

TECHNICAL INSIGHTS

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Under section 561 Corporations Act is the liquidator able to claim priority for remuneration, costs and expenses ahead of employee entitlements?

In this issue

- ▲ The encroachment on circulating security interests (floating charges) by section 561 Corporations Act 2001 discussed;
- ▲ Whether, and, if so, to what extent liquidator's remuneration, costs and expenses may take priority under section 561 ahead of employee claims payable under that section;
- ▲ Case law dealing with this issue;
- ▲ Whether section 561 needs to be amended in the manner adopted by the UK legislature.

Introduction

The circulating security interest by way of floating charge had its origins in England in the 1870's. It has been observed that floating charges played an invaluable role in bridging the gap between business and finance. This was achieved by a legal mechanism under which a financier, typically a bank, was able to provide a company with funds on the security of assets that continued to be used and turned over by the company in the ordinary course of its business (being "circulating assets" as opposed to "fixed assets").

The security afforded by a circulating security interest on the circulating assets of a company, and the security holder's ability to enforce its security in the event of the company's winding up has not always been allowed to prevail. On occasions, the legislature has intervened to correct the perceived imbalance between the rights and interests of circulating security holders on winding up and the rights and interests of other claimants.

For the purposes of our discussion, we are concerned with the operation of section 561, Corporations Act and the extent to which that provision has allowed encroachment on the rights of a circulating security holder.

More specifically, our concern is with the situation that commonly arises where a liquidator, with the consent of the circulating security holder, is in control of security

proceeds such that a decision will need to be made by the liquidator as to the manner in which those proceeds are to be distributed under section 561; and in particular whether the liquidator's remuneration, costs and expenses may be paid ahead of employee entitlements identified in section 561.

The operation of section 561, Corporations Act

In substance section 561 provides that where the non-charged assets of a company in winding up are insufficient to meet:

- ▲ the entitlements owed to employees which by section 556 are given priority in a winding up; and
- ▲ any amount being an advance to the company to pay employee entitlements which has a right of priority under section 560,

then payment of such claims may be made in priority over the claims of a secured party in relation to a circulating security interest created by the company, and may be made out of any property comprised in the circulating security interest.

Importantly, section 561 imposes a statutory obligation on a liquidator who, with the consent of the circulating security holder, is in control of secured assets to pay priority claims covered by the section if the relevant conditions are satisfied. In this regard the Federal Court

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in *Cook (Liquidator), in the matter of Italiano Family Fruit Company Pty Ltd (in liq) v Italiano Family Fruit Company Pty Ltd (in liq)* (2010) FCA 1355 observed:

“It necessarily follows that the controller is required to withhold funds from the secured creditor that are sufficient to pay priority creditors if it appears that the company’s property is likely to be insufficient. In these respects s 561 mandates an incursion into the proprietary rights of the secured creditor.”

Does section 561 allow the remuneration, costs and expenses of the liquidator to be met from circulating security proceeds ahead of employee entitlements and the rights of the circulating security holder?

This is an important question for there would appear to be uncertainty among liquidators as to the priority of the liquidator’s remuneration, costs and expenses in the circumstances under discussion. It is apparent that the answer to this question will largely turn on the proper interpretation of section 561.

It is unfortunate that at the present time there is no authoritative Australian case law directly on point. It may be noted, however, that in *Saker, in the matter of Great Southern Limited* (2014) FCA 771, the Federal Court had occasion to consider the operation of section 561, however, in circumstances where receivers were appointed concurrently with liquidators.

In the case receivers appointed under circulating security interests had transferred to the liquidators funds deducted from security proceeds with a view to the liquidators meeting employee claims under section 561. Subsequently the claim of the circulating security holder was paid and the receivership terminated.

Here the Court directed that the liquidators would be acting properly by distributing the company’s funds (including those transferred by the receivers) in accordance with section 556 priorities, which meant that the liquidators could recover their remuneration, costs and expenses from the funds on hand. However, the Court further directed that such distribution was “subject to (the liquidators) satisfying themselves that section 561 had been complied with.” This meant that in the event employee entitlements were not met by

the liquidators’ distribution the liquidators would be obliged to seek further funds from the receivers in order to satisfy the employee entitlements pursuant to section 561. As a consequence, the case did not directly address the question presently under consideration.

Perhaps the most useful case dealing with the situation where the liquidator, being in control of circulating security proceeds, seeks to determine whether the liquidator’s remuneration, costs and expenses may be paid from those proceeds ahead of employee claims, can be found in *Buchler v Talbot* (2004) UKHL 9. This is a decision of the House of Lords dealing with the UK equivalent of section 561.



