

CITY INSOLVENCY DISCUSSION GROUP

Wednesday, 3 July 2019

TOPIC

*What debts can be caught by a DOCA? – some guidance from
Justice Vaughan*

PRESENTED BY

David John, Partner - Herbert Smith Freehills



GREGSONS
AUCTIONEERS & VALUERS

WillisTowersWatson 



HERBERT
SMITH
FREEHILLS

What debts can be caught by a DOCA?

Some guidance from Justice Vaughan

Presentation to City Insolvency Discussion Group

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David John, Partner, Herbert Smith Freehills

Overview

- Legislative framework
- What we know
- What is unclear
- What is the status of contingent/future debts?
- Justice Vaughan's decision in Quintis case
- Conclusion

Legislative framework

Corporations Act

444D Effect of deed of creditors

(1) A [DOCA] binds all creditors of the company, so far as concerns claims arising on or before the day specified in the [DOCA] under paragraph 444A(4)(i).

(2) Subsection (1) does not prevent a secured creditor from realising or otherwise dealing with the security interest, except so far as:

(a) the [DOCA] so provides in relation to a secured creditor who voted in favour of the resolution of creditors because of which the company executed the [DOCA]; or

(b) the Court orders under subsection 444F(2).

(3) Subsection (1) does not affect a right that an owner or lessor of property has in relation to that property, except so far as:

(a) the [DOCA] so provides in relation to an owner or lessor of property who voted in favour of the resolution of creditors because of which the company executed the [DOCA]; or

(b) the Court orders under subsection 444F(4).

Legislative framework, cont

444H Extent of release of company's debts

A deed of company arrangement releases the company from a debt only in so far as:

- (a) the deed provides for the release; and
- (b) the creditor concerned is bound by the deed.

553 Debts or claims that are provable in winding up

(1) Subject to this Division and Division 8, in every winding up, all debts payable by, and all claims against, the company (present or future, certain or contingent, ascertained or sounding only in damages), being debts or claims the circumstances giving rise to which occurred before the relevant date, are admissible to proof against the company.

What we know

- The compromise or release doesn't have to be of all claims
- A release of the primary obligor under the DOCA doesn't release the guarantor (s444J)
- A DOCA cannot compromise claims other than claims against the company (*Lehman Brothers Holding Inc v City of Swan* (2010) 28 ACLC 10-011)
- The ATO is bound by a DOCA (*Dexcam Australia Pty Ltd (in liq) v DFC of T* (2002) 20 ACLC 1,372)
- Creditors can be 'forced' to take shares in return for the compromise of their debts (s444D(4))
- s447A cannot be used to extend the scope of the parties bound by the DOCA beyond the creditors (see *BE Australia Pty Ltd v Sutton* [2011] NSWCA 414)
- Claims by shareholders are debts which can be compromised (but shareholders cannot vote in relation to the DOCA without Court approval)
- A DOCA can bind contingent creditors such as guarantors (*Brash Holding Ltd v Katile Pty Ltd* (1994) 12 ACLC 472)
- But there is a distinction between contingent creditors and future creditors

What is unclear

- What is the position with respect to secured creditors:
 - *Australian Gypsum Industries Pty Ltd v Dalesun Holdings Pty Ltd* (2015) 33 ACLC 15-019
 - *In the matter of Bluenergy Group Ltd* (2015) 33 ACLC 15-060
- What is the position with respect to the right of set off:
 - *Winteran Construction Pty Ltd v MA Coleman Joinery Co Pty Ltd* (1996) 14 ACLC 1,168
 - *GM & AM Pearce & Co Pty Ltd v RGM Australia Pty Ltd* (1997) 15 ACLC 109
- Whether debts due to statutory authorities are released where the liability 'runs with the asset' (eg land or mining tenement)
- What constitutes a future creditor?

Future/Contingent creditors

- Warranty claims which hadn't manifested themselves at the date of the commencement of the administration can be subject to the DOCA (*Re Motor Group Australia Pty Ltd* (2005) 54 ACSR 389)
- Claims with respect to latent defects:
 - under contract, are probably subject to the DOCA, because the defect existed at the date of the commencement of the administration
 - in negligence, are probably not subject to the DOCA, if the damage has not manifested itself as at the date of the commencement of the administration
- The position with respect to claims for costs or fines, which have not been imposed at the date of the commencement of the administration is somewhat uncertain (compare):
 - fines and penalties are excluded by s553B (which is usually incorporated by reference into the DOCA)
 - costs of winding up application (*FAI v Philkar* (1996) 132 FLR 213)
 - *BE Australia and McLellan v ASX* (2006) 24 ACLC 36
 - *Central Queensland Development Corp. Pty Ltd v Sunstruct Pty Ltd* (2015) 33 ACLC 15-015

