HERBERT SMITH FREEHILLS

TRUST ISSUES FOR LIQUIDATORS – A RECENT NSW SUPREME COURT DECISION

PRESENTATION TO CITY INSOLVENCY DISCUSSION GROUP

6 APRIL 2016

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TRUE TITLE:

WHAT THE HELL IS JUSTICE BRERETON UP TO?

ISSUES FOR DISCUSSION

1. Does the liquidator of a company which is trustee for an insolvent trading trust have the power to sell trust assets?
   - *Kitay; Re Southwest Kitchens Pty Ltd (In Liq)*
   - *Re Stansfield DIY Wealth Trading Pty Ltd (In Liq)*
2. Upon realising those trust assets, ought the proceeds be applied in accordance with s556 of the Corporations Act and, in particular, should employees be entitled to a priority?
   - *Re Suco Gold Pty Ltd (In Liq)*
   - *In re Independent Contractor Services (Aust) Pty Ltd (In Liq)*
3. Is it appropriate for liquidators to charge on a time-cost basis?
   - *In re AAA Financial Intelligence Ltd (In Liq)*
   - *In re Independent Contractor Services (In Liq)*

POWER OF SALE OF LIQUIDATOR

Typical Situation:

- company is trustee of a trading trust
- all of the assets are held as trustee, and all liabilities are incurred as trustee
- Trust Deed includes a provision to the effect that if the trustee company becomes insolvent, it automatically ceases to be the trustee (**Disqualification Provision**)
- trustee company becomes insolvent, and a liquidator is appointed.

Sometimes a new trustee is appointed, although often, no steps are taken by the appointor under the Trust Deed to appoint new trustee.

POWER OF SALE OF LIQUIDATOR

Common ground in the authorities as to the following:

- if no new trustee is appointed, even though the trustee company in liquidation is no longer the trustee, under the Trust Deed (because of the Disqualification Provision), the company in liquidation becomes a 'bare trustee' of the assets of the trust
- a bare trustee holds legal title, but has no duties except to protect the trust assets and has no power of sale of the trust assets
- trustee company has a right of indemnity from trust assets (ie a right to access trust assets to pay liabilities incurred as trustee)
- the right of indemnity is secured by an equitable charge over all trust assets
- that the equitable charge does not give the trustee company a power of sale
- in a liquidation scenario, the right of indemnity (and equitable charge) vest in and can be enforced by the liquidator
- the liquidator may have recourse to trust assets to satisfy trust liabilities incurred in the course of the winding up, including the liquidator's costs, expenses and remuneration
- if the trust assets are transferred to a new trustee, the right of indemnity and equitable charge in favour of the old trustee continues to operate
- there is some controversy as to whether the new trustee is, as against the old trustee, entitled to possession of the trust assets prior to the right of indemnity being satisfied.

POWER OF SALE BY LIQUIDATOR (CONT)

If a trustee's equitable lien does not give the liquidator a power of sale, what are the options available to the liquidator to realise the trust assets:

1. the liquidator can apply to the Court for an order giving the liquidator the power of sale (under the Trustees Act).
2. There are a number of cases where liquidators have been given the power of sale retrospectively. These are usually cases where the liquidator sells the assets and then discovers:
    - that assets are held as trustee; or
    - that the trust deed contained Disqualification Provision.
3. But there is authority:
    - *Apostolou* – Justice Finkelstein
    - applied in *Kitay*,

    to the effect that the power of sale given to liquidators under s477(2)(c) was wide enough to give to the liquidator the power to sell trust assets. There were two main reasons for this conclusion, namely:
    - the section says the liquidator can sell 'property of company', and trust assets are legally owned by the company;
    - pragmatically, it would be highly inconvenient if every time a liquidator was appointed to a trustee company (ie where there was a Disqualification Provision), the liquidator had to apply to Court to be able to sell the trust assets.
4. The liquidator can also ask Court to appoint the liquidator as receiver to sell the assets. Such an approach is particularly appropriate if the insolvent company holds both trust assets and non-trust assets (including in a partnership). A receiver can sell all the assets, and then work out the allocation later.

POWER OF SALE BY LIQUIDATOR (CONT)

BUT in *Re Stansfield,* Brereton J disagreed with *Apostolou* and *Kitay* and found that the power given to liquidators in s477(2)(c) does not extend to selling trust assets.

Found that although the trustee company in liquidation:

- has legal ownership of the trust assets; and
- by the equitable lien, has an equitable interest in the trust assets,

that the 'property of the company', which s477(2)(c) authorises the liquidator to sell, does not mean trust property which is not beneficially owned by the trustee company.

Very technical legal argument, but it clearly has some justification at law. However, the argument is not compelling, and ignores the practical difficulties which arise. The decision certainly creates uncertainty.

POWER OF SALE BY LIQUIDATOR (CONT)

What should a liquidator who is appointed to a trustee company do?

First check the trust deed and determine whether it has a Disqualification Provision.

Secondly if so, seek legal advice.

The reality is that because the issue is uncertain, if there is enough money in the estate, a prudent liquidator should apply to the Court for directions and/or to be given a power of sale (or, where appropriate, to be appointed receiver).

