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legal update

RECOVERIES AGAINST RELATED ENTITIES

Lessons and considerations from a recent insolvency trial.

The recent judgment of Justice Rangiah of the Federal Court in *Pearce v Gulmohar* [2017] FCA 660 (*Pearce v Gulmohar*) provides a useful and comprehensive guide to a number of issues that arise in proceedings for recoveries against related entities. This article considers some of these issues and looks at ways to improve the odds of recovery in a voidable transaction case while also conducting the case efficiently.

BRIEF SUMMARY OF FACTS

Grass Valley Formulators (GVF) manufactured pesticides. A factory fire occurred in late March 2009 and an environmental notice was issued requiring GVF to clean-up and dispose of the toxic waste.

GVF engaged a waste disposal company (Toxfree) but disputed all the invoices issued. By 30 April 2009 these invoices exceeded $2.5 million, with more still to come. GVF had insurance but it was limited to approximately $1.55 million.

On 22 May 2009, GVF granted Gulmohar (a related entity) a charge over all of its assets. In the following months substantial payments were made to related entities for management fees and repayments of loans. No money was ever paid to Toxfree and the directors subsequently put GVF into liquidation by a court application.

THE PROCEEDINGS

The liquidator subsequently issued proceedings to recover these payments from the related entities as unfair preferences, uncommercial transactions and unreasonable director related transactions. A claim was also bought for breach of director duties.

These proceedings were defended primarily on the basis:

- That the Toxfree invoices were so unreasonable that they should not be considered in any insolvency analysis.
- The related entities were willing to financially support GVF.
- The court should treat the insurance proceeds as being available at all times despite them not being received for almost 8 months.
- The court should treat inventory as a current asset in the insolvency analysis.

Ultimately the court considered that:

- The Toxfree debt (as it was referred to) was substantiated for most of the amount claimed.
- The directors were not credible witnesses.
- The charge to Gulmohar and the payments to it were an unfair preference.
- The charge was not an unreasonable director related transaction, uncommercial transaction or a breach of director duties, however the payments to Gulmohar after the large insurance payment was received were still voidable(this did not change the amount ordered to be paid by the Defendants).
- The other payments claimed were all voidable transactions and also a breach of director duties.

This article discusses several specific issues that arose in this case and their application to other potential claims as follows:

- Is there any practical way to avoid proving a disputed debt in a voidable transaction case?
- Is a strike out application or a summary judgement a viable option now when financial support is claimed?
- How should inventory be treated in insolvency analysis?
- Can insolvency reports be prepared more efficiently between the experts?
- Can liquidators still provide their own insolvency reports?
- Is there available an expanded use of voidable transactions and director duty claims?

IS THERE ANY PRACTICAL WAY TO AVOID PROVING A DISPUTED DEBT IN A VOIDABLE TRANSACTION CASE?

One of the biggest complications in this matter was the dispute over the quantum of the Toxfree debt. Early on in the proceedings, the liquidator initially claimed that it was not necessary for the court to come to a concluded view on the Toxfree debt.

The reason for this was that the insurance company had approved the payment of $1.55 million and there was evidence that the directors of GVF had made a number of offers to settle, the highest being $1.05 million. A memo had also been prepared by one of the directors of GVF which was attached to his sworn affidavit that was used in an application to wind up GVF, claiming $1 million was fair and reasonable.

The insolvency analysis indicated that a $1 million debt clearly made GVF insolvent during the relevant period. The submission made to the court was on that basis there was no real argument that the debt was at least $1 million, therefore the Toxfree debt was irrelevant. Such a finding would have greatly reduced the costs of the trial.

However, well before the trial the Court held that evidence disputing the Toxfree debt was relevant and admissible. This meant substantial evidence and argument was put before the court on the Toxfree debt, this argument consumed probably four to five days of the 13-day trial.

The court did ultimately accept that the directors knew the Toxfree debt was substantial and the offers and the memo attached to the affidavit were crucial pieces of evidence. The insurance assessment itself received very little weight from the court.

However, this evidence of the knowledge of the directors was only used by the Judge to reject the good faith defences put forward by the defendants along with a claim they did not breach the director duties. It did not form any part of the Court's assessment of the Toxfree debt.

The Court relied on the other evidence produced by the witnesses from Toxfree and the documentation arising from the original dealings between GVF and Toxfree to determine the Toxfree debt.

This means that trials like this effectively mean a liquidator has to run two trials, one to substantiate the disputed debt and the other in relation to the voidable transactions that flow from the insolvency analysis afterwards. A liquidator will therefore need to be preparing evidence of the assessment of any disputed debt.

IS A STRIKE OUT APPLICATION OR A SUMMARY JUDGEMENT A VIABLE OPTION NOW WHEN FINANCIAL SUPPORT IS CLAIMED?

