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Article Information

Team: Piper Alderman

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Winding-up companies in a partnership – guidance for liquidators who are appointed to companies acting in partnership

A recent Western Australian Supreme Court case considered the insolvency of a partnership comprised of corporate members. When a partnership is formally dissolved

A recent Western Australian Supreme Court case considered the insolvency of a partnership comprised of corporate members. When a partnership is formally dissolved, the partnership assets are realised by a court-appointed receiver, who will realise and distribute the assets in accordance with the relevant State partnership legislation. ***Senior Associate, Stefano Calabretta*** *and* ***Lawyer, Brendan May*** *discuss this scenario further.*

In such a scenario, the receiver is required to first apply the assets of the partnership in payment of the debts and liabilities of the partnership, and subsequently distribute the surplus (if any) among the partners,[1] whereupon *Corporations Act 2001* (Cth) priorities will apply.

However, where there is no receiver appointed to the partnership, and instead a liquidator or liquidators are appointed to the partners individually, established authority was to the effect that the distribution of partnership assets was done in accordance with Corporations Act priorities. A recent Western Australian Supreme Court case, *Woods & White v Hopkins* (Woods)[2] has now rejected this approach.[3]

No external administrator appointed to the partnership

The question as to the distribution of assets arises where corporate partners in partnership are wound up and a liquidator is appointed to each of them in their own capacities, as opposed to a receiver appointed by the court to the partnership itself.

Under the usual liquidation process, in relation to *unsecured debts* and claims, a liquidator will realise the company's assets and apply them in accordance with ss 556 and 561 of the Corporations Act. Section 556 of the Corporations Act provides a 'cascade' of priorities in the payment of the debts and claims of a company in a winding up. It provides that, among other things, the expenses of the winding up will be paid first (such as those incurred by the appointee), followed by employee entitlements.

While a secured creditor ranks above these and is entitled to realise its security in any event, for employees, s 561 of the Corporations Act provides that this priority
is only available in the case of *non-circulating* security interests; employee entitlements will rank above
any *circulating* component of a security interest.

So when companies in liquidation are in partnership, and the assets realised by the liquidator are the assets of the partnership, how is a liquidator to apply the proceeds of realisation – in accordance with the relevant Partnership Act, or the Corporations Act? [4]

Woods & White v Hopkins

The question arose earlier this year in the Supreme Court of Western Australia in *Woods*. Two liquidators (the Liquidators) were appointed jointly and severally to three companies
who were in partnership in an accounting practice (the Partnership).

The Liquidators caused the Partnership to be dissolved, and realised the assets of the Partnership. The question was how to apply the funds. The Liquidators approached the Court for directions under s 479(3) of the Corporations Act as to:

- whether they could claim an indemnity for their costs and expenses, and if so, whether this indemnity was secured by an equitable lien over the funds realised, and
- the priority of this indemnity and the order in which the realised funds were to be distributed.

The relevant facts were:

- The corporate members in the Partnership were the corporate vehicles associated with the principals of the accounting practice.
- The accounting practice itself was conducted by the Partnership and another partnership referred to as the BP Partnership. The BP Partnership was operated by corporate trustees for various trusts, which were also associated with the principals of the accounting practice.
- The Partnership was the main operating entity behind the accounting practice.
- The Partnership acted through a corporate entity appointed as an agent, which was itself placed into liquidation on 28 October 2014 with a different liquidator.

In May 2014, the shareholders of the three corporate members of the Partnership, and the other corporate members of the BP Partnership, resolved to place these companies into voluntary liquidation. The intention was to dissolve both the Partnership and the BP Partnership.

Subsequent to the voluntary winding up, the Liquidators formed the view that the corporate members were insolvent and applied to the Court for orders that each corporate member be wound up in insolvency, which took effect on 15 September 2014.

The accounting practice had an overdraft and term loan facility (estimated as owing $340,000) with the Commonwealth Bank of Australia (CBA). These facilities were secured against assets of the corporate entity, and guarantees provided by the corporate members of the Partnership.

