

POOLING IN CORPORATE INSOLVENCY

by **Edmund Finnane**¹

Pooling in corporate insolvency occurs when the creditors of two or more insolvent corporations have their claims “pooled” so that, in effect, they are treated as creditors of one entity.

The prospect of pooling arises where there are two or more insolvent corporations whose affairs are intertwined such as to create real practical difficulties in an external administration. The corporations may have dealt with outsiders and with employees as though they were a single entity, or at least without making a clear distinction between themselves. The corporations may have dealt with each other on an uncommercial basis, particularly in the lead-up to the appointment of an administrator or liquidator. Often the corporations do not have up to date and accurate accounts. Quite simply, corporate groups which are insolvent or moving in that direction may be run in a completely chaotic fashion, with cash being allocated where it is needed and expenses paid by whatever company has the money.

Pooling may be an attractive alternative to the expense, if not impossibility, of untangling the affairs of the corporations and restating their creditors, assets and inter-company accounts on a correct and commercial basis. On the other hand, any proposal to pool the assets and liabilities of two or more companies infringes the basic obligation of a liquidator or administrator not to share the company’s money with anybody other than its creditors and contributories and on a *pari passu* basis subject to the statutory priorities. This can only be overcome by some legally effective means.

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Several such means have been recognised by the courts and this paper discusses them.

THE BANKRUPTCY PRECEDENT

The concept of pooling in corporate insolvency derives from bankruptcy law, where the courts have long been prepared to endorse the consolidation of blended estates in appropriate cases. Powell J in *Anmi Pty Ltd v Williams*² quoted the following passage from *Archbold on Bankruptcy*:

“Where (the joint and separate) estates are so blended together as to render it impracticable to keep them separate, they may be consolidated; but not where the accounts can be kept distinct, and a single creditor objects (*Re Buliver; Ex p Sheppard* (1833) Mon & B 415; 3 Dea & C 190); and even if the creditors at a general meeting agree to consolidate the estates, they will not be consolidated without it is ascertained that the proposed consolidation will be for the benefit of creditors generally (*Re Higton and breever; Ex p Strutt* (1821) 1 G1 & J29).

POOLING IN CORPORATE INSOLVENCY

Pooling in corporate insolvency is a more recent phenomenon, and in Australia the reported cases seem to commence in 1997, with *Dean-Willcocks v Soluble Solutions Hydroponics*³. The recent cases have recognised seven routes to effective pooling:

1. Scheme of Arrangement
2. Compromise with creditors under s. 477(1)(c)
3. Arrangement under s. 510
4. Orders under s. 447A
5. Deed of Company Arrangement
6. Directions under s 479
7. Active and unanimous consent

1. SCHEME OF ARRANGEMENT: CORPORATIONS ACT PART 5.1

The scheme of arrangement procedure is dealt with in Part 5.1 of the Corporations Act 2001 (Cth). The process is available where a “compromise or arrangement” is

² [1981] 2 NSWLR 138 at 164

³ (1997) 42 NSWLR 209

proposed between a “Part 5.1 body” (which includes a company⁴) and its members or any class of them.⁵ The court controls the process from the outset, and an effective compromise depends upon both creditor approval (which requires a 75% majority by value of debts of creditors voting or of creditors in each class, where applicable) and court approval.

There is “no doubt at all”, according to Young J in *Dean-Willcocks v Soluble Solutions Hydroponics*⁶ that a Scheme of Arrangement Act to give effect to a pooling could be approved by creditors and the Court.

The disadvantage of proceeding by way of a scheme of arrangement is the expense of compliance with Part 5.1, for it is undoubtedly the most onerous of the routes to pooling which are discussed in this article.

2. COMPROMISE WITH CREDITORS UNDER S. 477(1)(C)

In limited circumstances pooling might be achieved through a compromise between a liquidator and creditors, approved pursuant to s. 477 of the Corporations Act 2001 (Cth). Section 477(1)(c) provides:

“477(1) Subject to this section, a liquidator of a company may:

...

(c) make any compromise or arrangement with creditors or persons claiming to be creditors or having or alleging that they have any claim (present or future, certain or contingent, ascertained or sounding only in damages) against the company or whereby the company may be rendered liable;

...”

