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LITIGATION – RISKY BUSINESS FOR LIQUIDATORS

Guidance on mitigating risk of litigation for liquidators.

A liquidator can be exposed personally in litigation. In this article we discuss the risks to a liquidator associated with litigation by examining some recent cases where liquidators have been ordered to pay costs personally. To mitigate these risks, we provide guidance on litigation strategy for liquidators.

We also discuss three specific ways to mitigate risk: litigation funding, indemnification from creditors and ensuring there are sufficient unsecured assets in the company in liquidation. We also examine specific examples of conduct that liquidators should avoid and conclude by discussing assignment of claims.

While a liquidator is not obliged to litigate where there are no funds available to meet expenses,¹ a liquidator has a duty to examine the circumstances which precipitated the liquidation, and which may reveal improper dispositions of property and criminal offences. A liquidator has the power to bring and defend legal proceedings.² However, as a party to the proceeding (or even a non-party where the plaintiff is the company in liquidation and the court is exercising its inherent jurisdiction to award costs against a third party), a liquidator risks costs being awarded against them personally.³

Generally, unless a liquidator is negligent, has acted unreasonably, or has misconducted themselves in the proceeding, the liquidator will have a right to an indemnity out of the company's unsecured assets for costs.⁴ However, a liquidator is personally at risk if the company's assets are

insufficient to meet these costs or the court orders that the liquidator ought not be indemnified from the company's assets.

A liquidator has the unenviable task of weighing up their duty to pursue meritorious claims (in the interest of maximising returns to creditors), against the inherent risk of litigation including being personally liable for costs.

RECENT CASES WHERE LIQUIDATORS HAVE BEEN ORDERED TO PAY COSTS PERSONALLY

In the last two years, there have been numerous cases where liquidators have been ordered to pay costs personally, some of which are as follows:

Without indemnification from company assets

Damcevski v Demetriou⁵ – costs were awarded against the liquidators (who were not a party to the proceeding) on an indemnity basis, with no right to indemnify themselves from the assets (if any) of the company, where the liquidators had 'actively defended the proceedings, raised grounds of opposition that dramatically changed over time and defended proceedings in a manner not to the benefit of the creditors'.⁶

Re Lonnex Pty Ltd (in liquidation) (No.2)⁷ – costs were awarded against the liquidators for the appeal, and the court held that the liquidators were not entitled to an indemnity from the assets of the company as the costs incurred were not reasonable.

¹ *Corporations Act 2001* (Cth) s 545(1). ² Pursuant to s477(2)(a) of the *Corporations Act 2001* (Cth). ³ *Ferrier & Knight v Civil Aviation Authority* (unreported, Fed Ct, Lockhart J, 24 March 1994). ⁴ As a priority payment as a cost and expense of the winding up pursuant to s 556 of the *Corporations Act 2001* (Cth). ⁵ [2018] NSWSC 1915. ⁶ *Damcevski v Demetriou* [2018] NSWSC 1915, [38]. ⁷ [2019] 57 VR 238.

Australia's Residential Builder Pty Ltd (in liquidation) v Wiederstein (No.2)⁸ – the liquidator was ordered to pay costs of the appeal on a standard basis up to the date of a *Calderbank* offer and on an indemnity basis thereafter as the liquidator's rejection of the offer was unreasonable.

The court ordered that the liquidator was not entitled to be indemnified for these costs from the assets of the company. The court found that the liquidator had instituted the appeal for the sole purpose of 'meeting his own fees'⁹ and not for the benefit of the creditors.¹⁰ The court stated that the liquidator 'should not be able to avoid an adverse costs order by hiding behind the shield of an insolvent company when the proceedings were brought for his own benefit'.¹¹

Deputy Commissioner of Taxation v ACN 154 520 199 Pty Ltd (in liquidation)¹² – the general purpose liquidator was ordered to pay the costs of the special purpose liquidator on an indemnity basis, without a right of indemnity from the assets of the company, in circumstances where the general purpose liquidator had acted unreasonably in his inquiry into the conduct of the special purpose liquidator.

