

Banking & Finance Brief February 2009

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The GST liability of insolvency practitioners

A decision of the Federal Court of Australia handed down on Friday 12 December 2008 examines personal liability for GST payments that arise with respect to the sale of corporate property following the appointment of a liquidator, receiver, attorney or trustee in bankruptcy. The case has potentially significant implications for insolvency practitioners, however the Federal Government has recently proposed amending legislation with retrospective effect, leaving the current legal position of people appointed to incapacitated entities uncertain.

The facts

PM Developments Pty Ltd ('PMD') was the developer of a residential project in southern Queensland. In July 2007, PMD was ordered to be wound up upon application of the Deputy Commissioner of Taxation ('Commissioner'). A liquidator was appointed to the company.

Before the winding-up order was made, contracts for the sale of seven of the eight residential units in the development were completed. Contracts had exchanged on the eighth and final lot in the project ('Lot 8') prior to the winding up, however the sale had not been completed. The contract was terminated by the liquidator. PMD remained as the registered proprietor of Lot 8. Title to lot 8 never vested in the liquidator personally, either in his capacity as liquidator of PMD or in any other capacity.

PMD subsequently entered into a new contract for sale for Lot 8. The contract for sale included a special condition to the effect that the purchaser acknowledged that PMD was in liquidation and that the company had entered into the contract by its liquidator, and that the liquidator was not personally liable to satisfy any obligation arising under the contract.

Upon settlement, GST of 10% of the purchase price was paid and held in the trust account of the solicitors for the liquidator.

Shortly prior to and also after completion of the sale of lot 8, upon application by the liquidator, the Commissioner issued a private ruling with respect to the GST liability for the sale of Lot 8, which provided that:

'As the sale of Unit 8 was made by you in your capacity as liquidator of [PMD], you (rather than the incapacitated company) are liable for the GST on this supply.'

The liquidator made application to the Federal Court for directions with respect to the private ruling and his personal liability to the ATO.

Who owns the assets of a corporation in liquidation?

In his decision, Justice Logan discussed at length the well established principles of statutory construction and interpretation, in order to determine the application of the relevant provisions of the *A New Tax System (Goods and Services Tax) Act 1999* ('GST Act') to the present case. He emphasised the need to construe the statute

in its entirety, with careful consideration of the context, purpose and object of the legislation, and to give the words their 'sensible meaning'.

His Honour then went on to consider the general position of liquidators appointed to a company wound up in insolvency, and specifically noted that:

- upon winding up in insolvency, control of a corporation is vested in the liquidator for the purposes of winding up the corporation in accordance with the provisions of section 471A(1) of the *Corporations Act*;

however,

- there is no change to the beneficial ownership of the corporation's assets.

Logan J held that when PMD was ordered to be wound up and had a liquidator appointed, the liquidator did not become the beneficial owner of Lot 8. Rather, title to the property, as an asset of PMD, remained vested in the corporation. Accordingly, it was PMD (not its liquidator) which owned Lot 8, and PMD (not its liquidator) who subsequently sold Lot 8.

Who made the 'taxable supply'?

Pursuant to section 9-5 of the *GST Act*, a 'taxable supply' occurs when a supply is made:

- for consideration;
- in the furtherance of an enterprise carried on by the supplier;
- in connection with Australia; and
- where the supplier is registered or required to be registered for GST.

The Commissioner submitted that, as a result of Division 147 of the *GST Act*, which requires that 'representatives of incapacitated entities' are required to be registered for GST, the liquidator should be held to be the supplier for the purposes of determining GST liability on the sale of Lot 8.

Logan J held that section 9-5 requires that all four tests of a taxable supply be met. The mere fulfilment of the fourth element, the requirement to be registered for GST, did not mean that the liquidator was making a 'taxable supply' within the meaning of section 9-5 of the *GST Act*. His Honour stated that the only business relevantly conducted by the liquidator was the practice of his profession as an official liquidator and that the taxable supply of Lot 8 was made by PMD, not the liquidator.