Various positions of the parties

The Liquidators sought a declaration that they were entitled to an indemnity for their costs and expenses, secured by an equitable lien against the assets of the Partnership in accordance with the established authority of *Re Universal Distributing Co Ltd (in liquidation)* (Universal Distributing).[5] The Court noted that although many authorities described it as an 'equitable lien', the better term was 'equitable charge'.

This position was not opposed by the sixth defendant, the CBA, with the CBA conceding that the Liquidators were entitled to have their expenses paid in priority to the CBA. However the next question was what should happen to the assets once the equitable charge was satisfied. The Court noted that established authority – *Amni Pty Ltd v Williams (Amni)* [6] – was to the effect that the assets of the partnership were then be distributed in accordance with s 556 of the Corporations Act.

A former principal of the practice, Mr Napoli, and the corporate member of the partnership associated with him, Silverline Asset Pty Ltd (the Fourth Defendants), opposed the declarations sought by the Liquidators. The Fourth Defendants had lodged proofs of debt for the Partnership and the BP Partnership. The Fourth Defendants asserted that the assets of the Partnership were partnership assets, for which distribution should be in accordance with the relevant Partnership Act.

This would mean that their proofs of debt would be liabilities of the Partnership, which would be paid in priority under the Partnership Act, followed by a distribution of remaining surplus assets (if any), to the partners, from which the costs and expenses of the Liquidators could be paid as – so the fourth defendants contended – only if there is a surplus distribution would there be an interest to which the corporate members as partners could lay claim, and to which any equitable charge of the Liquidators could attach.

Equitable charge for fees and expenses?

After deciding that the case was an appropriate one for directions sought by liquidators under s 479(3) of the Corporations Act, the Court then had to decide whether the principle in *Universal Distributing* could apply in the present case, noting that such a course had been followed previously in the Supreme Court of New South Wales in *Amni*.

In *Amni* three companies in a partnership were placed into a members' voluntary liquidation, and subsequently appointed the liquidator as receiver and manager of the partnership. Powell J held that the liquidator's equitable charge *as liquidator of the companies in partnership* extended to a charge over the whole of the partnership property.

Gething AM noted that the Fourth Defendants were correct to say that the Liquidators were only appointed over the

companies in their own capacity; the Liquidators were not appointed as a receiver and manager to the Partnership, nor had any been appointed. However, Gething AM also indicated that the equitable charge was not sought over the assets of the individual partners, but was sought over the assets of the Partnership, as it was these assets that the Liquidators had incurred expenses in realising.

His Honour then stated a number of 'well-established' principles, including that:

- a liquidator has a right of indemnity out of the company's property for remuneration, costs and expenses
- this right of indemnity is secured by an equitable charge over the company's property, and
- a secured creditor may not have the benefit of a fund created by a liquidator's efforts in the winding up without the liquidator's costs and expenses, including remuneration, of creating that fund first being met, and equity will create a charge over the fund in priority to that of the secured creditor.[7]

What could the liquidators claim?

Importantly, the Court emphasised that the equitable charge secures only the liquidator's remuneration, costs and expenses that are reasonably incurred in caring for, preserving and realising the assets which have produced the fund. Gething AM also noted that the equitable charge included future realisations.

Accordingly, Gething AM had to decide whether to follow *Amni* and hold that the equitable charge was also available to the Liquidators over the fund that had been realised from the assets of a partnership carried on between three companies in liquidation.

His Honour held that the approach in *Amni* was correct, and that the Liquidators were entitled to exercise their indemnity in priority to both the secured debt of the CBA, and the unsecured debtors of the Partnership. Once the amount of the indemnity was determined and paid, the remaining funds were then available to satisfy the debts of the Partnership.

