Liquidators and Close Relationships – The application of the reasonable, fair minded observer test to determine reasonable apprehension of independence and impartiality

ASIC v Franklin (liquidator), in the matter of Walton Constructions Pty Ltd [2014] FCAFC 85

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Summary

In our May 2014 edition of TurkAlert entitled Liquidators and Close Relationships (the first TurkAlert), we noted that ASIC had appealed the decision in ***Re Walton Constructions Pty Ltd*** to the Full Court of the Federal Court of Australia. On 18 July 2014, the Full Court delivered Judgment in the Appeal and ordered that the Liquidators be removed because they had a conflict of interest and that a reasonable fair minded observer might reasonably apprehend that they might not discharge their duties with independence and impartiality.

The Full Court dismissed the second ground of appeal raised by ASIC, namely whether the Liquidators contravened disclosure obligations under s 436DA of the *Corporations Act* 2001 (Cth).

Facts

The Referrer acted as advisors to Walton Construction Pty Ltd (in Liq) and Walton Construction (QLD) Pty Ltd (in Liquidation) (the Walton Companies). The Referrer was involved in restructuring within the Walton Companies prior to their entering administration. The Walton Companies later entered into liquidation.

The other defendants (the 'Liquidators') were the Liquidators of the Walton Companies, having been initially appointed administrators following a referral to them by the Referrer.

On a number of prior occasions, the Referrer had referred to the Liquidators' other opportunities for insolvency appointment.

The restructuring had involved the Walton Companies assigning debts and transferring assets to companies associated with the Referrer.

The Administrators provided creditors with a Declaration of Independence, Relevant Relationships and Indemnities (DIRRI) as follows:

> "The [companies were] referred by … the Referrer, who refers us insolvency type matters from time to time. Referrals from solicitors, business advisors and accountants are common place and do not impact on our independence in carrying out our function as Administrators……"

Outcome

1. The Full Federal Court of Appeal found that the primary judge had erred in the application of the relevant test to be applied in determining whether a hypothetical, reasonable, fair minded observer might apprehend bias in the discharge of the Liquidators' duties. The test, referred to as the "double might" test arises from the decision in *Ebner v Official Trustee in Bankruptcy* [2000] HCA 63, being "whether a fair-minded lay observer might reasonably apprehend that the judge might not bring an impartial mind to the resolution of the question the judge is required to decide."

2. The Full Court found that some of the factors leading to an apprehension of bias, in the eyes of a reasonable fair minded observer, were:

   - most creditors were likely to regard the remuneration in the order received by the Liquidators ($750,000 for two companies) as significant, with a fair-minded observer possibly apprehending they may not wish to put their continued receipt of income in that proportion in jeopardy; that this was especially so, where the referral relationship had only recently been formed and the number of referrals had slowly been increasing;

   - questions raised at creditors meetings and the attempt to remove the Liquidators, when in their capacity as Administrators, indicated a fair minded observer not only might have, but did have, a reasonable apprehension the Liquidators might not discharge their duties independently and impartially; and

   - the Referrer appearing to have influenced the selection of the persons, who, as Liquidators, would investigate its pre-administration conduct.

3. The Full Court dismissed ASIC's appeal on the question of whether the Liquidators, when Administrators, had breached the disclosure provision of s 436A of the *Corporations Act* when preparing the DIRRI. The principal reason for this finding, was that the relationship between the Liquidators and the Referrer was not one requiring disclosure under s 436DA.

4. The Full Court held that the Code of Professional Practice for Insolvency Practitioners, published by the Insolvency Practitioner's Association (now known as ARITA), should not be taken into account in construing s 60 and s 436DA of the *Corporations Act*. (We will probably see these comments relied upon in future cases concerning the interpretation of statutory obligations of liquidators.)

5. There was no practical alternative to "quarantine" the conflict and therefore the Liquidators would need to be replaced.

Implications

1. The test for whether or not there is "apprehended bias" for a liquidator is the same as that which applies to the judiciary and administrative decision makers. While the Court noted that the application of the test would need to take into account that liquidators worked in a competitive business environment, the context did not result in a materially higher threshold for liquidators.

2. Liquidators would need to seriously question whether they have a conflict of interest in taking on an appointment as administrators from a referrer, where that referrer's conduct might be the subject of an investigation in the course of a liquidation of the relevant company.

3. Liquidators must carefully consider whether they have a relationship with entities, whom they may be required to investigate if an appointment were to be accepted. If they do have a relationship, they need to consider whether the closeness and materiality of the relationship to their business, gives rise to a conflict of interest.

4. It is expected that in the wake of this decision, there will be a heightened focus by creditors (and ASIC) on any pre-existing relationships between liquidators and any entities they may be required to investigate, and in particular, in the case where the appointment was the result of a referral.

It is not yet known whether the Liquidators in this case will seek to apply for leave to appeal to the High Court of Australia. Arguably, the commercial imperative to do so has been lost, as they have now been replaced.

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