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Insolvency, a year in review: Jane Sheridan surveys the latest insolvency cases across the Tasman

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We can thank the Global Financial Crisis (GFC) and 2009 for official interest rates dropping to a 49-year low and the ASX to a 5-year low. They did not, however, bring to Australia the iconic corporate collapses–the collapse of old businesses of significance and duration–that the US and the UK suffered. Rather, the large, high profile corporate collapses in Australia have been non-iconic–relatively new businesses, highly leveraged, and heavily structured. Many of them can be classified loosely into three categories:

- highly geared, complex, multi-entity groups (ie Centro and Babcock & Brown);
- forestry and horticultural managed investment schemes (ie Timbercorp and Great Southern); and
- highly geared companies offering security and margin lending facilities and other financial products and services (ie Opes Prime and Storm Financial).

Many of the complex multi-entity groups have large real property portfolios, whose value has been adversely affected by the GFC. Lenders have recognised that fire-sales of those portfolios will not generate sufficient returns to see debt repaid. These groups are instead generally being dealt with through agreed long-term sale or workout programmes.

The managed investment scheme collapses have dominated the headlines and involved a multitude of court applications. These collapses have highlighted the incompatibility of the corporate insolvency and managed investment scheme regimes and the need for reform in this area. They have required flexible and innovative solutions to overcome the lack of an adequate regime dealing specifically with insolvency of the responsible entities running the schemes and of the schemes themselves.

The last category of collapses has seen the biggest interplay between secured lenders and unsecured creditors. Participants in the security and margin lending facilities have taken issue with the manner in which the secured lenders to the companies have exercised their securities. Resolution of these claims has led to settlements and arrangements between the secured lenders and those participants either on an individual or group basis.

While the GFC may not have brought the level of financial collapses in Australia which were widely predicted, it has seen a number of interesting developments in insolvency law, including foreshadowed legislative changes.

Octaviar: a scare for lenders

The original Octaviar decision challenged a long-held view of the operation of the *Corporations Act* (Act) provisions dealing with the registration and validity of charges.

Chapter 2K of the Act details the statutory regime for registration and priority of charges. In broad terms, most charges, including fixed and floating charges, must be registered with the Australian Securities and Investments Commission (ASIC) within 45 days of their creation (section 263).

Registrable charges which have not been registered within the prescribed period, or at least six months before the chargor's insolvency, are void as a security as against a liquidator or administrator of the charger (section 266(1)). Variations in the terms of the charge having the effect of:

(a) increasing the amount of the debt or increasing the liabilities (whether present or prospective) secured by the charge; or

(b) prohibiting or restricting the creation of subsequent charges on the property;

must also be notified to ASIC within 45 days of the variation (section 268). A failure to notify such a variation within the prescribed period, or at least six months before the chargor's insolvency, renders the charge void as a security to the extent that the charge secures the amount of the increase in the debt or liability (section 266(3)).

In *Re Octaviar Ltd (No 7)* (2009) 69 ACSR 621, the chargor charged all of its present and future property as security for the payment of the Secured Money. The charge was registered within the prescribed period. *Secured Money* was defined as 'all money, obligations and liabilities of any kind that are or may in the future become due, owing or payable, whether actually, contingently or prospectively, by the Chargor to or for the account of the Lender under or in relation to a Transaction Document'.

The definition of *Transaction Document* included specified documents and 'each other document which the Lender and the Borrower or a Security Provider agree in writing is a Transaction Document for the purposes of the [facility agreement]'.

Some six months after the charge was granted, the Lender and Security Provider agreed by a deed in letter form that a guarantee given by the Security Provider of a separate facility was a Transaction Document for the purposes of the original facility agreement. No notice of any variation of the original charge, or the creation of a new charge, as a result of the inclusion of the guarantee as a Transaction Document, was lodged with ASIC.

At first instance, the Supreme Court of Queensland found that the inclusion of an additional document as a Transaction Document constituted a variation in the terms of the charge, which increased the liabilities secured by the charge, in that it added a liability under the additional guarantee which was previously unsecured (at [35]). As the variation had not been notified to ASIC, the liability under the additional guarantee was not secured by the charge.

The decision ran contrary to the long-held view that subsequent agreements to include additional Transaction Documents were not variations and the well-established market practice of not registering such agreements. Lenders were faced with the prospect that liabilities which they had thought were secured may not be and banking and finance lawyers hurriedly reviewed facility and security documents to try to quantify the extent of the issue and started redrafting precedents.

In September, the Queensland Court of Appeal brought an end to the six months of uncertainty that had followed the original decision. In a unanimous decision, the Court of Appeal upheld the Lenders' appeal, reaffirming the accepted view that the designation of additional documents as Transaction Documents did not constitute a variation in the terms of the charge (*Public Trustee (Qld) v Octaviar Ltd* (2009) 74 ACSR 156).

