Balancing Interests of Creditors v Public Interest Considerations – Eco Heat (Vic) Pty Ltd v the Syndicate Forty Four Pty Ltd (Subject to Deed of Company Arrangement) & Ors

August, 24 2018

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Earlier this year JHK Legal acted on behalf of Deed Administrators ("the Administrators") involved in Supreme Court of Victoria proceedings whereby a disgruntled creditor sought to have a Deed of Company Arrangement ("DOCA") set aside and a syndicate group of companies (which comprised the 38 Defendants in the matter) wound up.

The Deed Administrators remained neutral in the matter, however sought to appear to ensure their appointment as liquidators in the event the Defendants were wound up by the Court. Ultimately, the evidence presented at trial by one of the Administrators proved highly valuable in the Courts decision.

The case provides not only an interesting facts scenario, but the Judgment of His Honour Justice Sifris provides a solid commentary on what factors the Court may place importance on when determining whether a DOCA be set aside.

Background:

In October of 2016, our clients were appointed the Administrators of the 38 named Defendants, forming the Syndicate group of companies ("the Syndicate Companies").

The Syndicate Companies provided credit finance to fund the purchase of used motor vehicles in Queensland.

The Syndicate Companies sourced the funds for the loans from investors who were mostly clients of the Director's accounting firm. Funds totalling $250,000.00 collected from investors would be pooled to bank roll the loans, with 80% of the funding to be provided by investors and the remaining 20% to be provided by a related company. In consideration of their investment, investors were allocated shares in the relevant Syndicate Company they invested in.

Once a Syndicate Company had reached the required $250,000.00 investment, the company would be closed and a new Syndicate Company was established to receive further investments to fund the next tranche of loans. Investors were promised that they would receive their capital investment back within approximately 1 ½ years (66-78 weeks as per the letter of offer provided to investors).

The Administrators circulated their report in November 2016 pursuant to section 439A of the Corporations Act 2001 (Cth) ("the Act"). In their report, the Administrators provided a clear recommendation that the creditors resolve to wind up the Syndicate Companies.

The creditors ultimately voted (overwhelmingly) in favour of the DOCA despite the Administrators recommendation. The Plaintiff voted against the DOCA. It is at this time worthwhile noting that the Plaintiff had previously issued Supreme Court proceedings against the Syndicate Companies in 2014 seeking repayment of its principle investment and interest it was owed by the Syndicate Companies. The Syndicate Companies were placed into administration approximately a week before the matter was to proceed to trial and the proceedings were stayed.

Administrators Recommendation:

His Honour provides a detailed rundown of the report issued by the Administrators', however the key reasons behind the Administrators' recommendations were as follows[1]:

1. Legal action against the Syndicate Companies which was on foot at the date of the Administrators appointment may have potentially been recommenced and the stay on proceedings against the Syndicate Companies would end once the Deed was executed. As such, the Administrators were of the view that the sum of $218,000.00 that was paid to the Court by the Syndicate Companies may be lost in a DOCA, but may have been recoverable in a liquidation scenario;

2. Based on its investigation into the affairs of the Syndicate Companies and actions of the directors during the course of the administration, the Administrators had concerns that the businesses operated either as a Ponzi Scheme or an Unregistered Managed Investment Scheme ("MIS") or both;

[1] Eco Heat (Vic) Pty Ltd v the Syndicate Forty Four Pty Ltd (Subject to Deed of Company Arrangement) & Ors [2018] VSC 156 at 16

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3. The Administrators had doubts as to the viability of the business and the ability of the proposed Unit Trust to be created under the DOCA to generate profits in the future; and

4. Apart from "potential future profits", the DOCA did not provide any surplus funds to those that would be recovered in a liquidation scenario. It was the belief of the Administrator that the cost of continuing to trade the proposed Unit Trust would dissipate any funds from the collection of the car loan ledger.

Key portions of the Administrators report can be found at paragraphs 15 to 21 of His Honours Judgment.

The Plaintiff's Claim:

The Plaintiff issued proceedings to have the DOCA set aside in February of 2017, on the basis that the DOCA was contrary to the interests of creditors as a whole, and contrary to the public interest and commercial morality.

