Jackson McDonald

Legal Depth | Breadth | Presence

Assignment by a liquidator of statutory causes of action against a director - Cant, in the matter of Novaline Pty Ltd (In Liq)

Reconstruction & Insolvency Update

The recent Federal Court of Australia decision in Novaline considered the assignment of statutory causes of action. In particular, whether a liquidator could cause the company in liquidation to enter into a deed of assignment of causes of action the company had against a director for alleged breach of ss 180 – 184 of the *Corporations Act 2001* (Cth) (the Act).

The assignment of statutory causes of action for breaches of directors' duties under s 232 of the Corporations Law (the predecessor to ss 180 – 184 of the Act) was dealt with previously in the case of *UTSA Pty Ltd (in liq) v Ultra Tune Australia Pty Ltd*. However, *Novaline* deals with an assignment of causes of action for breaches of directors' duties to a director and shareholder of the company. It also highlights that in Australia, the doctrine of champerty and maintenance will not preclude assignments by the liquidator of statutory causes of action.

The facts

Novaline Pty Ltd (Company) was a cleaning company with operations in Victoria (run by Mr Cosoleto) and NSW (run by Mr Adams). The Company was wound up on 5 October 2007 under s 461(1)(k) of the Act under the just and equitable ground on the basis that Mr Cosoleto claimed that Mr Adams excluded him from the business. In May 2007, Mr Adams set up Novaline Engineering (NSW) Pty Ltd (NE). Following examinations of Mr Adams and his wife under s 596 of the Act, the liquidator suspected that Mr Adams had diverted funds and business from the Company to NE.

In May 2009, all creditors were paid and the liquidator provided the directors with an update on the liquidation. He informed the directors that he had $50,000 of Company

Who does this affect?

- Liquidators
- Company Directors
- Shareholders
- Creditors

Article Highlights

- Director of a company assigned with causes of action for breaches of directors' duties.
- Assignment of cause of action may prove an effective way to gain value for creditors.
- Highlights an alternative method of recourse for an aggrieved shareholder/ director in the context of a relationship breakdown in a private company.

funds on account and indicated that he thought there were causes of action available to the Company against Mr Adams and NE. Specifically, he suspected that Mr Adams has banked funds of the Company into the bank account of NE, that liabilities of the Company were paid from the NE bank account, that transactions with clients of the Company were conducted by Mr Adams in the name of NE and some Company funds were banked by Mr Adams into his personal account.

Mr Adams proposed that he be paid $20,000 and be released from any liability to the Company. Mr Cosoleto proposed that the $50,000 be split equally between the directors and that he take an assignment of the causes of action belonging to the Company against Mr Adams and NE.

The liquidator favoured the latter approach and, anticipating opposition from Mr Adams, applied to the court for an order under s 479(3) of the Act that he and the Company may enter into a deed of assignment of certain causes of action belonging to the Company, including breaches of statutory and common law directors' duties. Also, as the proposed assignment was likely to continue for more than three months, court approval was necessary under s 477(2B) of the Act.

Mr Adams opposed the application on the grounds that the court should not approve an assignment where the subject matter was not clear, and that the statutory causes of action are not capable of assignment.

Key points of the decision

The court considered the subject matter of the assignment, the power to assign statutory causes of action and other discretionary factors relevant to the application.

The relevant terms of the deed of assignment provided that:

- Mr Cosoleto would pay the proceeds of the claims, net of any legal expenses, to the Company;
- any legal proceedings were to be commenced within 12 months, failing which there would be a re-assignment to the Company;
- Mr Cosoleto was to keep the liquidator informed on the progress of the legal proceedings;
- Mr Cosoleto could only settle legal proceedings on the express written recommendation of legal advisors; and
- Mr Cosoleto was obliged provide the liquidator with copies of any such recommendation and the terms of settlement.

The liquidator favoured entry into the deed of assignment because it would enable the pursuit of a good arguable claim, it involved no expense to the Company and any proceeds would be distributed equally to Mr Adams and Mr Cosoleto (as the two

Contact

Rob McKenzie
PARTNER

t: +61 8 9426 6602
e: rmckenzie@jacmac.com.au

Michael Crommelin
SOLICITOR

t: +61 8 9426 6749
e: mcrommelin@jacmac.com.au

shareholders of the Company).