However, subsection (2A) provides:

“(2A) Except with the approval of the Court, of the committee of inspection or of a resolution of the creditors, a liquidator of a company must not

⁴ Corporations Act 2001 (Cth), s. 9

⁵ Corporations Act 2001 (Cth), s. 411(1)

⁶ (1997) 42 NSWLR 209

compromise a debt to the company if the amount claimed by the company is more than:

- (a) If an amount greater than \$20,000 is prescribed – the prescribed amount; or
- (b) Otherwise - \$20,000.”

No other amount is prescribed. Thus a court application or creditor approval will normally be necessary where a liquidator wishes to proceed under s. 477(1)(c).

The above provisions relate to court appointed liquidators, but also apply to a voluntary winding up with appropriate modifications.⁷

Unlike the provisions of Part 5.1, a compromise under s. 477(1)(c) is not a means of imposing a result on non-assenting creditors in respect of their claims in the winding up. Thus, for a pooling pursuant to a compromise under s. 477(1)(c) to be effective, it would be necessary for all creditors to be parties to it. Barrett J said in *Tayeh v De Vries re The Black Stump Enterprises Pty Ltd*⁸:

“It is important to emphasise that s. 477(1)(c) goes no further than allowing a liquidator to enter into a consensual compromise or arrangement with such, if any, of the creditors and other persons identified in the section as are minded to become party to the compromise or arrangement. Section 477(1)(c) is not a provision that can cause a compromise or arrangement to be binding on anyone who does not actively assent to it.”

The English equivalent of s. 477 has been successfully used in this context in England: *Re Bank of Credit and Commerce International SA (No 3)*.⁹ On the analysis of Barrett J in *Re Dean-Wilcocks*¹⁰, the pooling agreements in the English case fell within the limited scope discussed above. That is, all affected parties were parties to

⁷ Corporations Act 2001 (Cth), s 506(1)(b) and s 506(1A)(a)

⁸ [2005] NSWSC 475 at [8]. See also His Honour’s discussion of the provision in *Re Dean-Wilcocks; Alpha Telecom (Aust) Pty Ltd* (2004) 208 ALR 414 at [19] to [21]

⁹ [1993] BCLC 106 and [1993] BCLC 1490 (Court of Appeal)

¹⁰ (2004) ACSR 15 at 19-20

the agreement, so that the rights of non-contracting parties were not altered by the Court approval.

3. CORPORATIONS ACT S. 510

Where all of the corporations are subject to voluntary winding up – which includes winding up flowing from a Part 5.3A administration¹¹ - the liquidator or liquidators might consider pooling by way of an arrangement under s. 510 of the Corporations Act.

Section 510 provides:

“510(1) An arrangement entered into between a company about to be, or in the course of being, wound up and its creditors is, subject to subsection (4):

- (a) binding on the company if sanctioned by a special resolution; and
- (b) binding on the creditors if sanctioned by a resolution of the creditors.

(1A) The company must lodge a copy of a special resolution referred to in paragraph (1)(a) with ASIC within 14 days after the resolution is passed.

(2) A creditor must be accounted a creditor for value for such sum as upon an account fairly stated, after allowing the value of security or liens held by the creditor and the amount of any debt or set-off owing by the creditor to the company, appears to be the balance due to the creditor.

(3) A dispute about the value of any such security or lien or the amount of any such debt or set-off may be settled by the Court on the application of the company, the liquidator or the creditor.

(4) A creditor or contributory may, within 3 weeks after the completion of the arrangement, appeal to the Court in respect of the arrangement, and the Court

¹¹ Corporations Act 2001 (Cth), s. 446A(1) and (2)

may confirm, set aside or modify the arrangement and make such further order as it thinks just.”