Liability to pay GST on the taxable supply

As PMD made the taxable supply, PMD was liable to pay the GST on the sale of Lot 8 (not the liquidator personally).

The GST was held to be a post-liquidation debt of PMD and, as such, was captured under the payment priority provisions of section 566(1)(a) of the *Corporations Act* – that is, the debt to the ATO was held to be an equal-ranking debt with various other post liquidation debts of the corporation, and subordinated to the expenses properly incurred by the liquidator in preserving, realising or getting in property of the company, or in carrying on the company's business.

In practice, the reason the ATO pursued the matter was because whilst the GST was compiled a section 566(1)(a) expense, there was insufficient monies to pay all such expenses in full, and so they would only be paid pro rata. If the ATO could show the liquidator was personally liable, it would effectively be paid in full.

Accordingly, of course, insolvency practitioners would provide for the payment of GST. While the ATO is not afforded special priority, because of a revenue debt, it should be a matter of attention to insolvency practitioners.

Implications for liquidators

Subject to the passing of new legislation proposed by the Federal Government (as mentioned below), the case stipulates that a liquidator is not personally liable for GST on a taxable supply made by the corporation once in liquidation, and that a GST debt is subordinated to the costs and expenses incurred in the conduct of the liquidation.

It is noted that this is not the position if, in special circumstances, the liquidator obtains an order vesting some or all of the property of a corporation in the liquidator (under the provisions of section 474(2) of the *Corporations Act*). In such a case, the assets of the corporation vest in the liquidator personally, and the taxable supply is made by the liquidator personally.

In practice, the reason the ATO perused the matter was because whilst the GST was considered a section 566(1)(a) expense, there was insufficient monies to pay all such expenses in full, and so they would only be paid pro rata. If the ATO could show the liquidator was personally liable, it would effectively be paid in full.

Ordinarily, of course, insolvency practitioners would provide for the payment of GST. While the ATO is not afforded special priority because of a revenue debt, it should be a matter of attention to insolvency practitioners.

Implications for receivers

Logan J, in obiter dicta, noted that a receiver is liable for debts incurred in the course of the receivership 'for services rendered, goods purchased or property hired, leased, used or occupied' (under section 419(1) of the *Corporations Act*). However, His Honour also noted that the business of a corporation to which a receiver is

appointed remains that of the corporation. The principles outlined in this case as they apply to liquidators may equally be applied to receivers (subject to any statutory provision which makes a receiver liable personally for debts incurred during the course of a receivership) as the property of the corporation does not vest personally in the receiver and therefore a disposition of assets of the corporation made after the appointment of a receiver is not a taxable supply by the receiver personally.

The proposed amending legislation

The decision has left the legal position of representatives appointed to incapacitated entities unclear, and has received considerable attention from insolvency practitioners and the Australian Taxation Office.

On Friday, 6 February 2009, the Assistant Treasurer,

the Honourable Chris Bowen MP, released a statement announcing that the 'Court's finding is contrary to the underlying policy intention' of the *GST Act*. He confirmed that the Government intends to introduce legislation to amend the *GST Act*, to ensure that any person appointed to an incapacitated entity is personally liable for GST on taxable supplies during the period of their appointment. It is intended that the legislation will be retrospective, and take effect from the commencement of the *GST Act* (that is, 1 July 2000).

We note that the legislation is not presently in-force, and the position taken by the Federal Court in the PM Developments case is the current position under Australian law. However, insolvency practitioners should be aware of the proposed legislative reforms and consider their liability to remit GST should such reforms become law.

Financing troubled companies – is your security enforceable?

A judgment handed down late in 2008 has highlighted the need for financiers to have particular regard to the solvency of a security provider, and the risks involved in taking securities from a company which may be (or is at risk of becoming) insolvent. The decision is of particular significance in the current economic climate and has possible resonance for cases in which an 11th hour charge has been granted to perfect security against provision of a line of credit.

In *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239, the Supreme Court of Western Australia addressed many complex issues, including whether the directors of The Bell Group breached their duties by granting security over companies within the group, where those companies did not receive the benefit of the financial accommodation. In the 2600-page decision resulting from litigation spanning 13 years, the Court considered whether the securities were enforceable by the financiers in circumstances where they were obtained from insolvent companies (or where insolvency was impending).

