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legal update

ONE STEP AT A TIME

An example of how a liquidator can use a combination of court applications and procedures to finalise a liquidation and ensure the best outcome for creditors.

This matter involved a building company, Oxford Construction, (the Company) that had gone into liquidation as a result of being wound up by a large (but disputed) creditor. The Company did not make the application to set aside the statutory demand in time, which led to the winding up. It featured several complications, including:

- a) a very large, disputed proof of debt by the petitioning creditor
- b) numerous dealings with related entities (including substantial claims by external investors in those related entities)
- c) a tax credit of just over \$550,000 for amended income statements (the Tax Credit) filed just before it was wound up
- d) poor financial records and extremely limited contracts for a \$50 million mixed-use development, and
- e) a director who did not believe the Company should have been wound up and did not seem to understand the process.

Unfortunately, the decisions of the court in this matter were all ex tempore decisions but they still provide useful guidance on the court process. It should also be noted that each of these applications were heard by the same judge.

PLANNING AND COMMUNICATING THE COURT PROCESS

An important aspect of this matter was that the court steps were largely all planned in advance, and this was communicated to the parties involved and the court.

This meant that each step in the court process built on the previous steps and the court was able to see matters were progressing. For example, the court approved the deed of settlement (the Deed) which itself set out the further expectation that court applications would be required. That

same approval application also relied on the fact that a public examination had been carried out to support the application.

While creditors could have approved the Deed (which was not done for the reasons set out below), having it approved by the court made the subsequent court applications much simpler, as the court had already been made aware of the applications that were to be subsequently filed.

PUBLIC EXAMINATION

This arose because neither the director nor the large disputed creditor would provide all the necessary documentation or information requested. This information was critical, as without it the liquidator was unable to:

- a) determine if the Tax Credit was owing to the Company
- b) properly consider the proof of debt (which also formed part of the Tax Credit), or
- c) consider potential claims against related parties or determine any debts owed to those related entities.

The liquidator examined the director, the company accountant and the manager of the disputed creditor. Summonses to produce were issued to the previous lawyers for the Company, investors in the related entities and the related entities themselves. Due to various delays in responding by the other parties to various summonses, failing to provide all relevant documents and a reluctance to answer a number of questions, this examination process took over a year to be completed.

While a public examination is a fairly standard process it was crucial as it allowed the liquidator to:

- a) provide as complete a brief as possible to the accountant and tax barrister who were engaged to consider if the Company was entitled to the tax credit

- b) demonstrate to the ATO all the steps that were taken to assess the Tax Credit when asking for the Tax Credit to be paid, and in making the court application for approval below
- c) fully assess the disputed creditor proof of debt and demonstrate they were given every chance to provide any supporting evidence
- d) assess the merit of any claims against the directors and the related entities as well as the prospects of recovery, and
- e) show the court what had been done when asking for the various court approvals below, particularly in relation to the Deed and the Tax Credit.

COURT APPROVAL OF THE DEED

During very long, drawn out negotiations the liquidator entered into the Deed with the director and his related entities. Pursuant to this Deed:

- a) any claims the Company or the liquidator had against the related entities were released
- b) all unrelated creditors were to be paid in full (or if that was not possible then the related entities were entitled to a small dividend only)
- c) a court application had to be made to confirm the Company was entitled to the Tax Credit
- d) after the Tax Credit application was approved the director could require the liquidator to bring an application to terminate the winding up and release the liquidator if there were sufficient funds to do so, and
- e) if that was unsuccessful then the winding up had to be completed and the liquidator released in a further court application.

Significant consideration was given by the court to the opinion of the liquidator, who had carried out a detailed public examination and obtained substantial legal and accounting advice on the issues involved with the Company.

The court accepted the evidence of the liquidator that while there were potential claims against related entities, they would be difficult and costly given the related entities had been supporting the Company for a considerable period. Since the Deed was likely to pay the unrelated creditors out in full, the court accepted the view of the liquidator that this Deed was the best outcome for creditors.

This application for court approval was brought under both s 477(2B) of the *Corporations Act 2001* and s 90-15 of the

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Insolvency Practice Schedule (Corporations) (IPSC). However, the judge only made orders under s 477(2B) stating that s 90-15 of the IPSC requires an element of potential controversy in the proposed compromise before orders are granted under that section.

It should be noted that, by this time in the liquidation the director had been purchasing a number of unrelated debts of the company and likely would have been able to successfully approve the Deed at a creditors meeting. However, the liquidator took the view that a court application was the more appropriate forum for such a decision given the interests of the director in the Deed. Also, by engaging the court at this stage it meant the further applications required were able to rely on the court approval of this Deed as set out below.

COURT APPROVAL OF TAX REFUND

This was an unusual court application in that the liquidator was unable to verify the Tax Credit was owing, as ultimately it concerned a lot of related party dealings with uncertain records.

The liquidator was able to demonstrate to the court that he had undertaken a very thorough public examination, including an examination of the former accountant of the Company and the director. He had also engaged a tax barrister and an independent accountant to verify the Tax Credit as best as he was able.

He had also provided the full advice of the accountant and the barrister to the ATO to see if they had any objection or different view of the Tax Credit. The ATO was also of course served with the application and the material.

The concern of the liquidator was that if he took the Tax Credit on behalf of the Company and paid it to the creditors, he risked personal liability if the ATO ever audited this Tax Credit or sought to have it repaid.