Order of priority for distribution of assets of the partnership

The Liquidators contended that the assets of the Partnership should first be applied to the joint debts of the partners, and in so doing the order of priority in s 556 of the Corporations Act was to be followed. Secondly the separate estate of each partner, if there was any, was to be applied in to payment of its separate debts. This was the course taken by Powell J in *Amni*.

While the CBA agreed with the first proposition of the Liquidators that the partnership assets should be applied to joint debts, the CBA submitted that as the assets of the Partnership were partnership assets, they should be distributed in accordance with the Partnership Act, relevantly s 50 (Application of Partnership Property) and s 57 (Rules for distribution of assets on final settlement of accounts).

The CBA relied on the English decision of *In Re Rudd & Son Ltd* (Rudd),[8] where it was held that the relevant companies legislation did not alter the priorities applicable to the distribution of assets when a partnership was dissolved. This would mean that after the equitable charge of the Liquidators was satisfied, the fund would be paid in satisfaction of the debts of the Partnership, with all unsecured creditors (such as employees) ranking equally.

Gething AM held that the first proposition of the Liquidators was correct; that as the partners were 'joint debtors in their joint estate', the partnership assets realised by the Liquidators were to be first applied to payment of debts of the Partnership. Then the individual estate of each partner (if any) was to be applied in payment of its individual debts.

Should the order of priorities in the Corporations Act supplant the Partnership Act?

After deciding that the Partnership Act applied to the windings-up of the partners (as it effected a dissolution of the Partnership), the question for the Court was whether the order of priorities specified in s 556 of the Corporations Act should supplant the distribution regime in the Partnership Act (following *Amni*) or whether it should not (following *Rudd*).

Gething AM declined to follow *Amni*, for two reasons:

1. the language of s 556 clearly referred to the winding up of a company, and accordingly did not apply to the winding up of, or the dissolution of, a partnership. His Honour noted that s 556 was different to the corporations legislation of the time as considered by Powell J in *Amni*, and
2. section 556 could not apply to the dissolution or the winding up of a partnership unless all the partners were companies. It could plainly not apply if one or more of the partners were an individual. Accordingly, his Honour declined to follow *Amni* on this point as a matter of principle.

His Honour concluded by holding that the priority regime in the Partnership Act was 'the only logical outcome'. This meant that after joint debts of the partnership were paid, if there was a surplus payable to an individual corporate partner that was being wound up, only then would s 556 of the Corporations Act apply. Similarly, if the partner was an individual person who had become bankrupt, then Part VI Division 2 of the *Bankruptcy Act 1966* (Cth) would apply.

It is not clear why Gething AM did not refer to the 'roll-back' provisions of the Corporations Act, specifically ss 5E and 5G. These sections specify the circumstances in which the Corporations Act will yield to State and Territory laws when they are not capable of operating concurrently, which was clearly the case here.[9]

Section 5G(8) provides: 'The provisions of Chapter 5 of this Act do not apply to a scheme of arrangement, receivership, winding up or other external administration of a company to the extent to which the scheme, receivership, winding up or administration is carried out in accordance with a provision of a law of a State or Territory.'

Once Gething AM had decided that the Partnership Act applied to the windings-up of the partners, it is likely that this provision meant that the Partnership Act order of distribution applied (which was ultimately the conclusion reached by Gething AM).

Orders of the Court as to distribution of funds

The Court held that the following order of distribution applied to the fund realised by the Liquidators from the assets of the Partnership:

1. The Liquidators were entitled to an indemnity secured by an equitable charge against the Partnership assets for payment of the reasonable remuneration, costs and expenses of the Liquidators involved in caring for, preserving and realising the Partnership assets.
2. Payment of the secured debt of the CBA in accordance with its terms.
3. Payment of the debts and liabilities of the partnership, with all debts and liabilities to rank equally and to be paid in full, unless there was a shortfall, in which case the debts and liabilities were to be paid proportionately.
4. As set out in the Partnership Act (which meant that any surplus would be distributed to the individual partners in accordance with the Partnership Act or any agreement, and the order of distribution under the Corporations Act could then apply).