Re Azmac Pty Ltd (in liquidation) (No.2)¹³ – the defendant liquidator was ordered to pay the costs of the proceedings in circumstances where the liquidator's actions provoked the litigation in such a way that the defendant liquidator should be regarded as the party who initiated the proceedings, and having failed completely, costs should follow on that basis.

The court held that the liquidator's conduct was 'infused with self-interest' and therefore 'unreasonable and unnecessary',¹⁴ ordering that the liquidator pay costs personally without a right of indemnity from the assets of the company.

Without displacing a liquidator's right to indemnification from company assets

SJG Developments Pty Ltd v NT Two Nominees Pty Ltd (in liquidation)¹⁵ – costs were awarded against the non-party liquidators on an indemnity basis where the company in liquidation had issued a statutory demand in circumstances where there was a genuine dispute. In weighing up whether a personal costs order should be made, the court was of the view that the liquidators should 'bear the risk' of any shortfall of assets in the liquidation to meet the costs order.¹⁶

Fairfield Services Pty Ltd (in liquidation) v Leggett¹⁷ – the liquidators were ordered to pay costs on a standard basis after discontinuing the proceedings just under three weeks prior to trial. The liquidators contended that the discontinuance was because there were no prospects of settlement, and upon reassessment of a cost-benefit analysis the cost of pursuing the proceeding to a conclusion at trial had come to outweigh the benefits likely to be obtained from the trial.

The court did not consider whether the parties had acted reasonably, as this would require an assessment of the merits of the case.

The Oak Hotel Cessnock Pty Ltd (in liquidation) v Deputy Commissioner of Taxation¹⁸ – costs were awarded against the non-party liquidator on an indemnity basis where the company in liquidation had commenced proceedings prior to the liquidator's appointment. The court found that the liquidator had failed to communicate with the defendants' solicitors for seven months and although the duties under the *Civil Procedure Act* were imposed on the company in liquidation as a party, that company could only act through the liquidator.¹⁹ The court was of the view that ordering the company in liquidation to pay the costs would be to visit the consequences of the liquidator's conduct on the creditors and was not persuaded that this is appropriate since the liquidator 'ought be held responsible for his own conduct'.²⁰

As evidenced from the cases discussed above, liquidators were ordered to pay costs personally on the basis of their conduct as litigants and whether costs had been improperly incurred.

HOW A LIQUIDATOR CAN MITIGATE THE RISK OF PAYING COSTS PERSONALLY

Litigation strategy

Before embarking on any litigation, or continuing any litigation that is on foot at the time of the liquidator's appointment, a liquidator should carefully weigh up the benefits and risks of pursuing a particular course of action. Liquidators should:

- investigate matters promptly and with due consideration
- seek legal advice on the merits of the claim (which may include counsel opinion)

⁸ [2019] VSC 389. ⁹ *Australia's Residential Builder Pty Ltd (in liq) v Wiederstein (No.2)* [2019] VSC 389, [54]. ¹⁰ *Australia's Residential Builder Pty Ltd (in liq) v Wiederstein (No.2)* [2019] VSC 389, [53]. ¹¹ *Australia's Residential Builder Pty Ltd (in liq) v Wiederstein (No.2)* [2019] VSC 389, [54]. ¹² [2020] FCA 609. ¹³ [2020] NSWSC 363. ¹⁴ *Re Azmac Pty Ltd (in liq) (No.2)* [2020] NSWSC 363, [46]. ¹⁵ [2020] QSC 104. ¹⁶ *SJG Developments Pty Ltd v NT Two Nominees Pty Ltd (in liq)* [2020] QSC 104, [27]. ¹⁷ [2020] QSC 183. ¹⁸ [2020] NSWSC 1589. ¹⁹ [2020] NSWSC 1589, [108]. ²⁰ [2020] NSWSC 1589, [108].

