a departure from the well established general principle that a person seeking to restrain a mortgagee from exercising rights should pay the amount sworn by the mortgagee as due and owing into Court.

The Court declined to restrain the appointment of a receiver. However, the plaintiffs were permitted to conduct litigation in the name of the company, so long as they agreed to bear the costs of the proceedings unless ordered otherwise in the future.

## **What happens to an administration fund if a deed of company arrangement is terminated?**

In *Purchas, in the matter of Estore Pty Limited (in liquidation)* the Federal Court was asked to consider how liquidators should distribute a fund of \$84,813, which they had had received in their previous capacity as deed administrators.

According to the deed under which the monies had been paid, the funds were held on trust 'for the benefit of the administrators and ...participating creditors'

However, before those funds were distributed the creditors had passed a resolution to terminate the deed and have the company wound up.

The deed administrators - now in their capacity as liquidators - sought guidance from the Court as to whether the balance of the fund should be distributed solely amongst the participating creditors as defined by the now-terminated deed, or whether the funds should be shared between all creditors of the company.

The Federal Court held that:

- Despite proper notice being given, there were no other parties to the proceedings to represent the different interests involved. In the absence of a 'contradictor' the Court should not make of a declaration of right against the interests of the affected parties.

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- However that deficiency was not the fault of the liquidators, who were entitled to be guided towards an appropriate course of action.
- On termination of the deed of company arrangement the fund became the property of the company, and was therefore available for distribution to all creditors.

### Costs of unsuccessful winding up application

In *Bridgecorp Finance v Sterling Estates* the New South Wales Supreme Court was required to make orders about the costs of an unsuccessful winding up application.

The petitioning creditor was also a secured creditor, and had appointed receivers after the winding up application had been commenced. Before the winding up application was heard, the directors of the company appointed an administrator.

The winding up application was adjourned twice to allow the creditors the opportunity to consider a deed of company arrangement – which was ultimately accepted. By that time, section 459R(1) of the *Corporations Act* required the Court to dismiss the winding up application as it had not been finalised within the specified six-month period.

Once the application was dismissed, the Court then turned to consider whether the petitioning creditor was entitled to recover the costs of its ultimately unsuccessful action.

The Court determined that:

- The *Corporations Act* allowed the Court to determine the question of costs at its discretion, with very little guidance as to the discretionary principles to be applied.
- Prima facie, the high priority afforded to a successful applicant for winding up was also appropriate where an application was unsuccessful because of the intervention of another form of external administration.
- The principal question for the Court to consider was whether the creditor's opposition to the adjournment was reasonable in the circumstances.
- In seeking an adjournment of the winding up proceeding, the administrators were seeking an indulgence. It was clear that the initial application was 'less than compelling,' and that

the evidence presented to the Court about the proposed deed of company arrangement was 'very thin and incomplete.'

In those circumstances it was not unreasonable for the plaintiff to oppose the adjournment application.

The Court ordered that the petitioning creditor's costs should be paid by as a priority expense from the deed of company arrangement fund.

### Assignment of a charge securing all-moneys

In *Windslow Corporation Pty Ltd (In Liquidation) v Olympic Holdings Pty Ltd* the Western Australian Supreme Court dealt with the assignment of a loan agreement and mortgage debenture.

A company in liquidation had owed \$304,220 to its bank. That debt had been paid out by another company controlled by a director of the company in liquidation, in return for an assignment of the securities held by the bank.

However, the 'new mortgagee' claimed that the securities did more than secure repayment of the \$304,220 that it had actually paid. According to the new mortgagee, clauses that referred to 'all amounts...payable or owing...on any account whatsoever' meant that the charge would operate to also secure an additional debt of around \$500,000 created prior to the date of the assignment.

The Supreme Court held that:

- The deed of assignment was entered into between the Bank and the new mortgagee only, and it did not purport to include the company in liquidation.
- Although it was theoretically possible that a lender might endeavour to create a marketable security capable of assignment to third parties, it was unlikely that this was the lender's intention in this case.
- The Bank's rights under the mortgage were confined to securing moneys advanced by the Bank to the borrower.

For that reason, the securities could not extend to debts payable to a third party, whether pre-existing or incurred after the assignment was executed.

The Court held that the charge did not secure any amount in excess of the amount actually paid to the Bank.

## PATTISONS

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### Severing a joint and several tenancy

In *Peldan v Anderson* the High Court considered whether the severance of a joint tenancy was a 'settlement' which could be recovered by a bankruptcy trustee.

A husband and wife purchased a property in 1995 and became registered proprietors as joint tenants. In November 2003 the husband unilaterally severed the joint tenancy by registering a transfer in accordance with the relevant provisions of the *Land Title Act*. In January 2004 the wife died. In April 2004 the husband became bankrupt.

The severance meant that the wife's half-share in the property passed to her estate. The bankruptcy trustees commenced legal action to have the effect of the severance reversed, arguing that it was a transaction intended to 'defeat creditors.'