What about other costs incurred by the liquidators?

Gething AM finally considered the position of the costs of the Liquidators that were directly related to a particular member being wound up rather than the Partnership (his Honour gives the examples of statutory reporting requirements and closing down bank accounts), and held that such costs were separate debts which were to be paid out of each member's separate assets.

However, where the Liquidators standing in the stead of the partners had jointly incurred a debt, one that was incurred on behalf of the Partnership but was not strictly for the proper care, preservation and realisation of partnership assets, this was to be paid out of joint assets, and in accordance with the Partnership Act would rank equally with the other joint debts of the Partnership.

As with other debts of the Partnership, such a joint debt was payable equally and in full, unless there was a shortfall, in which case it was to be paid proportionately.

What about employees?

Some may consider this decision results in unjust treatment of employees of a partnership, in that (unlike the Corporations Act) employee entitlements do not rank in priority to circulating security interests and unsecured debts of and claims against the partners.

Accordingly, if there is a shortfall in assets to pay the debts and liabilities of the partnership, an employee would either rank pari passu as an unsecured creditor if they were in fact an employee of the partnership, or could potentially receive nothing on a distribution of assets if they were in fact an employee of an individual partner.

The decision also has consequences for the Commonwealth under the Fair Entitlements Guarantee scheme. When the Commonwealth makes a payment to an employee under the scheme, they become a priority creditor of the company under s 560 of the Corporations Act. However, under this decision they would not be able to recover from the assets of the company until partnership debts are satisfied and a surplus distributed (if any).

Parallel with recent case law on trusts

The decision is paralleled by a recent decision of the New South Wales Supreme Court by Justice Brereton in *Re Independent Contractor Services (Aust) Pty Ltd ACN 119 186 971 (in liquidation) (No 2)*.[10] Here his Honour held that upon the winding up of a trust and the distribution of its assets, a liquidator must not apply the priority regime provided for in the Corporations Act, instead a liquidator must observe the long-established law of trusts that provides that, after the costs of winding up the trust are paid, the trust creditors of all classes (including employees) are paid proportionately. Only then will a surplus (if any) be distributed to the beneficiaries of the trust.

Final Thoughts

There is clearly a split in the law between earlier NSW authority and this recent WA decision regarding the winding up of companies in partnership. Nevertheless, the conclusion reached by the WA Supreme Court in *Woods* may offer some guidance for liquidators who are appointed to companies acting in partnership, and have questions as to how funds realised from the assets of the partnership are to be distributed.

However, it is to be remembered that Woods is in conflict with the earlier NSW authority of *Amni*, and until the question is firmly settled by a higher court, a liquidator appointed to a company or companies in partnership may still be wise to apply to the Court for directions and/or declarations as to the most appropriate way to distribute the proceeds of realisation.

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1 See, for example, ss 39 and 44 of the *Partnership Act 1892* (NSW).

2 [2016] WASC 16.

3 See also *Re Brisbane Meat Agencies Pty Ltd* [1963] Qd R 525, where Hart J noted that the rule in bankruptcy is that joint estates must satisfy joint creditors before satisfying any separate creditor; also see section 110 of the *Bankruptcy Act 1966* (Cth).

4 Note however that a partnership may be wound up under the provisions of the Corporations Act if it has more than five members (and so meets the definition of a 'Part 5.7 body') under s 583 of the Corporations Act.

5 (1933) 48 CLR 171.

6 [1981] 2 NSWLR 138.

7 See *Stewart v Atco Controls Pty Ltd (in liquidation)* (2014) 252 CLR 307.

8 [1984] 1 Ch 237.

9 See ss 5E and 5G(8) of the Corporations Act, and Facade Treatment Engineering Pty Ltd (in liq) v Brookfield Multiplex Constructions Pty Ltd [2016] VSCA 247 at [182] per Warren CJ, Tate and McLeish JJA.