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SHAREHOLDER'S RIGHTS IN A BANKRUPT ESTATE

Using shareholder's rights in a bankrupt estate to take control of a company associated with the bankrupt.

In this article we will illustrate how, in appropriate circumstances, exercising shareholder rights can facilitate the preservation of assets and improve the chance of achieving a return to creditors in a bankrupt estate. The article covers:

- Our involvement in **Federal Court proceedings** for the trustee of a bankrupt estate arising from his exercise of shareholder rights, resulting in the Court appointing the trustee as provisional liquidator of a company associated with the bankrupt.
- **The *Bar Machiavelli* case**[1] which shows that the same insolvency practitioner can be appointed in more than one capacity even if a theoretical conflict of interest exists.
- The decision of Black J in ***Re Loremo***[2] in which a provisional liquidator was appointed without any requirement for the plaintiff to give an undertaking as to damages.

LEGISLATIVE FRAMEWORK

Where a Registered Trustee is appointed to a bankrupt estate, if the bankrupt is a shareholder, the trustee may have the opportunity to preserve assets of an associated company and achieve a prompt recovery for the bankrupt estate if:

- the bankrupt is the beneficial owner of shares in a company, and
- the bankrupt is a creditor of the company, contingent or otherwise, or
- some other feature of the legal relationship between the bankrupt and the company concerned means that it is appropriate for the company to be wound up.

Assets of which the bankrupt is the beneficial owner vest in the trustee and are divisible pursuant to s 58(1) and 116(1) of the *Bankruptcy Act 1966* (Act). Accordingly, shares of which the bankrupt is the beneficial owner vest in the trustee.

Section 1072C of the *Corporations Act 2001* (Corporations Act) operates where such shares have vested in the trustee and the bankrupt is the registered holder of those shares. It provides that where the trustee produces to the directors such evidence as they require (in a practical sense, the Certificate of Appointment from AFSA and evidence of the beneficial shareholding), the trustee has the same rights as the bankrupt in respect of the shares.

Importantly, these rights include entitlement to information about the company and voting and other rights connected with the shares.

Section 1072C(7) renders any provision in the company's constitution void against the trustee if it removes the shareholder's rights because a shareholder is bankrupt.

The trustee is therefore specifically empowered to become registered as the shareholder in place of the bankrupt pursuant to s 1072E(2) of the Corporations Act in his or her trustee capacity (meaning, non-beneficially). However, such registration is not a condition precedent to the trustee exercising rights in respect of the shares pursuant to s 1072C. Thus, a trustee can:

- do the same things as the bankrupt could have done, as a registered shareholder, and
- specifically, sell the shares.

This article examines the first of those possibilities, because in each case discussed, a sale of the shares was, due to factual circumstances, impracticable.

1 *Hurst v Bar Machiavelli Pty Limited ACN 609 268 037 (No 2)* [2018] NSWSC 1549. **2** *Re Loremo Pty Ltd* [2018] NSWSC 1355.

FEDERAL COURT PROCEEDINGS

This matter raised the issue of the manner in which the trustee exercised shareholder's rights, and why.

The directors who held office in September 2018 were close relatives of the bankrupt and were appointed to the board a few months before the bankrupt presented a debtor's petition. The trustee wrote to the directors requiring that, pursuant to s 1072C, he was to be recorded in the register as the holder of the bankrupt's beneficially owned share in the company. That share was the sole issued share in the company.

The board complied with the request, and so the trustee became the sole registered shareholder (albeit, non-beneficially) of the company.

Exercising the rights in s 1072C(2) of the Corporations Act to inspect company records, the trustee obtained access to financial statements and tax returns of the company, and thereby ascertained that the company: had been appointed as, and remained, the trustee for a discretionary trust; that it was sole registered proprietor of two parcels of land in its trustee capacity; and that there were doubts about its solvency.

The trustee's investigations revealed that:

- Debt of the company was secured by first registered mortgage over one of the residential properties.
- That debt was cross-collateralised with debt of the bankrupt to the same lender secured by first registered mortgage over another residential property of which the bankrupt was sole registered proprietor.
- The residential property of which the bankrupt was sole registered proprietor was subject to an exchanged contract for sale of land which the bankrupt, as vendor, entered into at an auction on a date prior to the presentation of the debtor's petition. The contract remained on foot, specified an appropriate price and the purchaser remained willing to complete it.

The trustee determined that it was appropriate to complete the auction sale contract and to obtain a recovery from the company, based on a right of contribution in favour of the bankrupt estate against the company. That right arose from the impending discharge of cross-collateralised debt to the mortgagee for which the bankrupt and the company were jointly and severally liable (the bankrupt being the guarantor and the company being the principal debtor).

After identifying these rights and the opportunity to enforce them, the trustee in the Federal Court matter passed a resolution as sole shareholder under s 249B(1) of the Corporations Act that the company be wound up pursuant to s 461(1)(a) of the Corporations Act.

General statements of principle which have been given in decided cases emphasise the need for a liquidator to be independent of creditors, the company in liquidation, its directors and major shareholders.