The Court held that:

- The severance transfer was lodged at a time when both husband and wife were unwell, and it was believed more likely that the husband would not outlive his wife.
- If the severance transfer had been lodged by the wife rather than the husband, then it would not have been a transfer of property made *by the bankrupt*, and could not be attacked.
- Even if the severance transfer had not been lodged, severance would have occurred when the sequestration order was made.
- For that reason the creditors were not disadvantaged by the severance - because the tenancy would have severed anyway.

The trustees were unsuccessful in their attempt to recover the 'other' half of the proceeds.

### Liquidation becomes administration

In *Peter Ngan re JKB Constructions Pty Ltd* the New South Wales Supreme Court was asked to make a series of orders to allow the company to transition from liquidation into voluntary administration, to allow creditors to consider a deed of company arrangement.

The liquidator asked the Court to grant leave so that he could be appointed as administrator, excuse the director from filing another report as to affairs, and stay the winding up application until further order.

Noting the liquidator's opinion that a deed of company arrangement would enhance the return to creditors, the Court held that:

- In considering whether a liquidator should be appointed as administrator the main issue was whether the liquidator was an appropriate person, with a primary focus on the possibility of a conflict of interest.

In this case, there was no suggestion of any issue that would prevent the liquidator from being a suitable administrator.

- In view of the director's co-operation with the liquidator, and the liquidator's opinion that that re-submission of a report as to affairs would provide 'nothing of use' it was appropriate to waive the submission of a second report as to affairs.
- The Court had consistently refused to make orders terminating a winding up until creditors had actually made a decision to accept a deed of company arrangement.

Although the present application was for a stay of a winding up rather than a termination, the same considerations applied and the winding up should be left in place until it could be seen that a deed of company arrangement had placed the company onto a 'new financial footing.'

### Execution of a DOCA within 21 days

The creditors of a company voted to accept a deed of company arrangement at a second meeting of creditors. Before that deed was executed, however, the administrator called a third meeting of creditors.

At that meeting a second insolvency practitioner - separately consulted by the director - told creditors that the original proposal had proven to be unviable, and outlined a proposed alternative deed of company arrangement.

Shortly afterwards the administrator convened a fourth meeting of creditors which then passed resolutions authorising the company to execute the alternative deed of company arrangement, and appointing the second practitioner as deed administrator.

Some five months later the deed administrator and the director became aware that there was a question about the validity of the alternative deed of company arrangement. This was because of a provision in the *Corporations Act* which terminates administration and creates a transition to a winding up if a deed of company arrangement is not executed within 21 days of the resolution.

Although the alternative deed had been executed within 21 days of its acceptance, by that time more than 21 days had passed from the acceptance of the 'original' deed.

In *Willi Kruger re Kruger Engineering Pty Ltd* the New South Wales Supreme Court held that:

- The deed administrator's concerns were 'well founded' because the administration had terminated prior to the fourth meeting and the company had passed into liquidation.
- By a significant majority the creditors had voted to accept the 'varied' deed clearly aware of the legal significance of such a decision and with the benefit of appropriate disclosure and explanation.
- In light of that and in the absence of objections from the former administrator, ASIC or creditors, it was appropriate to make orders to implement the varied deed – which was after all, the outcome sought by the majority of creditors.

The Court ordered that the resolutions of the fourth meeting would operate as if they had been passed by a properly convened meeting, within the appropriate period.

#### **Uncommercial transaction & breach of duty**

*Kalls Enterprises Pty Ltd (in liquidation) v Baloglow* concerned an attempt by the liquidator of two companies to recover monies paid to a former director of one of the companies.

Controlled by a common director, the companies at different times conducted a laundry business, although precisely which company owned which share in the business was 'quite unclear.'

When a sale of that business was achieved, the director paid \$555,000 to the former director to discharge an obligation under a deed of settlement negotiated to settle a judgment debt owed by the director, his wife, and his brother.

The liquidator claimed that the payment was recoverable either as an uncommercial transaction, or as 'monies paid away in breach of trust or breach of fiduciary duty.'

The New South Wales Supreme Court held that:

- The liquidator's explanation of his complete failure to attempt at any time to recover the payment from the director's wife or brother was 'extraordinary.'
- The deed of settlement specified that it was the director - not either company - that was required to pay the money to the former director. At no stage was the former director ever a creditor of either company.
- It was impossible to characterise the payment as a 'transaction' by either company. For that reason the claim of an uncommercial transaction was unsuccessful.
- It was true that the director had breached his fiduciary duties by causing the payments to be made. However, to succeed the liquidator had to prove that the former liquidator was aware – or should have been aware – of the director's breach of duty.

The next question was thus whether the former director had received that payment without notice of the director's breach of duty.

- It was not uncommon for private companies to pay money on behalf of directors, and generally such transactions were 'perfectly proper transactions.'
- In this case the former director had established that he did not have knowledge that the companies were insolvent or that the director was in breach of his duty.

The liquidator was unsuccessful.

#### **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.**

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