The Plaintiff sought to terminate the DOCA pursuant to s445D of the Act on the grounds that:

1. The DOCA did not propose to provide any funds surplus to the funds that would have been recovered in the event the Syndicate Companies were wound up and the assets realised by a liquidator;

2. The likely costs of continuing to trade will dissipate any funds from the collection of the car loan ledger;

3. Returning the Syndicate Companies to the control of the directors would have likely caused them to experience the same difficulties they experienced before the commencement of the administration;

4. The creditors would be deprived of the benefit of an independent investigation of the conduct of the directors and potential recoveries from them whether for insolvent trading or otherwise;

5. It was contrary to public policy and commercial morality to return the Syndicate Companies to the control of the director on the basis that he had:

    a. allegedly operated the business as a form of Ponzi Scheme;

    b. repeatedly promised returns that were unrealistic and unattainable;

    c. promised interest rates of between 20%-50% per annum, which went unpaid to investors for the most part;

    d. failed to operate the business in a manner represented to investors;

    e. failed to maintain adequate books and records;

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f. mixed the funds of the Syndicate Companies without keeping adequate records;

g. operated the business as an unregistered managed investment scheme;

h. continually set up new companies and invited investment into them when it was clear that the business model was failing;

i. lost approximately $15 million of investors' funds, most of which was sought and obtained by the Director from superannuation funds even though the Director knew that much of it would never be repaid;

j. improperly resisted the inspection of the books and records of the Syndicate Companies by their members and investors; and

k. improperly caused the Syndicate Companies to defend the Supreme Court proceedings mentioned above when there was no proper basis to do so.

Defence:

Despite the extensive claims raised by the Plaintiff in the proceedings, the Defendant sought to deny every allegation on the basis that creditors of the Syndicate Companies were likely to obtain a substantially greater benefit under a DOCA as opposed to a liquidation scenario.

In support of this, the Defendant sought to rely on affidavit evidence provided by a number of creditors deposing, inter alia, that they understood the better return to creditors would be available under a DOCA scenario, and that despite the advice of the Administrators, opted to rely on the view of the Director that a DOCA was in their best interests.

Two such creditors provided oral evidence at the trial essentially reconfirming the position held by a number of creditors. However, under examination and cross examination it is interesting to note that both witnesses provided evidence to the effect that they were long-time friends/associates with the Director, and despite the obvious failings of the Syndicate Companies, they wholeheartedly trusted the Director to give them good advice despite the Administrators' clear recommendations.

Decision:

His Honour determined that the DOCA ought to be set aside and the Syndicate Companies be wound up based on the evidence provided at hearing. The Administrators were appointed as liquidators and the Plaintiff's costs were also ordered to be paid as a priority from the proceeds of the liquidation.

His Honour noted as a general proposition, if a return under a DOCA is not insubstantial or token, and the public interest and commercial morality issues are unlikely to translate into a cause of action realistically worth investigating, this may tip the scale in favour of retaining a DOCA.

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On the other hand, if a DOCA return is nominal or token, and there may be causes of action that could result in a greater return, these ought to be investigated and the DOCA set aside[2].

His Honour throughout his judgment commented that he was of the view that the anticipated returns to creditors under the DOCA were overstated. His Honour went as far as saying the anticipated returns were "…..extravagant, unsubstantiated and entirely misleading"[3] and the figures provided by the Director were "….nonsense, nonsensical and troublesome"[4].

His Honour was largely uninterested in the prospect of the creditors of the Syndicate Companies receiving something under a DOICA as opposed to potentially nothing in a liquidation given the returns under a DOCA were negligible in comparison to the extravagant returns promised to investors[5].

Generally speaking, His Honour was rather scathing of the Director's conduct in his judgment (see paragraph 77). His Honour was of the opinion there needed to be an investigation and examination of the Syndicate Companies and that there was sufficient basis for the Administrators' opinion that there were grounds that the Syndicate Companies were both potentially a Ponzi scheme and that they were operating as a MIS[6]. Importantly, His Honour determined that in the circumstances presented by this case, what went wrong and why were important issues affecting the public, public policy, regulation, commercial morality, and the investors despite their position; and that the loss of the right to investigate is very important in the circumstances[7].

Ultimately, whilst the interests of creditors versus commercial morality and public interests will be a subjective determination by the Courts, His Honour's decision in this matter demonstrates that where conduct of a company and its directors warrants a public examination/further investigation by liquidators, the public interest aspect of s445D of the Act will outweigh a meagre return to creditors under a DOCA. This however will be balanced against the likelihood any adverse actions by the directors would result in a cause of action.

This matter presented a relatively unique set of circumstances, however, in our view the decision demonstrates the public interest and commercial morality element of s445D of the Act is a very real consideration for the Courts and not something that is simply paid lip service when considered against the interests of creditors. The decision demonstrates that a party should not assume a Court will deem a DOCA to be appropriate purely on the basis that it presents some form of return to creditors, and that any indication of suspected cause of action against directors may prompt the Court to take a harder look at the value of a DOCA.

[2] Ibid at para 57
[3] Ibid at para 58
[4] Ibid at para 60
[5] Ibid at para 67
[6] Ibid at para 66
[7] Ibid at para 76