Whether the relief that followed the successful appeal will last is yet to be determined. An application for special leave to appeal to the High Court was filed in October and is yet to be decided. In the interim, prudence dictates that care be taken with any new transactions to list all relevant transaction documents or notify when additional documents are designated as transaction documents. In relation to existing securities where there have been subsequent designations, the risk of insolvency will need to be weighed against the costs associated with rectifying the problem.

Opes Prime: third-party claims

It is increasingly common, in large-scale corporate collapses, for claims to be made by unsecured creditors against both the relevant companies, and third parties, such as auditors. Where the claims involve class actions, the ability to settle the claims efficiently and effectively can be limited.

Re Opes Prime Stockbroking Ltd (No 2) (2009) 179 FCR 20 provides a mechanism for dealing with such claims. Opes Prime was a stockbroking firm that was involved in securities lending and equity financing. Clients of Opes Prime received loans from Opes Prime which were secured by the transfer of securities held by the clients. Opes Prime entered into back-to-back securities lending arrangements with various financiers to obtain the funds needed to finance its clients' share trading. The security given by clients participating in the securities lending activities was then used by Opes Prime as security for its own financing. On the collapse of Opes Prime, its financiers exercised their security.

The Opes Prime clients claimed that they had been misled by Opes Prime into entering into the 'lending' transactions, which, in fact, involved a transfer of the clients' securities to Opes Prime and that Opes Prime had committed breaches of trust, fiduciary duties, and contracts. They also claimed that Opes Prime's financiers were knowingly involved when they had received the securities and financed the clients' share trading.

Following a protracted mediation of the claims, terms of settlement were reached. The settlement required the Opes Prime liquidators to propose a scheme of arrangement. The scheme provided for a fund to be established, to be funded predominantly by Opes Prime's financiers, on the proviso that the financiers and other third parties would be released from all claims against them. The fund would be shared between the Opes Prime clients, the litigation funders, and other unsecured creditors.

When the scheme of arrangement came before the Court for approval, the primary issue was whether a scheme of arrangement could bar a claim against a third party. Justice Finkelstein, of the Federal Court of Australia in *Re Opes Prime Stockbroking Ltd (No 2)* (2009) 179 FCR 20, accepted that the approach to the construction of the relevant provisions governing schemes of arrangement should ensure that the provisions have a flexible operation. He held that, if there was a sufficient nexus between a release and the relationship between the creditor and the scheme company, the scheme could validity incorporate a release. In the case of Opes Prime, the nexus was sufficient particularly given that the creditors' claims against Opes Prime and their claims against the financiers largely or completely overlapped, the schemes were in settlement of interlocking claims and, in the absence of the release, none of the claims would be compromised.

On appeal, the Full Court upheld the decision of Justice Finkelstein (*Fowler v Lindholm and Others* (2009) 178 FCR 563). The Full Court noted that a scheme of arrangement made between a company and its creditors under section 411 of the Act binds only the company and the creditors. However, there was no reason why a bargain might not be struck between a company and creditors whereby the creditors were bound to enter into an arrangement with third parties, so long as the creditors received something in return for the benefit conferred on the third party.

Three weeks after the Full Court's decision in Opes Prime, a differently comprised Full Court of the Federal Court in *City of Swan and others v Lehman Brothers Australia Ltd and others* (2009) 179 FCR 243 held that, having regard to the objects and purposes of the administration provisions in Part 5.3A of the Act, a deed of company arrangement could not have the effect of depriving creditors of the benefit of claims they may have against entities other than the company under administration. Section 444D(1) provides that a deed of company arrangement binds all creditors of the company so far as concerns claims arising on or before the relevant day. As a matter of statutory construction, the reference to 'claims' in section 444D(1) was a reference only to claims which would be provable against the company under administration in winding up. A deed of company arrangement could not therefore extend to claims against third parties.

Hall v Poolman and litigation funding

This case arose from a decision by a trial judge to order an inquiry, under section 536 of the Act into the conduct of a company's liquidators. The conduct in question was a decision by the liquidators to bring and prosecute proceedings against the directors of the company, using funds provided by a litigation funder, in circumstances where it was clear that the likely return to creditors would be minimal, with the majority of any amount recovered paying the costs of the liquidator and the litigation funder.

In finding for the liquidators, the NSW Court of Appeal in *Hall v Poolman* [2009] NSWCA 64 confirmed that, regardless of the actual return to creditors, there may be a wider public interest that is served in liquidators commencing and continuing recovery proceedings.