In *Dean-Willcocks v Soluble Solutions Hydroponics*¹² Young J considered that there were two problems with using s 510 for pooling. **First**, His Honour said, on the authority of *Farmer’s Freehold Land Co Ltd*¹³, the Court will not confirm an arrangement under s 510 unless it provides that the creditors are to be paid *pari passu* or unless the unfavoured creditors assent to it. His Honour considered that the resolution for combining recoveries in respect of the two companies would offend the *pari passu* principle. **Secondly**, His Honour considered that it was virtually impossible to hold the required creditors’ meetings of each company because of the difficulty of allocating creditors to the correct company (which was the very reason for the pooling application in that case), although His Honour recognised that this could be regularised by an order under s. 1322.¹⁴

These problems have been addressed in subsequent cases, which shall now be considered.

*Re Switch Telecommunications Pty Ltd (in liq)*¹⁵ is the first reported decision in which the use of Section 510 to achieve a pooling arrangement was given court approval. In that case the two companies were engaged in two related businesses. All receipts and payments were made through one bank account operated by the first company. All employees were employed by the second company. It was unclear what the role each company played in the operation of each business – and this could not be ascertained because the employees had moved on. There was a large but unexplained debt recorded as being owed by one of the companies to the other. Invoices had been issued by one company in respect of a business apparently operated by the other. The companies were subject to a creditors’ voluntary winding up following a period of voluntary administration.

¹² (1997) 42 NSWLR 209 at 214

¹³ (1892) 3 BC (NSW) 39

¹⁴ (1997) 42 NSWLR 209 at 215

¹⁵ (2000) 35 ACSR 172

Santow J held in that case that s. 510 was available to be used to facilitate a pooling arrangement in these circumstances.

The second problem identified by Young J in *Soluble Solutions Hydroponics* was present, in that the intertwined state of affairs of the companies rendered it virtually impossible to hold the required creditors' meetings of each company. The solution was the holding of a combined meeting of the creditors of both companies. When that meeting had been held, and had resolved, unanimously, in favour of the pooling proposal, His Honour made remedial orders under s. 1322(4), validating the combined meeting as a meeting of creditors of each of the companies. That provision empowers the Court to make, inter alia,

“(a) an order declaring that any act, matter or thing purporting to have been done, or any proceeding purporting to have been instituted or taken, under this Act or in relation to a corporation is not invalid by reason of any contravention of a provision of this Act or a provision of the constitution of a corporation.”

His Honour left for a future case the question of whether s. 1322 can be used to validate a combined creditors' meeting where there is a minor dissent.

As regards the first problem identified by Young J in *Soluble Solutions Hydroponics*, His Honour accepted the proposition that all unfavoured creditors would need to assent to a compromise which does not operate on a *pari passu* basis.¹⁶ It is open on His Honour's reasons to conclude that, whilst the creditors at the combined meeting voted unanimously to support the pooling deed, not all creditors participated in the meeting.¹⁷ Accordingly, it can be inferred that His Honour did not regard the pooling arrangement as one which breached the *pari passu* principle.

Helpfully for practitioners making similar applications, Santow J set out in his judgment details of the procedure which was followed and the orders which were made. Broadly, the following steps were involved:

¹⁶ 35 ACSR 172 at 181

¹⁷ 35 ACSR 172 at 173

1. The arrangement itself was set out in a deed, which deed was subject to court and creditor approval. There was also an explanatory memorandum for creditors, which was to accompany the notices of meeting.
2. An application was made to Court at an early stage, at which time the Court gave directions to the liquidator, under s. 511, that he was justified in executing the deed and convening a combined meeting of creditors for the purpose of approving the deed.
3. The required meetings of creditors and contributories were held. The combined creditors' meeting approved the pooling deed unanimously.
4. The liquidator returned to court and reported the results. His Honour made the order under s. 1322(4) to validate the meetings.
5. In addition, His Honour made an order under s. 477(2A) approving the Deed insofar as it was a compromise of debts.

Arguably the approval under s. 477(2A) was not necessary in that case, as the creditors had already passed a resolution authorising the compromise.

The **first of the problems** identified to by Young J in *Soluble Solutions* was addressed directly in *Kassem v Sentinel Properties Ltd.*¹⁸ In that case the liquidator of a group of five companies was able to, and did, hold all of the necessary meetings required under s. 510, without the need for curative orders under s. 1324 (because the creditors could be identified in respect of each company). At each meeting a resolution was passed in favour of a deed to pool the recoveries in the liquidations. At one of the meetings, a single creditor dissented. The liquidator sought directions.