The judge effectively found in his *ex tempore* judgment that where the liquidator:

- a) had carried out substantial investigations to identify the best available evidence under the circumstances
- b) had obtained detailed advice on the issue
- c) had provided all of that information and advice to the ATO, and
- d) was obligated pursuant to the Deed approved by the court to deal with the refund, then

it would be fundamentally unfair if the court was to leave him exposed to the risk of dealing with the tax refund which he couldn't control or minimise by any further reasonable action. The court then made orders (this time granted under s 90-15 of the IPSC due to the controversy given the uncertainty over the Tax Credit set out above) stating the liquidator would be justified in receiving the Tax Credit and dealing with it in the course of the liquidation of the company.

TERMINATION APPLICATION

After payment of the unrelated creditors and the receipt of the Tax Credit, the application to terminate the winding up was brought by the liquidator. Because of the length of time required to complete the earlier steps, this application was brought three-and-a-half years after it had gone into liquidation. Of course, as the liquidator was making the application, full and frank disclosure was required to be made to the court.

There were several distinctive issues involved that favoured this termination application as:

- a) by this stage the company was clearly solvent as it had substantial cash in the bank and would have no creditors if the termination application was granted, given the terms of the Deed stated all related party debts were to be forgiven if the termination application was granted
- b) the main unrelated creditor had wound it up under a claimed debt of \$1.8 million which the liquidator had determined should have been \$276,000, and

- c) if the company had contested the statutory demand it may not have been wound up.

At the same time there were other issues against the application as:

- a) books and records had not been properly maintained which had created substantial problems in the liquidation of the Company
- b) the director had also not been cooperative with the liquidator and as set out above, a large part of the public examination was to get books and records and information the director should have handed over as part of the liquidation process, and
- c) there were numerous related party dealings and also complicated disputes with investors that raised concerns over how the Company was run, leading to a number of potential claims that could have been brought against the director.

As most practitioners would be aware, the main consideration for the courts is the solvency of the Company. While public interest and commercial morality is also a concern, it is extremely rare to find a case where a termination of the winding up was refused for a solvent company on public interest grounds.

This case is the exception, as the judge accepted there was no dispute over the solvency of the company and he refused to terminate the winding up.

In this instance, the judge held that the public interest meant that the winding up should be completed given there were real concerns that the company would continue to be managed in a similar way in the future. The fact that the director did not appear at the hearing or provide any affidavit material in this respect was also a problem given the conduct that had been identified.

This order was made despite the fact it was accepted that the director could still run other companies as a director. Ultimately, however, it was held that this was a matter for ASIC and that it was not a factor to stop a court from exercising its discretion on matters that are within the control of the court.

While the application was unsuccessful, the judge made it clear that the liquidator had acted appropriately at all times as:

- a) it was brought pursuant to the Deed approved by the court
- b) the application was fairly put before the court, setting out evidence and submitting the matters both for and against the court making these orders, and
- c) in doing so the liquidator complied with his obligations under the Deed and to the court.

As the termination application wasn't granted, the court did not release the liquidator either at this stage but made it clear that would be dealt with when the winding up was completed.

RELEASE APPLICATION

The liquidator subsequently brought the final application to be released. One final issue that had to be dealt with was the timing of this application.

Under the terms of the court-approved Deed the payment to the related parties was to be made once the unrelated creditors were paid and all the costs and expenses of the winding up had been paid. This included the costs of the release application. The liquidator was concerned that the director would take legal action against him once the funds were paid out to the related entities as this payment was substantial.

While the Deed clearly released the liquidator, the director had made a number of threats and the liquidator obviously did not want to be left without any funds in the Company to defend any such proceedings and get them dismissed.

Ultimately, this was resolved by making orders similar to those in the case of *Re Better Drums*.¹ This meant the court ordered the liquidator be released 30 days after an affidavit setting out the costs that were to be paid for remuneration and expenses as well as the final balance paid to the related entities (a schedule had been provided to the court showing the proposed payments).

No further court application was required, and the liquidator then had the benefit of the release being self-executing by virtue of these court orders.

CONCLUSION


What this liquidation does show is that it is important to properly consider what court applications will be required to finalise a matter and what evidence is needed for each application. It is hard to see, for example, that the court would have approved the Deed without a public examination (and even if it did it certainly would not have approved the Tax Credit payment).

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If a liquidator or lawyer considers only one application each time in an ad hoc manner in a matter like this, they are likely to run into problems later on in subsequent court applications.

If the whole of the court process is considered at the start, however, you can set it up properly so that each application or court step ends up assisting the next application, and the court is more likely to approve each additional step. The public examination clearly demonstrated the efforts the liquidator had gone to in this matter to satisfy the court to approve the Deed.

The public examination and the Deed then demonstrated to the court the basis for the Tax Credit application. Even though it was rejected, the court accepted that this termination application was required under a Deed it had approved and the liquidator had acted appropriately throughout in bringing these applications.

The release and deregistration application is then straightforward (aside from timing issues) given everything else the court is already well aware of. Taking the time to plan these court steps out is crucial in any liquidation that is going to involve substantial court supervision, and should be done well in advance of the first court application being filed. 

¹ *Re Better Drums Pty Ltd (in liq)* [2019] NSWSC 1262.