One ground on which Mr Adams opposed the application was that the subject matter of the assignment lacked sufficient clarity. The deed assigned to Mr Cosoleto any claim the Company may have arising out of conduct of Mr Adams identified during the public examination of Mr Adams including, but not limited to, claims for breaches of his statutory and common law duties as a director. It was argued that it was insufficient for the deed to merely set out the conduct which might give rise to causes of action and that, for a court to be sure of what had been assigned, the deed needed to identify the causes of action intended to be assigned and the precise allegations on which the causes of action were based.

The Federal Court held that the deed of assignment identified the subject matter of the assignment with sufficient clarity to enable the court to determine what was to be assigned.

The other ground on which Mr Adams opposed the application was that statutory causes of action were not assignable.

The court noted that, as a general rule, a statutory right to damages cannot be assigned where the relevant section does not allow for an award of damages to a person who has not suffered the damage. That is, a bare right to litigate cannot be assigned. In this case, s 1317H of the Act (in the context of claims under ss 180–184 of the Act) allows for orders for compensation ***to the corporation*** for damage suffered ***by the corporation***. However, the question was whether a liquidator is able to assign such a cause of action pursuant to the specific power in s 477(2)(c) of the Act.

The court considered the decision in UTSA2 in which Hansen J held that the liquidators were empowered under s 477 of the Corporations Law to assign causes of action, which clearly fell within the expansive definition of "property" under s 9 of the Corporations Law. Hansen J found that s 477 operates as a statutory exception to both the rule against champerty and maintenance and the closely related principle that a "bare right to litigate" cannot be assigned.

The court, also citing *Trendtex Trading Corporation v Credit Suisse* held that as the assignee (ie, the first director who was also a shareholder) had a genuine commercial interest in taking the assignment and enforcing it for his own benefit, the assignment would not be struck down as an assignment of a bare right to litigate.

The court ultimately held that the liquidator had the power to assign the claims against one of the directors for breaches of his statutory duties as a director under ss 180–184 of the Act. There was a sufficient basis for the claims against the director to approve the assignment, and therefore the court granted an order for the liquidator and Company to enter into an assignment on the terms of the draft deed.

Considerations relating to a possible assignment of a statutory cause of action

In the situation where the liquidator identifies potential breaches of directors' duties under ss 180–184, but does not have the funds available to pursue them, assignment of any cause of action could have the potential to add value to the funds available for distribution to creditors.

It should be noted that liquidators are unable to assign claims under ss 588FB (uncommercial transactions), 588FC (insolvent transactions) and 588FE (voidable preferences) of the Act. The reason being is that s 588FF states that these claims "must be brought by the liquidator". However, there is often a potential overlap between s 181 and uncommercial transactions under s 588FB, in that an uncommercial transaction is inherently one that is not in the best interests of the company. Therefore, an uncommercial transaction that could not be pursued (or assigned) by the liquidator could be pursued by way of assignment of any cause of action the company may have against the relevant director under s 181 of the Act or for breach of the fiduciary duty to act in the best interests of the company.

Under s 477(2B) of the Act, the liquidator needs approval from the court, the committee of inspection or by a resolution of creditors to enter into an agreement on the company's behalf that will be discharged or come to an end more than three months after the agreement was entered into. Therefore, liquidators may wish to consider including assignment proposals for any identified cause of action at the time of any of the creditors' meetings. These proposals could be either for approval (when an assignee has already been identified) or for the liquidator to ask if any creditor would be interested in taking up an assignment.

Further, in the context of the assignment of causes of action for breach of directors' duties in director/member companies, it would be common for the director against whom the breaches are alleged to make an objection to the assignment. Accordingly, the liquidator will usually prefer to simply apply for directions from the court in relation to the proposed assignment under s 479(3) of the Act.

The facts of *Novaline* differ from previous decisions in that the assignment of the statutory cause of action occurred before proceedings had been commenced by the liquidator. Due to this, considerations such as the specificity of the subject matter of the assignment and adequate restraints on the time in which the assignee must commence the action were important considerations for the court.