Barrett J determined that the resolution was valid notwithstanding the dissent. In reaching this conclusion, His Honour held that, whilst s. 510 cannot be used to discriminate within the body of creditors or members of a company in the absence of assent of the disadvantaged creditors, such discrimination is not brought into being by a compromise *between bodies of creditors* of different companies.¹⁹

¹⁸ [2005] NSWSC 403

¹⁹ [2005] NSWSC 403 at 11-20

4. APPROVAL UNDER S. 447A OF A CREDITORS' RESOLUTION AT S 439A MEETING

Another possible route to an effective pooling is Court orders under s. 447A of the Corporations Act. Section 447A is part of Part 5.3A of the Corporations Act which relates to voluntary administrations. The section provides, in part:

“447A(1) The Court may make such order as it thinks appropriate about how this part is to operate in relation to a particular company.”

In *Dean-Willcocks v Soluble Solutions Hydroponics*²⁰ there were two companies, both of which had been in administration and had passed into winding up as a consequence of resolutions of the creditors (at separate meetings of both companies). At the time of making those resolutions the creditors had also resolved “to approve combining recoveries, costs and distribution to creditors of Soluble Solution Hydroponics Pty Ltd and Soluble Solution (Wholesale) Pty Ltd.”

Prior to the appointment of an administrator to both companies, one of the companies had been a manufacturer, and the other was wholesaler, of hydroponics products. The sole director and secretary of companies had been indiscriminate in his ordering process, using order forms of one company when the stock was recorded as an asset of the other company. The sole director was deceased.

His Honour Justice Young granted orders under s. 447A of the Corporations Act to the effect that the resolutions of the creditors of each company “to approve combining recoveries, costs and distribution to creditors” of the companies should be acted on by the liquidator. In so doing His Honour held that the Court may make an order under s. 447A after a company has passed into liquidation (and is thus no longer being administered under Part 5.3A), if the pooling resolution was passed while Part 5.3A was still applicable to the Company.

²⁰ (1997) 42 NSWLR 209

Later decisions, including the High Court decided *Australasian Memory Pty Ltd v Brien*²¹ confirmed the comprehensiveness of the jurisdiction in s. 447A and its availability to alter the statutory incidents of winding up.²²

Section 447A was again employed in *Re Dean-Willcocks*.²³ In that case Barrett J made orders under s. 447A to give effect to pooling resolution which had been made at the s. 439A creditors' meetings of the companies, as though it were a compromise under s. 510, subject to conditions analogous to those in s. 510. Importantly, His Honour made the order notwithstanding that a creditor had dissented and made its objection known to the Court. His Honour considered it appropriate to approach any creditor objections in the same way as a creditor's objection to a Part 5.1 scheme is approached. This involves determining whether the required resolutions have been duly passed, and then considering discretionary factors including adequacy of the information provided and the reasonableness of the compromise.²⁴

5. DEED OF COMPANY ARRANGEMENT

Another route to pooling is the Deed of Company Arrangement.

If each company is in voluntary administration, the creditors may resolve, at their respective meeting under s 439A of the Corporations Act, to enter into a deed of company arrangement which has the effect of creating a pooled fund from which the claims of the creditors of each of the companies would be met. As with s. 510, the result can (in the absence of irregularities or other problems) be achieved without the need for a court application.

The use of a Deed of Company Arrangement for the purpose of pooling was accepted as valid by Finkelstein J in *Mentha v GE Capital Ltd*.²⁵ His Honour said:

²¹ (2000) 200 CLR 270; See also *Gibbons v Liberty One Ltd (in liq)* (2002) 41 ACSR 442; *Application of Walker* [2002] NSWSC 705, *Re One.Tel Ltd* (2002) 43 ACSR 305, *Re Centaur Mining & Exploration Ltd* (2003) 48 ACSR 1

²² *Re Dean-Willcocks* (2004) 50 ACSR 15 at 21

²³ (2004) 50 ACSR 15

²⁴ (2004) 50 ACSR 15 at 22

²⁵ (1997) 154 ALR 565, 16 ACLC 1,032, 27 ACSR 696

“In my opinion the power to enter into a deed of company arrangement under Pt 5.3A is sufficiently broad to permit an arrangement binding on two or more insolvent companies pursuant to which their respective assets and creditors will be consolidated.”