If not enough money in estate, a liquidator could seek advice from their lawyer, who will probably say that the issue is uncertain, but that it is definitely arguable that the liquidator has the have power of sale under s477(2)(c). On the basis of that advice, a pragmatic liquidator may decide that because the return to creditors will be greater, because no fees will be 'wasted' on the application to the Court, to effect the sale of the trust assets, and hope no-one takes the point. Such an approach definitely attracts a risk.

EMPLOYEE ENTITLEMENTS

Independent Contractor Services was another case where the only function of the company in liquidation was to act as trustee, and all assets of the company were trust assets and all liabilities were trust liabilities.

The liabilities included a superannuation guarantee charge liability:

- with respect to employees; and
- also, with respect to contractors.

Two issues arose:

1. whether the superannuation guarantee charge liability for contractors attracted the s556 priority; and
2. whether the superannuation guarantee charge, and (by analogy) other employee entitlements, attracted the s556 priority.

EMPLOYEE ENTITLEMENTS (CONT)

Contractors

Under the Superannuation Guarantee (Administration) Act, there is an expanded definition of 'employee', so that an employer must remit super, even if the person is only a contractor, in circumstances where the contract is only for the 'provision of labour' (anti avoidance provision).

Under s556, 'employees' are defined in a way which does not include contractors.

Brereton J found that even though there is an obligation to remit super for contractors, the contractors are not employees under s556, and therefore the superannuation guarantee charge (ie if employer does not remit the super) for contractors does not attract a priority under s556.

It might be argued that where the legislature decided to give contractors who are employees in 'all but name' the same super entitlement as employees, that it may have intended to also give those entitlements the same priority as for employees. However, debts due to such contractors (ie effectively wages) are not given a priority under s556, so the outcome is not particularly anomalous, and the decision is simply useful clarification on the issue.

EMPLOYEE ENTITLEMENTS (CONT)

Does s556 operate with respect to trust assets?

Brereton J found that:

- the proceeds realised from the sale of trust assets should not be paid to employees as a priority, because s556 is only intended to operate with respect to property beneficially owned by the company
- although the trust assets can be accessed via the liquidators equitable lien, the creditors only have a derivative right to those assets, and s556 has no operation.

In coming to that conclusion, Brereton J refused to follow a decision of the Full Court of the SA Supreme Court in *Re Suco Gold*. He took comfort in doing so because the decision in *Re Suco Gold* has been doubted by a number of commentators, including in:

- McPherson – Law of Company Liquidations
- Jacobs Law of Trust

EMPLOYEE ENTITLEMENTS (CONT)

For most insolvency practitioners, their immediate reaction is that such an outcome must be wrong. That is, there is a clear legislative policy in favour of benefitting employees, so why should it matter whether the employees are employed by a trading trust or the company in its own right. The existence of the trading trust is a consequence of a decision of the employer, not the employee, so why should employees be prejudiced by an employer's structuring/tax decision.

BUT *Re Kayfords Ltd* decision gives reason to pause:

- Kayfords was carried on mail order business
- sometimes received deposits, sometimes payment in full, prior to supply
- Kayfords was in financial difficulty, and on advice, the directors set up a separate account and deposited receipts into the account, on the basis that those funds would be held on trust for the customers pending supply
- Kayfords fell into liquidation with a substantial amount in the separate bank account

Held – the moneys in bank account were held on trust for the customers only, and were not available to creditors generally (or employees).

Megarry J:

> '*I wish that, sitting in this Court, I heard of that occurring more frequently; and I can only hope that I shall hear more of it in the future*'.

EMPLOYEE ENTITLEMENTS CONT'D

Once again, in reaching the conclusion that employees should not be entitled to a priority, Brereton J applied a technical legal argument. On the other hand, the Full Court in *Suco Gold* acknowledged that their decision was pragmatic, and that they were taking a view supported by strong practical considerations. In doing so, the judges in *Suco Gold* adopted an approach which seems to reflect the intent of the legislation, namely to protect employees.

What should a liquidator do?

Once again, if the estate is large enough, the only way to be fully protected is for the liquidator to apply to the Court for directions.

If the estate is not large (ie and an application to Court would consume a significant proportion of the estate), it may still be possible to get a lawyer to advise that it is arguable that the liquidator can follow the *Suco Gold* decision, and pay the employees in priority. That is, *Suco Gold*:

- is a Full Court Decision
- has not been overturned, even though it is 30 years old
- clearly reflects legislative intent.

However, once again, if a liquidator adopted such an approach, there would be some risk of a claim by a disgruntled unsecured creditor.

REMUNERATION ISSUES

In 4 recent decisions, Brereton J has refused to order that liquidators be paid their remuneration calculated on a time-cost basis, and only allowed remuneration as a percentage of recoveries.

There are some older authorities where such an approach has been approved, but they were quite compelling cases such as *Mirror Group v Maxwell*, where, in a complex administration, receivers had realised $1.6M and claimed costs, disbursement and remuneration of $1.6M.