There have been a number of recent cases where directors have asserted they were financially supporting the company and that should be considered when assessing solvency.[1]

It is accepted that such support can lead to a conclusion the company is solvent. A defendant needs to show proper evidence of a commitment to provide or continue to provide such financial support to satisfy a court that such funds would be available to claim the company is solvent.

By claiming financial support, the defendants can greatly increase the expense and effort required for a liquidator to pursue such a case. Solvency can be claimed and good faith defences maintained which would otherwise fall away.

This case and *Ashala Model Agency Pty Ltd (in liquidation) & Anor v Featherstone & Anor* (2016) 309 FLR 321 (Ashala) suggest that in the more clear-cut cases where there is no record of any support being provided (or even worse, money is in fact being taken out) arguments of financial support will not be entertained by a court.

In *Ashala* Justice Jackson stated 'Therefore, the immediate question in the present case is whether the first defendant was truly willing to provide the support required. An obvious point is that he did not in fact do so.'

Justice Rangiah in *Pearce v Gulmohar* stated 'Their evidence is inconsistent with what actually happened. That is enough to require a conclusion that financial support... was not likely to be provided'.

Given these two judgements, practitioners should give serious thought to bringing summary judgement or a strike out application in similar cases. While this will increase the costs prior to trial, if the application is successful (and these cases strongly suggest they should be) the costs of an actual trial will be substantially reduced as the insolvency evidence will be much simpler and may not be contested.

HOW IS INVENTORY TREATED IN INSOLVENCY ANALYSIS?

Inventory often seems to be included in insolvency reports as a current asset. Many ratios are often then prepared using this inventory. However, this should be more closely analysed by a liquidator.

In *Pearce v Gulmohar* Justice Rangiah applied *Rees v Bank of New South Wales* (1964) 111 CLR 210 (*Rees*). In that case Chief Justice Barwick stated:

> *The asset whose value was said to negative a conclusion of insolvency, or at any rate to obviate the suspicion of it, was its trading stock of foodstuffs. In the ordinary course of the company's business this asset was not available to be realized except by means of retail sales through its various shops.*

1 *International Cat Manufacturing Pty Ltd v Rodrick* (2013) 97 ACSR 200 & *Williams v Scholz* [2008] QCA 94.

Voidable transactions

Barwick CJ went on to note that 'no proposal to realize surplus stock by some bulk disposal for cash was in contemplation' and led to the conclusion that 'Clearly that stock, in the company's circumstances, was not within the category of realizable assets to which Justice Isaacs refers in *Bank of Australasia v Hall*'.

In *Pearce v Gulmohar*, GVF was effectively a manufacturing business, the inventory it had was mainly raw materials to be prepared and packaged before it could be sold. His Honour held this was in the same category as a trading business was in *Rees*.

It has been suggested elsewhere that it is for the liquidator in the insolvency analysis to determine the value of such inventory and provide this evidence to the court which of course is a significant burden on the liquidator.[2]

Before doing this however, the liquidator should firstly determine if the company is a trading business, a manufacturing business or some other business that effectively has the similar restrictions to these types of businesses.

If it is and it had no plan to realise the surplus stock, then the liquidator would be justified in removing any inventory from the insolvency analysis. Based on this case and *Rees* it is then appropriate to leave evidence of any ability to sell such inventory to be raised by the defendants.

If inventory is removed, then often the issue of solvency becomes much simpler as the assets to be considered to be available to the company reduces to debtors, potential finance and cash in bank and any assets the company could actually have reasonably sold or financed taking into account the constraints in *Rees*.

CAN INSOLVENCY REPORTS BE PREPARED MORE EFFICIENTLY BETWEEN THE EXPERTS?

In this case, as in most other insolvency trials, substantial insolvency reports were prepared by both parties. A joint insolvency report was also prepared, which ran for several hundred pages. Numerous spreadsheets, ratio analyses and attachments were included.

On the eve of the trial the liquidator produced a spreadsheet on a month by month basis showing what each expert considered was the company's available assets. Differences were highlighted in the spreadsheet which allowed for each experts' qualifications to be shown.

As all practitioners know, the tests of insolvency can be stated quite simply, with the practical application to the facts being the subject of challenge. The insolvency reports were not referred to in any great length at the trial (although certainly referred to in the submissions afterwards).

It is also apparent from the judgement that Justice Rangiah was greatly aided by the spreadsheet and then simply addressed the differences between the two experts which effectively came down to four factual points to be determined by the court (the Toxfree debt, financial support, inventory and the treatment of insurance proceeds).

Rather than preparing complex reports and ratio analysis it is suggested that experts on both sides in such insolvency matters should be trying to work towards a situation where a single document is provided for reference to the court with figures and the reasons then simply attached by each expert as to why they differ from the other expert.

Focusing on the real question of insolvency (assets available to meet debts), rather than reviewing all the indicia that may or may not be relevant, is a much simpler process.