The trustee then commenced proceedings in the Federal Court seeking an order for winding up under s 461(1)(a), his appointment as Liquidator of the company (see *Pascoe v Ambernap Pty Ltd* [2008] FCA 1975) and his appointment as receiver of the property of the discretionary trust (*In the matter of Stansfield DIY Wealth Pty Limited* [2014] NSWSC 1484 and *In the matter of Australasian Barrister Chambers Pty Ltd* [2016] NSWSC 1767 and [2016] NSWSC 1939).

At the time of publication, the trustee had been appointed as the provisional liquidator of the company and there are appropriate interim orders for the preservation of the trust property. The trustee had also completed a sale of the property of which the bankrupt had been registered proprietor, thereby discharging the secured liabilities to the lender of both the bankrupt and the company.

The decision highlights that rights of contribution and subrogation are of the kind which registered trustees should identify, and may be able to enforce, using shareholder's rights as a starting point.

QUESTIONS OF CONFLICT

Questions of conflict in the trustee becoming the liquidator of the bankrupt's former company and the receiver of trust property were also raised.

When the matter was in the Duty Judge's List, the parties opposing the orders asserted a conflict existed because the trustee as sole shareholder was seeking his appointment as provisional liquidator of the company.

However, the Duty Judge indicated that even if a theoretical conflict existed, that was secondary to the need

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to place the affairs and assets of the company (including trust properties of which the company was registered proprietor) under the control of a person other than the directors (who were the bankrupt's close relatives). The provisional liquidator was given limited powers only.

Questions of conflict commonly arise in this and related contexts. General statements of principle which have been given in decided cases emphasise the need for a liquidator to be independent of creditors, the company in liquidation, its directors and major shareholders.

In *Advance Housing Pty Ltd (in liquidation) v Newcastle Classic Developments Pty Ltd* (1994) 14 ACSR 230 Santow J (as his Honour then was) cited with approval the following statement of principle in *Chevron Furnishers Pty Ltd (in liquidation), Re Qld Amalgamated Industries Pty Ltd v Harris* [1995] 1 Qd R 125:

> *The principle established by [the] cases is undoubted. The liquidator must have had no prior or other involvement either with the company in liquidation, its directors and major shareholders, or one of its creditors so that he could not fairly and impartially carry out his duties as liquidator requiring him, in broad terms, to act in the best interests of the general body of creditors.*

BAR MACHIAVELLI

But courts have a balancing act to perform in assessing conflict. It was stated recently by Parker J in *Bar Machiavelli* at [9] that 'even where a potential conflict, or even an actual conflict, arises, the Court does not automatically remove the liquidator whatever the circumstances of the administration.'

The court will assess all the relevant circumstances, including how the liquidator moved from one position (e.g. trustee or administrator) into the role of liquidator. Prior relationships will be relevant, as will circumstances in which the Corporations Act provides for an administrator to become a liquidator.

Where it is asserted that a trustee's or administrator's own status as a creditor for their remuneration and expenses gives rise to a conflict, the court will consider its powers to direct the liquidator in the conduct of the administration and any statutory mechanisms for the review or assessment of those fees, including the wide powers the court has to ensure that there is proper contradictor to a claim for remuneration and expenses: *Bar Machiavelli* at [11] – [13].

In addition, the court will consider whether it is to the creditors' benefit to retain the trustee's or administrator's background and knowledge, whether substantial work has been done and the likelihood of costs savings by retaining that person: *Workers Compensation Nominal Insurer v Perfume Empire Pty Ltd* [2011] NSWSC 380 at [9] – [10]; *Bar Machiavelli* at [10]; see also *Hooke v Bux Global Limited (No 6)* [2018] FCA 1545.

If questions of conflict are to be raised before the court, parties will need to consider the precise factual circumstances of the matter said to give rise to a conflict. Even where a conflict can be established, the court will go on to consider other factors, outlined above, in determining whether the conflict is such as to disqualify the person from acting in the proposed capacity.

RE LOREMO

In this case, a director of the company applied to the Court for the winding up of the company, and pending the hearing of the winding up, for the appointment of a provisional liquidator.

The company owed a substantial debt to its shareholder and appeared to be insolvent. The secured creditor of the company supported the application for the appointment of a provisional liquidator, as did the trustee in bankruptcy of a former director and the sole shareholder in the company.

Significantly, Justice Black's decision confirms that:

- where a company itself has standing to bring an application for its winding up on the just and equitable ground (which would be the case if its sole shareholder passed such a resolution and the company then applied to the court for the appropriate order), and
- by its director, the company seeks the appointment of a provisional liquidator,

then the balance of convenience favours the appointment of a provisional liquidator, and the party seeking that order is not required to provide an undertaking as to damages.

Providing an undertaking as to damages is not automatic and the trustee of a bankrupt estate should carefully consider whether it is necessary to do so. Providing such an undertaking creates a potential liability for the trustee which if crystallised, may not necessarily be limited to the assets in the bankrupt estate and could therefore generate losses which the trustee cannot recoup fully from the bankrupt estate.