Comparably, the first decision of Brereton J in the line of decisions is *AAA Financial Services*, in which, if the application for remuneration had been allowed in the amount claimed, 70% of recoveries (of $327,000) would have gone go to the liquidators in remuneration and disbursements.

Further, in a trustee scenario, for the reasons already discussed (ie the trust not property is not beneficially owned by the company) Brereton J seemed to find that approval by the creditors of the trust (ie at a creditors meeting) is not approval for the purposes of s499, and the liquidator must, nevertheless, apply to Court for remuneration approval. However, the decision is not clear on this issue.

REMUNERATION ISSUES (CONT)

Conclusion in *AAA Financial Intelligence* [para 45-47]:

"In my view, reasonable remuneration cannot be assessed solely by the application of the liquidator's quoted standard hourly rates to the time reasonably spent. The application of the standard hourly rate to liquidations of diverse size and complexity cannot take into account a number of the factors referred to by [the cases]. It does not reward liquidators for value, but indemnifies them against cost. It disregards considerations of proportionality. Moreover, it cannot reflect some of the factors referred to in section 504(2), and in particular (d) the quality of the work performed, (g) the degree of risk and responsibility involved, and, above all, (h) the value and nature of the property involved. This must mean that it is wrong to assess 'reasonable remuneration' by reference only to time reasonably spent at standard rates. Yet virtually every application for remuneration that the Court sees is made on that basis, regardless of the amount of property involved. In my view, while time reasonably spent at standard hourly rates is a relevant consideration, it is only one of several, should not be regarded as the default position or dominant factor, and is to be considered in the context of other factors, including the risk assumed, the value generated and proportionality.

…

While *ad valorem* remuneration has its own shortcomings, it seems to attract less opprobrium a time based costing. This is probably because it is proportionate, and because it incentivise as the creation of value, rather than creating' 'an incentive to run up hours and to do too much work in relation to the stakes of the case.'"

REMUNERATION ISSUES (CONT)

Issues arising out of remuneration decisions:

- Court did not say that the time claimed was not reasonably spent, nor that the rates claimed were too high. The Court simply found that using a time-cost basis for remuneration on small liquidations cannot be justified.
- However, Court did also take the opportunity to point out the inherent contradictions in time-based costing, such as practitioners being rewarded for inefficiency.
- Not a 'swings and roundabouts' situation, where some 'good' jobs will recover back the losses on 'losers'.
- Although in one case Brereton J increased the amount allowed from a strict application of % charging, he did so to avoid discouraging liquidators from undertaking small but difficult liquidations. It is implicit in the decisions that Brereton J considered that liquidators losing money on small liquidations is an incident of the job.

Also, the Court gave guidance on how liquidators should approach solicitors bills (and other disbursements).

BRERETON J APPROACH TO REMUNERATION

Case	Amount claimed	Revised amount claimed	Allowed amount	Court's Approach
Re AAA Financial Intelligence Ltd (in liq) ACN 093 616 445 (No 2) **[2014] NSWSC 1270**	$58,487	$49,915	$36,000	20% on realisations. The rate of 20% was higher than conventional (ie of Bankruptcy Regulations), however, the time consumed influenced Brereton J to allow a higher rate than may be ordinary.
Re Hellion Protection Pty Ltd (in liq) **[2014] NSWSC 1299**	$47,399	N/A	$25,000	10% on realisations ($4,500), however this was below starting point under statute, so $5,000. 5% on distributions ($12,500). Arrived at not more than $20,000, however, as the creditors meeting had approved the remuneration at $25,000, he was unwilling to disturb that.
Re Gramarkerr Pty Ltd (No 2) **[2014] NSWSC 1405**	$64,000	$24,196	$27,750	10% on first $100,000 of realisations and 5% on balance ($27,750). On that basis, Brereton J was willing to grant remuneration of $27,750, but as the revised amount claimed was lower, he ordered that lower amount.
Independent Contractor Services (Aust) Pty Ltd (in Liq) (No 2) **[2016] NSWSC 106**	$66,643	$49,510	$30,000	2% on realisations ($4,236), reflecting the very limited work (ie recoveries had been outsourced to a debt collector). 15% on distributions ($16,647) (unusually high rate, mainly to reflect the complicating feature of the two applications for directions). Arrived at $20,833, but because the liquidation was highly troublesome and presented many costly challenges, allowed $30,000.

REMUNERATION ISSUES - CONCLUSION

Is there a risk of a similar approach in WA?

The bias against time-cost charging does not seem to be prevalent in the WA Supreme Court. However, at least one of the cases relied upon by Brereton J, which challenges the appropriateness of time-cost charging in some circumstances, is a decision of the Full Court of the WA Supreme Court in *Conlan v Adams*.

Conlan v Adams is a 2008 decision, and does not seem to have gained much 'air time' in the WA Supreme Court.

Conclusion

The combination of:

- the recent spate of decisions of Brereton J; and
- the *Conlan* decision,

means that it is quite likely that a disgruntled creditor will take the point in a case in WA in the short term.

Particularly where there is a risk that such a 'test case' will be at the '*Maxwell v Mirror*' end of scale, the result may set a difficult precedent.

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