Liability for costs

- estimate the costs (including the liquidator's fees, legal fees and disbursements) and ascertain the likely recovery of a claim
- be prepared to settle the claim
- as a preliminary step, consider whether to examine company directors particularly to obtain a better understanding of a claim
- consider seeking directions of the court on whether to continue a claim, and
- comply with court rules and liquidator's statutory duties.

General measures

In addition to being cognisant of the matters raised above, a liquidator can mitigate the risk of paying costs personally by:


- Obtaining non-recourse funding from a litigation funder, including an indemnity to pay any adverse costs orders (which is sometimes underwritten by after the event insurance). This form of funding shifts all risk to the funder, as the liquidator is only obligated to pay the funder upon successful recovery of the funded claim. Funding can also be provided for preliminary steps such as investigations and public examinations. With portfolio funding (a facility provided for all claims arising out of a liquidation), a liquidator can run more claims risk free.
- Obtaining funding and an indemnity to meet adverse costs from a creditor.
- Ensuring there are sufficient unsecured assets to meet the costs of the litigation, including any adverse costs. However, liquidators should be wary that a court may order that the liquidator is not entitled to an indemnity from the company's assets and creditors may not be supportive of liquidators risking funds that would otherwise be distributed, to pursue litigation.

Lessons from case law

Below we have set out specific examples from case law of conduct that liquidators should avoid to mitigate the risk of paying costs personally.

- Issuing a statutory demand when a genuine dispute exists.²¹
- Abandoning proceedings (as plaintiff) shortly before trial.²²
- Initiating an appeal in circumstances where it is manifestly clear that the motivation for doing so is to maximise remuneration for the liquidator as opposed to recovery for the company in liquidation, and failing to provide the court with evidence that substantiates costs incurred for the appeal are properly incurred.²³
- Rejecting a reasonable *Calderbank* offer where a liquidator pursues litigation when evidence suggests, if successful, moneys would principally benefit the liquidator.²⁴
- Appropriating net proceeds of a sale transaction from the company in liquidation for remuneration and for use to pay solicitors without notifying the relevant creditor, and where the proceeds of that sale were principally to repay a debt.²⁵
- Treating a company as a secured creditor within the meaning of the *Corporations Act 2001* (Cth) and then provoking litigation in light of unfounded allegations that this is to the contrary.²⁶
- Actively defending proceedings where the company in liquidation has no assets without informing the court and other parties to the proceeding.²⁷

ASSIGNMENT OF CLAIMS

Liquidators ought also consider whether to assign a claim, rather than commence proceedings. Under the *Corporations Act 2001* (Cth), external administrators have the ability to assign the right to sue.²⁸ This option provides liquidators with an additional means to improve creditor outcomes and reduce the risk of being personally liable for costs in litigation. See 'Assigning Claims, a practical update' in the March 2020 edition of the Journal for further discussion of this option. 

²¹ *SJG Developments Pty Ltd v NT Two Nominees Pty Ltd* [2020] QSC 104. ²² *Fairfield Services Pty Ltd (in liq) v Leggett* [2020] QSC 183. [2], [7]. ²³ *Australia's Residential Builder Pty Ltd (in liq) v Wiederstein* [No.2] [2019] VSC 389, [32], [52]-[53]. ²⁴ *Australia's Residential Builder Pty Ltd (in liq) v Wiederstein* [No.2] [2019] VSC 389, [52]. ²⁵ *Re Azmac Pty Ltd (in liq) (No.2)* [2020] NSWSC 363, [42]. ²⁶ *Re Azmac Pty Ltd (in liq) (No.2)* [2020] NSWSC 363. ²⁷ *Damcevski v Demetriou* [2018] NSWSC 1915. ²⁸ s 477(2)(c) and *Insolvency Practice Schedule (Corporations)* s 100-5.