The NSW Court of Appeal gave a broad interpretation to the power given to the court under section 536 of the Act to inquire into the conduct of a liquidator. Conduct that can be the subject of such an inquiry is not limited to conduct establishing a lack of faithful performance of a liquidator's duties or a failure to comply with the law or requirements of a court. The power extends to an inquiry into any conduct of a liquidator in respect of which a complaint has been made. There is no requirement that the complaint be a formal complaint. A complaint or criticism made during the hearing of a proceeding being prosecuted by the liquidator may be sufficient.

The decision in *Hall v Poolman* clarifies that liquidators who have obtained the fully informed approval of creditors, are not required, as a matter of course, to seek the approval of the Court prior to entering into a litigation funding agreement. It also confirms the circumstances in which a liquidator may pursue litigation with the aid of a litigation funder, even if there is little or no likelihood of recovering more than the liquidator's costs and expenses and the funder's fees.

Those circumstances are:

(a) the liquidator has incurred costs in preliminary investigations and in creditors' meetings;

(b) the liquidator considers that the prospective benefits to creditors justify further investigation in which more costs and expenses will be incurred;

(c) there are no assets, in the absence of litigation, to pay the costs already incurred;

(d) the pre-litigation costs were either necessary or reasonably considered to be justified because of the prospective benefits to creditors;

(e) the litigation costs themselves were reasonably incurred and proportionate to the prospective benefits (including not only possible direct benefits to creditors but also benefits derived through the reimbursement of the liquidator's fees and expenses); and

(f) the litigation funding agreement is not on manifestly unreasonable terms.

Issues of fact, degree, and timing may render it difficult, in practice, to determine that these criteria are satisfied. In some cases, in order to satisfy a liquidator's duty of skill, care, and diligence, the prudent course for a liquidator may be to seek directions from the Court. If a liquidator were to enter into a litigation funding arrangement without satisfying these criteria in circumstances where the anticipated total recovery for creditors was minimal, the likelihood of the litigation funding arrangement being approved by the Court is lowered. Further, the risk is increased that a court would conduct an inquiry, under section 536, into the liquidator's conduct. Obtaining the prior approval of creditors to the litigation funding agreement will not nullify the risk of an inquiry.

Since the decision in *Hall v Poolman,* the Federal Court has examined the issue of litigation funding more generally. In *Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd* [2009] FCAFC 147, the full Federal Court found that the standard form of litigation funded class actions constituted a registrable managed investment scheme. As such, the arrangements surrounding the litigation funded class action would need to comply with Chapter 5C of the Act and there would need to be a public company appointed as a responsible entity to manage the scheme. That public company would be required to hold an Australian Financial Services Licence.

ASIC granted exemptions for those involved in litigation funded class actions on foot at the time of the decision. However, its current policy is now not to grant such exemptions.

Allmere: a change of ultimate control

Allmere was a member of the Feltex group. In 2006, administrators were appointed to Allmere and to the other companies in the Feltex group. Burbank and Allmere were equal shareholders of Carpet Call. Their shareholdings were governed by a shareholders' agreement providing that if either shareholder wished to sell its Carpet Call shares or was to undergo a change in ultimate control, the other shareholder would be entitled to exercise pre-emptive rights over the Carpet Call shares held by the affected shareholder.

The Court of Appeal of the Victorian Supreme Court in *Burbank Trading Pty Ltd v Allmere Pty Ltd* [2009] VSCA 82 unanimously held that the appointment of administrators to Allmere constituted a change in the ultimate control of Allmere. In particular, the Court of Appeal found that:

(a) 'ultimate control' is the supreme or most authoritative decision-making power and a 'change in ultimate control' signifies a change in the identity of the supreme decision maker;
(b) a 'change in ultimate control' need not be long-term or permanent (but had to be more than the temporary inability of an existing controller to act due to illness or similar incapacity); and
(c) the appointment of voluntary administrators effects a radical and sweeping change in the powers of ultimate decision making in a corporation that cannot be viewed as a typically short-term displacement of existing controllers and a brief suspension of the status quo.

Before dealing with a company's property, administrators will therefore need to examine carefully each shareholders' agreement and other contract to which a member of the relevant group is a party, so as to ensure that no pre-emptive or termination rights have been triggered by virtue of their appointment. Such rights would, of course, arise if the relevant contract confers them expressly on the happening of an insolvency event. (In this case, the pre-emptive rights were expressly triggered by a change in the ultimate control of Allmere, but not by the occurrence of an insolvency event.)

As a result of this decision, rights conferred as a consequence of a change in ultimate control are also triggered by the appointment of an administrator, thereby extending the range of circumstances that have the potential to result in the loss of a key asset as a consequence of the appointment.

As a change in ultimate control need not be long-term or permanent, entering into a deed of company arrangement or a resolution that the administration end will not remedy the problem as the pre-emptive or termination rights will already have been triggered by the appointment. In fact, in relevant circumstances, the ending of an administration over a company may give rise to a second change in the ultimate control of the company.