Quintis case – Decision of Vaughan J

- Conflicting authorities regarding ‘mere expectancies’, namely:
 - *Lam Soon Australia Pty Ltd v Molit (No 55) Pty Ltd* (1996) 70 FCR 34
‘[f]uture breaches of covenant’ may be quite another matter. No doubt it is true, for example, that the right of a lessor under an existing covenant to keep leased premises in repair is an existing right or claim which may in theory have a value. A right to sue for damages for a particular future breach of that covenant, however, is we think, looked at before the breach occurs, not even a contingent claim: ***it is a mere expectancy and could not be the subject of proof.*** But that is a question which does not arise in this case.
 - Compare with *Re National Express Group Australia (Swanston Trams) Pty Ltd; Thiess Infracore (Swanston) Pty Ltd v Smith* (2004) 209 ALR 694 and *BE Australia*

Quintis case, cont

- His Honour concluded that he should not follow *Lam Soon*, preferring *Theiss* and *BE Australia* and found that:
 - ‘a claim for damages in relation to possible future breaches of an agreement may be a ‘claim’ arising within s444D(1) (as a contingent claim) and the company’s contractual counterparty thus a ‘creditor’ within s4444D(1).’
- Apart from the weight of authority, His Honour relied on the following:
 1. it is clear that claims include ‘contingent claims’, and full meaning should be given to the expression (ie so that it extends to future claims). A contingent claim might be identified where there is an existing legal obligation (ie a contract) and out of that obligation, there may emerge a liability of the company to pay an amount of money on the happening of an event, even if that event may not necessarily occur

Quintis case, cont

2. with respect to continuing contracts, the future breach will often be an inevitable consequence of the administration (and the directors conclusion as to insolvency). As a consequence, the breach can be foreseen as at the date of the administration
3. where it is accepted that the meaning of 'claims' for the purpose of s444D(1) is co-extensive with the meaning of claim under s553(1) in liquidation, the conclusion at 2. is more compelling, given that a liquidation will be 'terminal' for a company (and therefore as to (lack of) future performance)
4. the legislative history, via the bankruptcy legislation, supports such a conclusion
5. such a conclusion is consistent with the legislative policy of using the administration process, and therefore DOCAs, to give a company a 'clean start', indicating the need to construe the provisions relating to DOCAs in a way which enables DOCAs to comprehensively deal with all future and contingent claims

Quintis case, cont

- Doesn't mean that DOCA **must** cause all claims under all pre-administration contracts to be released – it may be that it is intended that the company will continue to perform some pre-administration contracts, in which case, a clause releasing claims for future breaches raises the spectre of s445D – the company cannot insist on performance, by the counter-party, but be released from its contractual obligations

Quintis case outcome

- Plaintiffs made investments in managed investment schemes – sandalwood plantations
- Plaintiffs were obliged to pay an establishment fee and certain annual fees in return for Quintis managing the plantations
- Upon maturity, the plaintiffs were to be paid the net proceeds of harvesting the sandalwood
- Plaintiffs had the option of deferring the payment of the annual fees, with the consequence that the proceeds payable to the plaintiffs upon harvest would be reduced by an amount reflecting the annual fees (deferral rights)
- Plaintiffs exercised deferral rights
- Quintis went into administration before harvest and then a DOCA
- The DOCA purported to extinguish the deferral rights, but otherwise the plantation management contracts were to remain on foot (or be novated)

Quintis case outcome, cont

- On the basis of the analysis above, the plaintiffs are (contingent/future) creditors, having regard to the contingency that Quintis will breach its management obligations and are therefore bound by the DOCA
- However, His Honour concluded that a DOCA couldn't 'cherry pick' the provisions of the contract the company wanted to perform and those which the company didn't, and therefore the DOCA couldn't release the deferral rights but insist on payment of the annual fees in cash rather than by set off of the harvest proceeds
- Quintis also argued that it could refuse to accept the election of the plaintiffs to exercise their deferral rights, which refusal was a breach of contract, which gave rise to a claim which could be released by the DOCA
- His Honour rejected that argument on the basis that it was Quintis who was the creditor (ie entitled to payment of the annual fees), and the exercise of the deferral right effectively allowed for payment in kind
- A DOCA can only impact upon a claim against the company, not a claim by the company

Conclusion

- In relation to the issue of whether future breaches of contract can be released by a DOCA, Justice Vaughan's reasoning is compelling
- However, the decision is simply one of a first instance Judge, and we are still faced with inconsistent Court of Appeal decisions on the issue in other states
- Cannot be entirely confident, but in WA, probably safe to advise that a DOCA can release all claims (ie for future breaches) under a pre-administration contract

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GREGSONS
AUCTIONEERS & VALUERS

WillisTowersWatson 