It is clear from that case that the validity of the Deed did not depend upon court approval. His Honour refused, indeed, to make a direction that the administrators execute the Deed of Company Arrangement, because, the resolutions being effective in themselves, an order would serve no purpose.

The use of a Deed of Company Arrangement in this context was again upheld in *Re Humphris, in the matter of ACN 004 987 866 Pty Ltd.*²⁶

*Re Ansett Australia Limited*²⁷ shows one limit to the use of deeds of company arrangement for pooling. The facts are complicated by the fact that two of the companies in the group had come out of administration at the time of the proposed vote and some of their assets were being held in trust for creditors. Also, the other companies had already entered into deeds of company arrangement, and what was proposed was that there be meetings of the creditors pursuant to the terms of the deeds of company arrangement for the purpose of approving the pooling. The administrators were in a position of conflict in relation to their duties to the various bodies of creditors and beneficiaries. The pooling would be beneficial for the creditors overall. However, several groups of creditors would be worse off. Essentially, the administrators wore various hats and were in a position to vote in the meetings (because they were administrators of inter-group company creditors) and also to exercise their casting votes, but if they did so in favour of pooling this would clearly be to the disadvantage of certain bodies of creditors. Could they get a direction under s 447A (as well as under the Victorian *Trustee Act*) to excuse them voting against the interest of particular classes of creditors (and against the interests of particular beneficiaries)?

²⁶ (2003) 21 ACLC 1,474, [2003] FCR 849 (Goldberg J)

²⁷ (2006)151 FCR 41

Goldberg J held that neither the *Trustee Act* provision, nor s 447A, could be used in this way. His Honour said:

[108] Section 447A of the Act has little room for operation in this context. That section enables the Court to say how the statute is to operate in relation to a particular company. That power must be considered against the backdrop of the object of Pt 5.3A of the Act which, according to s 435A is to provide, inter alia, in an administration scenario, for a better return for the company's creditors and members than would result from an immediate winding up of the company. In a group situation, like the Ansett Group, I do not consider that one can consider an exercise of power under s 447A without regard to the interests of the particular company, the subject of the exercise of this power, and its creditors.

6. DIRECTIONS TO A LIQUIDATOR UNDER S 479

In *Dean-Willcocks v Soluble Solution Hydroponics*²⁸ Young J said in obiter:

“It would be possible for the court to advise a liquidator in a court winding up that he should consolidate debts, but it would be unlikely that the court would do so unless every creditor agreed or a regime was put in place for creditors to object”.

His Honour was referring to the court's power under s. 479 of the Corporations Law to give directions to a court-appointed liquidator. His Honour pointed out that the power in s. 479 is broader than the corresponding provision in voluntary winding up, being s. 511. The former, but not the latter, extends to giving the court power to direct its own officer to commit a breach of trust or to do something which he arguably has no power to do.²⁹ Section 479 was not available in that case because the companies were subject to voluntary winding up.

However, s 479 was available a short time later in *Re Charter Travel Co Ltd*³⁰. The companies were in court liquidation. On the facts a basis for pooling was made out.

²⁸ (1997) 42 NSWLR 209

²⁹ (1997) 42 NSWLR 209 at 212

³⁰ (1997) 25 ACSR 337

The liquidators of the two companies sought orders and directions to enable them to hold a combined meeting for the purpose of approving a simple pooling arrangement, whereby the liquidators would open a joint account with recoveries from both companies to be paid into it. Priority claims were to be treated *pari passu* and other creditors of the companies would be treated equally. Young J made the orders, which provided that if the creditors unanimously resolved in favour of the proposal, then the liquidators would be justified in implementing it. However, the matter was to return to court if there was any dissent. His Honour was not sure whether the pooling could proceed if a creditor objected.³¹