In some circumstances, the statutory moratorium provided to administrators under section 437D of the Act may be used to avoid the implementation of pre-emptive rights. However, this moratorium only operates during the administration and would therefore not serve to prevent the exercise of rights that have been triggered by the appointment of the administrators even if their appointment only lasted for a short-term.

The Stake Man: relief from insolvent trading

Discretionary relief for civil liability for insolvent trading may be available under section 1317S of the Act. The Court may relieve a director either wholly or partly from civil liability for a breach of a duty, if a director has acted honestly and, having regard to all the circumstances of the case, ought fairly to be excused.

Justice Goldberg of the Federal Court exercised this discretion in McLellan, in the matter of T*he Stake Man Pty Ltd v Carroll* [2009] FCA 1415 to relieve a director wholly from civil liability for insolvent trading. Despite rejecting the director's defence under section 588H, Justice Goldberg found that the director had acted honestly and, in all the circumstances, ought fairly to be excused. He adopted the test for honesty given in *Hall v Poolman* at [325]:

> "[T]he Court should be concerned only with the question whether the person has acted honestly in the ordinary meaning of that term, ie whether the person has acted without deceit or conscious impropriety, without intent to gain improper benefit or advantage for himself, herself or for another, and without carelessness or imprudence to such a degree as to demonstrate that no genuine attempt at all has been to carry out the duties and obligations of his or her office imposed by the *Corporations Act* or the general law. A failure to consider the interests of the company as a whole, or more particularly the interests of creditors, may be of such a high degree as to demonstrate failure to act honestly in this sense. However, if failure to consider the interests of the company as a whole, including the interests of its creditors, does not rise to such a high degree but is the result of error of judgment, no finding of failure to act honestly should be made, but the failure must be taken into account as one of the circumstances of the case to which the Court must have regard under [sections 1317S(2)(b)(ii) and 1318 of the *Corporations Act*]."

The director in *The Stake Man,* who had suspicions and knowledge as to the company's solvency, had been provided with advice from an accountant retained to provide general accountancy and advisory work as to the company's solvency. The Court held that, in the circumstances, it was still reasonable for the director to rely on that advice. The director had taken active steps to expand sales and improve the company's business and was monitoring stock sales (which had been increasing). The director also sought, and relied on, advice from an insolvency practitioner and actively sought further capital for the business. Further, the director did not profit personally from permitting the company to trade.

Somerville: a warning for solicitors

As companies near insolvency, solicitors are often asked to advise on ways to avoid pending insolvency or its effect. In *ASIC v Somerville* 259 ALR 574*,* the Supreme Court of New South Wales held that a solicitor was liable as a person involved in the contravention by directors of their statutory duties.

The case involved the advice given by a solicitor in relation to a series of impugned transactions by companies under threat of insolvency. Each of the transactions involved a company which was facing imminent or immediate financial problems. Statutory demands had been served or other claims had been made against the company (often in relation to tax debts), which the relevant company would be unable to meet.

The directors of each company sought advice from the solicitor. The advice was generally given in the form of a letter of advice, which canvassed the issues arising from insolvent trading and the advantages and disadvantages of each of the options open to the company. The letter concluded that the only viable alternative was to transfer the business to a solvent company, in which the director continued to be seen to be in control, so as not to destroy the goodwill of the business by any form of insolvency administration.

In each case, what occurred was an asset-stripping transaction–the old company ceased to trade, a new company was formed (often with a similar name), the old company agreed to transfer its assets to the new company, but there was no assignment to the new company of the majority of the old company's debts. The consideration for the transfers was not cash, but the issue of 'V' class shares in the new company. These shares carried with them the right to receive all dividends declared by the new company until a specified amount had been paid, which did not necessarily reflect the value of the assets transferred. The solicitor prepared, or had prepared, the transfer agreement and all other transaction documents to bring about the restructure.

The Court described the effect of the agreements as follows:

> "The result of the implementation of the agreements was that the purchaser company acquired all the assets of the vendor company; the vendor company would receive no payment unless dividends were declared by the purchaser company and none were; the purchaser company obtained the employees, premises and equipment of the vendor company free of all liabilities of the vendor company other than liabilities under lease or hire purchase agreements."

The liabilities remaining in the vendor company included trade creditors and also taxation debts and debts for insurance premiums.

ASIC claimed the directors of each of the old companies had contravened certain of their statutory duties as directors (ie sections 181(1) duty of good faith, 182(1) improper use of position; and 183(1) improper use of information), and that the solicitor was involved in the contravention for the purposes of section 79 of the Act. A person involved in the contravention of the applicable statutory duties of directors also contravenes the relevant provisions (sections 181(2), 182(2), and 183(2)).