

## LESSONS IN LITIGATION: GROWING PAINS

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Sooner or later in the life of every business, one (or more) of your clients is going to go broke.

In that situation - unless you're fortunate enough to hold some sort of charge (or 'security') over your client's assets – you're unlikely to get paid what you are owed. **Statistically you're likely to receive less than ten per cent** of whatever it is the client owes you at the time that it 'goes under'.

The insolvency of a client is always a bitter pill to swallow. **You don't get paid what you're owed, and – quite often – you lose a valued client**, not to mention the valued income from the valued client. However, the problems that can arise from a client's insolvency don't necessarily stop with a bad debt, as a client of ours recently found.

### FACTS

Our client is in the business of being paid by the owners of certain living things – let's call them, say, 'wedgets' (as opposed to 'widgets' which is the term typically applied to hypothetical inanimate things) - to grow those wedgets until they reach a certain specified stage of development. You can imagine the type of business that might be – say a feedlot, a plantation, or a chicken farm.

Our client entered into a contract with the owner of lots and lots of baby wedgets. Let's call the owner of the wedgets (that is, our client's client) 'Flying Wedgets'.

So the baby wedgets were delivered to our client. Our client was diligently growing them in accordance with its contractual obligations when suddenly (and it's always sudden) Flying Wedgets realised it was insolvent and entered into voluntary administration (VA). Companies who enter into a VA typically finish up being liquidated. **It was pretty clear to our client that Flying Wedgets had no hope of surviving administration**, and would almost certainly be wound up, leaving a trail of unpaid creditors in its wake including our client.

The one small mercy was that the wedgets were not subject to any charge in favour of a secured creditor of Flying Wedgets.

What was our client to do? They were already owed a very significant amount of money by Flying Wedgets which they were unlikely ever to be paid. At the same time if they were to keep the wedgets alive, they would need to spend even more money that they would probably never recover. **They needed to find a way – quickly – to 'stop the bleeding'**. In doing so they had to deal with the Administrators, and they needed to navigate a treacherous set of laws.

## RIGHTS AND OBLIGATIONS

We advised our client that they and the Administrators had certain rights and obligations, including the following:

- Although it was a way of stopping the ongoing cost of looking after the widgets, our client could not simply let the widgets die, nor could they do something to destroy the widgets. If they did that – or at least if they did that without the permission of the Administrators – they may well find themselves facing a civil action, if not criminal proceedings. Remember that the widgets belonged to Flying Widgets, not to our client. Just because our client was owed money – and was owed more money every day in keeping the widgets alive – **that did not give our client the right to ‘take the law into its own hands’.**
- Our client was entitled to a lien over the widgets until our client was paid. That is, the Administrators were not entitled to simply come and collect the widgets. If they wanted the widgets, then they would first have to pay our client the amount owed to it by Flying Widgets. That lien gave our client the ability to propose that a third party buyer be found for the widgets. **Our client would be paid what it was owed and would release the widgets to the third party buyer.** Any money ‘left over’ from the sale would go back to the VA.
- Our client could terminate the contract (it was expressly entitled to do so if Flying Widgets entered into voluntary administration) and – in doing so – bring an end to its contractual obligation to look after the widgets. The problem remained however that if our client stopped looking after the widgets – whether or not our client remained contractually bound to do so – **our client could still potentially risk action being brought against them for allowing a significant asset of Flying Widgets to lose its entire value,** not to mention (again) the possibility of criminal proceedings.
- The widgets were using a significant amount of our client’s property to stay alive, and section 440C of the Corporations Act (Cth) 2001 prevents a person in possession of property being used or occupied by a company in VA recovering the property without leave of the court.
- **The Administrators might be personally liable for expenses incurred by our client** in looking after the widgets from the date of the Administrators’ appointment onwards.
- In order to resolve the situation once and for all – to create certainty for itself about what it could and could not lawfully do – it was open to our client to bring an application to the court under section 447B(2) of the Act. That section states:

On the application of a creditor of a company, the court may make such order as it thinks necessary to protect the creditor’s interests while the company is under administration.

**The court has a very broad discretion under section 447B to make an order that solves the problem in a practical way, and that discretion is bolstered by powers of the court created by other nearby sections of the Act** (such as authorising the sale of the widgets under section 440BA, or the ‘recovery’ of our client’s property being used to care for the widgets under section 440C).

Our view was that the court would likely be sympathetic to our client’s predicament, and would find a solution. On the other hand, litigation is expensive (even when compared to the costs of maintaining growing widgets) and there can never be any guarantees about the outcome.

All things considered, it was a particularly complex situation, **bordering on the diabolical**.

### **WHAT WAS THE SOLUTION?**

We were instructed to enter into communications with the solicitors for the Administrators, which we did. Those communications - like any other attempt to resolve a difficult legal situation without the intervention of the courts – **involved some robust (and ultimately productive) back and forth about the rights and obligations of the parties**, and the various ways in which the situation could possibly end for each of the parties.

Our challenge was to ensure that the Administrators – through their solicitors – gained a rapid appreciation of the gravity of our client’s predicament, the rights that our client had to resolve the situation, and the possible ‘downsides’ for the Administrators.

Initially the Administrators agreed to permit our client to explore a sale of the widgets. Unfortunately a buyer couldn’t be found.

In the meantime a further complication arose – the widgets had become diseased. There was a potential for the disease to spread to all of the widgets, and beyond. A solution needed to be urgently found.

Ultimately the Administrators consented to the (perfectly humane) destruction of the widgets by our client, without the court’s intervention. While our client was left – along with all the other unsecured creditors - with the debt owed to it by Flying Widgets, **it had ‘stopped the bleeding’**.

### **CONCLUSION**

The matter serves as a useful reminder of the complications that can arise for creditors of a business that is placed into some form of external management, be it an administration, a liquidation, or a receivership.

If you find yourself – as you almost certainly will at some stage – faced with a client who ‘goes under’ then keep the following points in mind:

- Consider what property you might have that belongs to the client (whether alive or otherwise) and don’t deal with that property without legal advice.
- Consider what property of yours that the client may be using, particularly if you’re the owner of premises being leased by the client (an unpleasant but typical situation). Again, your ability to do anything to deal with your property is likely to be subject to certain unique restrictions that only arise upon external managers taking control of your client.
- Don’t be tempted to take the law into your own hands, say by way of selling property that belongs to your client.
- Assuming it makes commercial sense, be prepared to insist upon your rights and obligations, even if that means seeking the assistance of the courts.
- If you’re in any doubt about your legal rights and obligations, seek advice as quickly as possible – timeliness can be critical.

If you have any questions in relation to this bulletin please do not hesitate to contact any of the members of CG Law’s litigation team.

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