The court, in exercising its discretion to approve the assignment, was also concerned with whether the assignment would lead to frivolous or oppressive litigation and

whether there was a reasonable prospect of success. The court was comforted by the relevant terms of the deed which required proceedings to be commenced within 12 months of the assignment, and failing this, all rights would revert to the liquidator.

However, the court may still exercise its discretion and deny an assignment, especially where it is of the opinion that it is not in the best interests of the majority of creditors.

Is assignment of a statutory cause of action for breach of directors' duties dangerous in the context of director/member companies?

The court in *Novaline* made no comment as to the dangers that may be associated with an assignment of a statutory cause of action for breach of directors' duties to a director or shareholder in the context of a winding up in insolvency. However, in the case of *Krishell Pty Ltd v Nilant*, it was submitted that it is contrary to the policy of the Act for a liquidator to assign property of a company to a former controller whom the liquidator believes may have acted in breach of his obligations under the Act. The submission was unsuccessful and Master Newnes stated that he did not accept that the liquidator's hands are tied in that way when disposing of property of the company to the best advantage of the creditors.

Where the assignment is made to a shareholder, the liquidator should ensure that the person taking the assignment is not an associate or related party of the person whom the cause of action is against. The terms of the deed of assignment can be tailored to restrict the conduct of the proceedings by the assignee in order to provide further protection to the liquidator against any fraudulent action by the assignee or their associates.

In *Novaline*, the terms of the deed of assignment required the assignee to keep the liquidator informed of the progress of the proceedings and provided that settlement could only occur with the express written advice of legal advisors, the terms of which (and related advice) had to be supplied to the liquidator.

Could an assignment of a cause of action to a member on favourable terms be acceptable in an insolvent external administration?

Novaline was not a case involving the winding up of a company in insolvency. The Company was wound up on the just and equitable ground and surplus funds existed after the payment of creditors. Different considerations may apply in the case of an insolvent company.

It can be assumed the court would be more wary in the assignment of a cause of action for breach of ss 180–184 of the Act to a member had there also been unsecured creditors participating in the distribution of funds.

In *Novaline*, the deed of assignment required that the assignee pay all the proceeds of the claim, net of any legal expenses, to the Company. However, this was done in the context of there being no creditors and where the member knew all the proceeds of the claim would flow to him and the other member. If other unsecured creditors were involved, the member may require some form of guarantee as to payment (at a stage when what will be recovered is unknown) before they are willing to take the assignment. This would disturb the fundamental order of priority of returns in liquidation.

It could be argued that if any profit or commission is made by the member on the conduct of the proceedings (the subject of the assignment) then this is a payment to members ahead of creditors and in breach of the priorities established in the Act.

No comment was made by the court in *Novaline* as to whether it would be unacceptable in a winding up in insolvency for a member to make a profit ahead of creditors. This issue was briefly discussed in the UTSA case, where Hansen J commented that it would be hard to see a situation in which an assignee would fund a proceeding if it were not to receive a profit. Although his Honour found no reason to deny the assignment due to the fact the assignee was to make a profit, he deferred consideration on the associated point of what level of profit is acceptable. It appears that if an unreasonable percentage of the profit of the action is acquired, or the proceeds of the whole action are acquired, at a significant undervalue, this may be a valid reason to challenge an assignment.

Any departure from the order of priority of returns would require the approval of the court. In a situation where the claim would not be pursued unless an assignment is made to a member prepared to pursue the claim, the terms of the deed of assignment can be tailored to provide for a reasonable return to the assignee member and still ensure that creditors are better off due to the fact that the member took the assignment.

Impact on phoenix activities

The decisions of UTSA and *Novaline* have significant implications for companies, liquidators and creditors in the context of phoenix companies, where some of the directors may have stripped the assets of the company leaving the liquidator with few funds available with which to pursue them. Assignment of the company's claims against these directors under ss 180–184 of the Act may prove an effective way to reverse the effect of these transactions and gain value for creditors.

The decision in *Novaline* also highlights an alternative method of recourse for an aggrieved shareholder/director in the context of a relationship breakdown in a private company.

Contact Us

t +61 8 9426 6611 f +61 8 9321 2002 e jacmac@jacmac.com.au
a Level 25, 140 St Georges Terrace, Perth, Western Australia 6000
GPO Box M971, Perth, Western Australia 6843

www.jacmac.com.au