At trial these issues can then be sensibly debated and resolved by questions to the experts giving concurrent evidence from the judge and the parties to see where the differences lie, with easy reference to the figures to show the appropriate factual determinations that need to be made.

A more focused approach by all parties and the insolvency experts from the beginning of a matter could lead to substantial reductions in cost, court time and the volume of reports provided.

CAN LIQUIDATORS STILL PROVIDE THEIR OWN INSOLVENCY REPORTS?

There is a potential conflict in a liquidator providing an insolvency report as an expert witness while relying on a successful outcome of the case to recover their fees. In federal courts there appears to be increasing concern over this conflict.

It's unclear if a practitioner with funds faces the same problems.

This conflict concern was raised last year by Justice Edelman in *Hussain v CSR Building Projects Limited; in the matter of FPJ Group Pty Ltd (in liquidation)* [2016] FCA 392. While Justice Edelman considered the liquidator to be honest, he did

2 *Hussain v CSR Building Projects Limited; in the matter of FPJ Group Pty Ltd (in liq)* [2016] FCA 392.

not consider he was impartial or independent. He also considered that this affected the evidence of the liquidator.

For the same reason, Justice Rangiah also stated that he was predisposed to not accept the evidence of the liquidator where it conflicted with the expert for the defendants. However, the Judge held that the differences between the experts simply did not require any assessment of credibility of the experts so the issue of conflict was not a relevant consideration in this matter.

Based on these decisions it seems clear that the deference previously given to court-appointed liquidators seems to be disappearing. While the practitioner could engage an independent insolvency practitioner to prepare such reports, this is time-consuming and expensive. Also, if the practitioner then engaged was also acting on a speculative basis the same conflict would arise. Paying another practitioner personally out of your own pocket is not an attractive option.

While this area will remain a concern, what this case shows is that a practitioner can still provide their own report if they can demonstrate that any disputes with the other expert are no more than factual determinations to be made by the court without assessing the credibility of the expert witnesses.

Due to the way in which the spreadsheet was prepared and by setting out clearly the factual issues to be determined by a judge (as explained above) the costs of another practitioner were avoided.

A careful and early assessment of what the real insolvency issues at trial might be will be required in the future to determine if an independent practitioner is necessary.

EXPANDED USE OF VOIDABLE TRANSACTIONS AND DIRECTOR DUTY CLAIMS

A useful analysis of claims against related party proceedings is also contained in *Pearce v Gulmohar*.

First, Justice Rangiah has explicitly agreed with the decision in *Vasudevan v Becon Constructions (Australia) Pty Ltd* (2014) 41 VR 445 that an unreasonable director related transaction can include an indirect benefit to a director or a close associate of a director. This clearly increases the scope of such a voidable transaction claim (particularly as there is no need to prove insolvency and there is no good faith defence).

Second, Justice Rangier has also confirmed the reasoning of *Re Solfire Pty Ltd (in liquidation)* [1998] 2 Qd R[3] and *Ashala* which held that a claim for an uncommercial transaction and an unreasonable director related transaction is satisfied if it can be shown there was an intention to prefer one creditor over another. This makes it easier to establish such a voidable transaction as the fact that certain creditors were to be preferred may be enough in itself.

Practitioners should note however, that showing this intention to prefer certain creditors will require evidence that can meet the higher standard of proof set out in the case of *Brigginshaw v Brigginshaw* (1938) 60 CLR 336 rather than the usual 'balance of probabilities' test.

Third, Justice Rangiah did not consider the granting of a charge to a related entity on its own to be an uncommercial or unreasonable director related transaction (although it was a preference). However, the subsequent payments made to the related entity after the charge were uncommercial and unreasonable director related claims, even though the payments were made under a secured charge at that time.

Finally, using the same reasoning for why these transactions were uncommercial it was also held that the payments were a breach of director duties.

Combining these causes of action together therefore allows liquidators to pursue all the related parties and the directors where payments have been made with the intent of preferring one creditor over another.

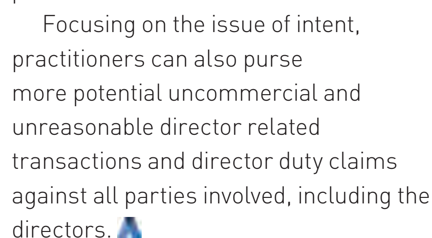
It may even be possible to pursue unrelated parties for uncommercial transactions and the directors of the company for breach of director duties using these cases, provided it can be shown the directors intended to prefer the unrelated creditor or party.

CONCLUSION

Voidable transaction claims often involve a number of complex legal arguments and factual circumstances. Some of these complexities cannot be avoided.

However, by carefully considering recent case law practitioners should be able to reduce the number of arguments at trial, particularly in relation to how insolvency reports and analysis are provided to the court.

Focusing on the issue of intent, practitioners can also purse more potential uncommercial and unreasonable director related transactions and director duty claims against all parties involved, including the directors.



3 At 92.