Here the House of Lords concluded that the language of the UK section (in terms similar to section 561) was unequivocal as to the claims that could be met from floating charge/circulating security proceeds. As a result there were no grounds for implying an additional incursion, such as liquidation expenses, into the security holder’s rights in respect of their charged property. It was observed that:

“The fact that liquidation expenses enjoy priority over the claims of preferential creditors in a winding up is not of itself a reason for according to liquidation expenses the like priority in respect of charged assets... according a like priority in respect of liquidation expenses would represent a potentially major additional incursion into the proprietary interests of debenture holders” (para 16).

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Does the principle in *Universal Distributing* apply?

Although denying priority to liquidation general expenses, including liquidator's remuneration, the House of Lords had regard to the "practicalities involved" in applying their decision.

In particular it was recognized that costs incurred by the liquidator in realizing charged assets are payable ahead of the floating charge/circulating security holder's claims, as opposed to general expenses incurred by the liquidator for purposes not associated with realizing the charged assets. In addition the liquidator's costs and expenses incurred in identifying preferential creditors and paying them pursuant to the statutory obligation will be payable ahead of the security holder "just as much as they would be if the debenture holder had incurred costs and expenses in discharging this statutory duty" (para 19).

This recognition is consistent with numerous Australian authorities applying the principle in *Universal Distributing* (see, for example, *Stewart v Atco Controls Pty Ltd (in liq)* (2014) HCA 15). The underlying rationale of this principle is that it is inequitable to claim the benefit of the protection or realization of charged assets without recognizing the liquidator's costs, expenses and fees incurred in producing those outcomes. Typically, cases involving these issues arise as a result of the mutual cooperation of the liquidator and the secured creditor, with the latter seeking to take the benefit of the liquidator's work and expertise in realizing the charged assets.



UK legislative developments following the House of Lords decision in *Buchler v Talbot*: A possible future direction for section 561?

In 2008, the UK Government took the opportunity to reverse the House of Lords decision in *Buchler v Talbot* with the insertion into the Insolvency Act 1986 of section 176ZA. This section provides that where non-charged assets are insufficient to pay the expenses of winding up, the proceeds of assets subject to a floating charge/circulating security will be available to meet those expenses, in priority to the claims of the security holder and to preferential creditors entitled to be paid in priority to the security holder.

In justifying the reversal of the House of Lords decision, the UK legislature recognized that where there is a floating charge/circulating security it has been accepted that in appropriate cases charged assets do not solely protect the interests of the security holder. The costs and expenses of winding up have always carried a high priority such that it was perceived by the UK legislature to be incongruous that any curtailing of the security holder's rights did not also extend to such a high ranking priority as the costs and expenses of winding up.

The obvious question arising from these UK developments is whether our section 561 should be amended to similarly reflect the UK reasoning.

Note: On reversal of the *Buchler v Talbot* decision circulating security holders voiced a concern that liquidators would be given a free rein to use their charged assets to fund speculative recovery actions for the benefit of unsecured creditors. Consequently, new rules were introduced giving effect to an approval regime with respect to the liquidator's litigation expenses. Under these rules, it will not be possible for litigation expenses above a prescribed threshold to be paid from circulating security proceeds without the approval of the security holder, or a preferential creditor entitled to be paid in priority to the floating charge holder, or the court.

Concluding comments

As a result of the unequivocal terms of section 561, Corporations Act 2001 it is suggested that there is no ground for implying incursion of a liquidator's

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remuneration, costs and expenses into a circulating security holder's rights, except to the extent allowed under the principle in *Universal Distributing*. The fact that, when distributing the proceeds of non-charged assets, other claimants may rank ahead of employee entitlements is not a reason for transporting those claims into section 561 ahead of employee claims and the rights of the circulating security holder.

This outcome may well result in claims that usually rank ahead of employee entitlements, such as the winding up applicant's costs, or the general costs and expenses of the liquidator, not being met, with a lower ranking priority, namely, employee entitlements, being paid ahead of those higher ranking claims from funds that would otherwise vest in the circulating security holder.

If this outcome is perceived to be incongruous and not in the public interest then changes to the operation of section 561, with further encroachment of the circulating security holder's rights, will need to be brought about by legislative intervention as occurred in the UK, and not by doubtful interpretation of the unequivocal language of section 561.

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