

# What is the priority of a payment negotiated in a settlement with a liquidator?

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## Summary

The Supreme Court of Victoria delivered judgment on 4 March 2016 in *Warehouse Sales Pty Ltd (in liq) v WHS2 Pty Ltd (in liq)* [2016] VSC 63. This case is particularly useful to liquidators as it deals with a number of questions that often confront liquidators, including:

1. When will an application under section 511 *Corporations Act 2001* (Cth) (the Act) be heard in the absence of a contradictor?;
2. What are the grounds on which a direction under section 511 of the Act can be made?;
3. When will the Court give directions approving a settlement agreement?; and
4. When will a payment under a settlement agreement between a liquidator and a creditor have priority under section 556(1)(a) of the Act?

The main focus of this Turkalert is the fourth question, which related to a settlement payment by the liquidators to a number of creditors who were TurksLegal clients.

The Court found:

Any settlement sum payment consequent on breach of a contractual obligation of the liquidated company will likely be properly incurred (and therefore be afforded a section 556(1)(a) priority) if the settlement was entered

into after extensive investigations, negotiations and advice in order to minimise the direct costs to the liquidations, truncate litigation and prevent further expense.

## Background

Prior to their liquidation, Warehouse Sales Pty Ltd (WHS) and WHS2 Pty Ltd, a related entity, were in the business of selling white and brown goods. The liquidators for WHS initially received legal advice that WHS's suppliers held a security interest in the goods in the possession of both WHS and WHS2. Acting in reliance on this advice, the liquidators entered into terms of settlement with a number of suppliers, and allowed another supplier (Electrolux) to collect stock from WHS2 in part satisfaction of that supplier's claim against WHS (the Original Settlements).

Subsequently, the liquidators learnt that their earlier legal advice may have been incorrect and sought judicial advice on the matter. Pending orders from the Court, the liquidators suspended the release of stock to the suppliers. As a consequence, the suppliers issued interlocutory processes against the liquidators for delivery up of the stock or damages for breach of the terms of settlement, or in the case of Electrolux, compensation or damages for conversion or detainue.

Following the decision of *Warehouse Sales Pty Ltd (in liq) & Lewis and Templeton v LG Electronics Australia Pty Ltd* [2014] VSC 644<sup>1</sup> which confirmed the initial legal advice received by the liquidators had been incorrect, the liquidators negotiated conditional settlements agreements with the suppliers of the interlocutory proceedings (the Conditional Settlements).

The liquidators then sought directions from the Supreme Court of Victoria approving and authorising the Conditional Settlements under sections 511 and 477(2B)

of the Act. In determining whether the directions sought should be made, Justice Sifris considered a number of things, but particularly useful to liquidators was the judge's consideration of when settlement sums have priority under section 556(1)(a) of the Act.

## Decision

Section 556(1)(a) of the Act provides that a debt which is an expense that has been properly incurred in preserving, realising or getting in property of the company, or in the carrying on the company's business has priority to all other debts and claims in the winding up of that company.

The Court held that the inquiry into whether a settlement payment is such an expense requires an assessment of whether it was a bona fide<sup>2</sup> expense incurred in the discharge of the liquidator's duties,<sup>3</sup> and the expense must fall within the confines of the statute and have sufficient nexus with the preservation, realisation or gathering of property or the carrying on of the company's business.<sup>4</sup>

Ultimately, the Court approved and authorised the Conditional Settlements, finding the settlement sums had priority under section 556(1)(a) of the Act. In coming to this conclusion the Court held that both the Original Settlements and the Conditional Settlements originated in acts taken by the liquidator to deal with the company's assets in the interests of those persons ultimately entitled to them.<sup>5</sup>

The Court considered that the liquidator's intention in entering the Original Settlements was to carry out its primary function of distributing the companies' assets in accordance with law. The mere fact that the initial advice on which the liquidators acted was incorrect did not of itself take the expenses incurred in reliance on that advice outside the scope of "properly incurred". The solicitors' advice, although wrong, was not unreasonable, perverse or wrongheaded.<sup>6</sup>

The Court further considered that the withholding of stock from the suppliers, which had led to the filing of interlocutory proceedings against the liquidators, had been taken to preserve the assets in the companies' possession and determine their ownership with a view to the proper realisation or distribution of those assets.<sup>7</sup>

In light of the above, the Court held that the settlement sums had been properly incurred as the liquidators had agreed to the Conditional Settlements after extensive investigations, negotiations and advice, and was done so in order "to minimise the direct costs to the liquidations and truncate the litigation so as to prevent further expenses being incurred" and preserve as much as possible of the companies' assets for distribution.<sup>8</sup>

The judge commented that while in hindsight it would have been better had the solicitors advised the liquidators to delay dealing with the assets prior to obtaining directions of the Court, at the time the liquidators were confronted with a complex high pressure situation,<sup>9</sup> and reasonable allowance must be made for commercial realities and the exercise of professional judgment.

## Implications

The decision shows that expense can be given a very wide meaning under section 556(1)(a) of the Act. However this is a unique set of facts and creditors and liquidators must think carefully about the priority of any payment under a settlement agreement entered into post-liquidation. They should also note the following key points:

1. Liquidators must critically assess legal advice as expense incurred as a result of action taken in reliance on legal advice that is unreasonable will not have priority under section 556(1)(a) of the Act.
2. Where there is considerable uncertainty as to questions of law it may be best for a liquidator to delay the incurring of any expense relying on that legal advice and seek directions from the Court.
3. Expenses incurred in reliance on incorrect legal advice may, in certain circumstances, be properly incurred, but will not be properly incurred where the legal advice is unreasonable, perverse or wrongheaded.
4. Taking action that results in breaching contractual obligations of the liquidated company will not necessarily result in improperly incurred expense where those actions were taken to preserve the company's assets and determine their ownership with a view to the proper realisation or distribution of those assets.

<sup>1</sup>For more information see: Daniel Turk, "PPSA Retention of the Title Precedent Case – Debtor Transfers to Related Entities and Lay-by Sales" (December 2014) TurkAlert.

<sup>2</sup>Warehouse Sales Pty Ltd (in liquidation) v WHS2 Pty Ltd (in liquidation) [2016] VSC 63 at [149].

<sup>3</sup>Ibid at [131].

<sup>4</sup>Ibid at [141].

<sup>5</sup>Ibid at [143].

<sup>6</sup>Ibid at [150].

<sup>7</sup>Ibid at [144].

<sup>8</sup>Ibid at [145].

<sup>9</sup>Ibid at [150].

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