By way of a brief summary of the facts of the complex case, refinancing facilities were provided by Westpac and 20 other banks (as bilateral loans and a syndicated loan arrangement) to several companies within the Bell Group. At the time that the loans were made, the banks' facilities were unsecured but supported by negative pledges. When the Bell Group began to have financial problems, the facilities were restructured and several companies within the group who were not parties to the original loan arrangements provided security in favour of the banks. The effect of the securities was to give the banks priority over the claims of other creditors, including bondholders. Shortly thereafter, several companies in the group were placed into insolvency and the banks enforced their security.

The liquidator of the Bell Group companies commenced proceedings in an attempt to recover the money received by the banks from the enforcement of the securities, which amounted to approximately \$283 million. The

plaintiffs also sought monetary compensation in the amount of approximately \$1.5 billion.

As a preliminary issue, it was submitted that the directors of the Bell Group had entered into the security arrangements at a time when they knew (or ought reasonably to have known) that the companies were insolvent. The Court was required to determine whether, by so doing, the directors had breached their duties to the companies under common law or the (then applicable) statutory provisions of the Companies Acts.

The Court held that the directors had breached their duties to act in the best interests of the company, and to exercise powers for a proper purpose. Owen J held that in exercising their duties, directors must balance the interests of the individual company and the Group, and may be required to take into account the interests of creditors where there is a prospect of insolvency. Since the events leading to this case, directors' duties have been codified in sections 180-184 and 588G of the *Corporations Act 2001* (Cth).

It was held that the companies over which security had been taken had, in fact, been insolvent when the security was granted and that the directors were aware of the likelihood of insolvency. In granting security, the directors had breached their statutory and fiduciary duties to the Bell Group companies.

Were the financiers liable?

The Court went on to consider whether the banks' securities were unenforceable because they were received

when the companies were insolvent. It was submitted that, on the facts, the banks 'knew of this vulnerability and it was an integral part of the reasoning process that led them to adopt the refinancing structure that they did'. His Honour determined that the banks were aware that, in taking the securities, the transactions may be set aside, however they proceeded on the basis that this was a mere 'risk'.

On the facts found by the Court, the banks believed that if any of the companies were wound up within six months of taking the securities, many of their securities would very likely be set aside. If the companies were wound up some time after six months, there was still a risk of at least some of the securities being set aside due to a lack of commercial benefit or under other insolvency

provisions. His Honour held that, on the facts, the banks 'harboured concerns about the solvency of the companies'.

The Court concluded that each bank possessed the requisite knowledge of the companies' insolvency, and that their securities were not enforceable. Owen J also held that the banks had knowledge of the breaches by the directors. Accordingly, they were liable under the first limb of the rule in *Barnes v Addy* for being in knowing receipt of trust property. The banks were not liable under the second limb (knowing assistance) or in equitable fraud. The final orders are yet to be made, but the plaintiffs may seek declaratory relief relating to the avoidance of the transactions and return of proceeds from the realisation of assets under the securities.

In Brief: What's happening with Personal Property Securities reform?

On 13 November 2008, the exposure draft Personal Property Securities Bill 2008 ('PPS Bill') was referred to the Senate Standing Committee on Legal and Constitutional Affairs for inquiry and report. The PPS Bill is presently open for public examination.

The PPS Bill aims to introduce a national system for the registration of security interests in all property other than real property. The new law will replace more than 70 pieces of Commonwealth, State and Territory legislation. The Bill is modelled on the PPS reforms implemented in New Zealand, Canada and the USA.

The PPS Bill aims to be a functional approach to the regulation of personal property securities, codifying rules relating to the creation of security interests, the determination of priority between competing interests and establishing when an interest in personal property is acquired free of any security interests. A PPS Register will be established and maintained by a Registrar, and it is expected that it will be searchable in a manner similar to the current REVS system.

If you wish to discuss the proposed legislative reform, please contact Kemp Strang.

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