7. ACTIVE AND UNANIMOUS ASSENT

In *Re Whittingham*³² Barrett J considered an application where the requirements of s 510 had not been satisfied in their entirety, but there was nevertheless “active and unanimous assent” of all the creditors to a pooling proposal. His Honour was prepared to give a direction under s 511 that the liquidator would be justified in implementing it, but said that such relief was available only on the basis of “active and unanimous assent”. This was a creditors voluntary winding up, and so, unlike *Charter Travel*, the broader directions power in s 479 was not available. But this really did not matter, because the force of the arrangement lay not in the court order, but in the fact of consent by all affected persons. As His Honour pointed out, each individual is at liberty to agree to a variation of his or her rights.³³

Note that this route is similar to Route 2 (compromise with creditors under s 477(1)(c)) and Route 6 (directions under s 479). The distinction between this route and s 477(1)(c) – discussed in *Re Whittingham* – is that a compromise with creditors under s 477(1)(c) requires some sort of contract between each creditor and the company. According to Barrett J, a vote at a meeting does not involve conduct of a contractual type.³⁴

³¹ (1997) 25 ACSR 337 at 338-9

³² [2006] NSWSC 1070

³³ *Ibid* at [40]

³⁴ *Ibid* at [30]

The distinction between this route and the sixth route (ie, s 479 directions) is slight, particularly if the latter requires unanimity. But the s 479 route would seem to be available even if some creditors chose not attend the relevant meeting. In contrast, *Re Whittingham* requires every affected creditor to actively assent to the proposal.

Note that *Re Whittingham* is also an example of how some of the routes to pooling can overlap.

WHAT DOESN'T WORK

In *Black Stump Enterprises Pty Ltd*³⁵ the administrator of nine companies, who subsequently became their liquidator did not use any of the means discussed above to achieve pooling. He advised the creditors prior to the s 439A meeting that he planned to seek a court order for the pooling of the assets and liabilities of the companies, although he did not put it to a vote. Subsequently (after the company was wound up by the creditors) he sent a circular to the creditors asking them to advise by a certain date whether they opposed the pooling. There was no response, and the liquidator applied to the court for an order for pooling. The application was rejected by Barrett J. Essentially, there was no legal basis to make the order sought in those circumstances. The Court of Appeal agreed, and Young J reserved consideration whether the solicitors should pay the costs of the application and of the appeal personally. (Ultimately, the solicitor was not so burdened.³⁶

SUMMARY

1. Scheme of arrangement

Availability: companies in liquidation and/or companies not in liquidation.

Limitations: cost, need to get 75% majority in each company and in each class of creditors, as well as court approval, in order to be effective.

2. Compromise with creditors under s 477(1)(c)

Availability: Court ordered winding up; also voluntary winding up (see s 506)

Limitations: All creditors of each company would need to be a party to the compromise. That is, dissentients and abstainers cannot be bound by such an arrangement.

³⁵ [2005] NSWCA 480

³⁶ *Re Black Stump Enterprises Pty Ltd (No 2)* [2006] NSWCA 60

3. Corporations Act s 510

Availability: Companies in voluntary winding up or about to be so wound up.

Limitations: Requirements include special resolution of the company, ie, the company's shareholders. Further, s 510 cannot be used to discriminate against a creditor within a company's body of creditors unless the disadvantaged creditor consents (but a compromise between the creditors of two different companies does not amount to such discrimination).

4. Court approval under s 447A

Availability: Where the companies are placed into administration and the creditors at the meeting to decide the company's future resolve in favour of pooling.

Limitations: Needs an application to the court.

5. Deed of Company Arrangement

Availability: Where the companies have been placed in administration and all are prepared to execute deeds of company arrangement to facilitate pooling.

Limitations: Normally, no need to approach the court. Note that deeds of company arrangement can be set aside by the court or varied. Further, administrators need to be careful to avoid any conflicts of duty when exercising any votes on behalf of intercompany creditors or when exercising their casting vote.

6. Directions under s 479

Availability: Only court appointed liquidators can apply for such a direction.

Limitations: Probably not available in the face of any dissent.

7. Active and unanimous assent

Availability: Arguably, the active and unanimous consent route is available in both voluntary and court appointed winding up, and could also be used at a s 439A meeting in the case of a company in administration.

Limitations: Not practical where there is a large number of creditors and must fail in the face of any dissent or abstention.