CREDIT ISSUES

WOODGATE & CO.

Chartered Accountant
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BEWARE THE LAST MINUTE TRANSACTION

Woodgate v Fawcett illustrates the dangers of the last minute director related transaction.

On 22 March 2006 Giles Woodgate ("Woodgate") was appointed Voluntary Administrator of Herd by OS, the secured creditor, under Section 436C of the Corporations Act ("the Act"). On 28 March 2006 Woodgate was also appointed Voluntary Administrator of MGB by OS, under Section 436C of the Act. Subsequently, both Herd and MGB were wound up. The sole director and sole shareholder of MGB and Herd was MF.

Herd manufactured armoured cars, aluminium trailers and bull bars from premises owned by MGB at Kemblawarra, NSW. MGB also owned a property at Revesby, NSW.

From August 2002 MGB borrowed monies from C. MGB's borrowings were secured by mortgages over the Kemblawarra property and the Revesby property. On 17 March 2006 MGB owed $3.36M to C.

HF and DRF ("the Fs"), the parents of MF, owned properties at Revesby and Abbotsford. From August 2002 the Fs also borrowed funds from C. They had executed Deeds of Loan and had the assistance of solicitors. The loans were secured by mortgages over the the Fs' Revesby property and the Abbotsford property. The funds borrowed from C were on-lent to MGB. MGB paid interest on the Fs' loans from C. DRF died in October 2005. On 17 March 2006 the Fs owed C the sum of $2.593M. The Fs' loans and MGB's loans were cross collateralised.

On Friday, 10 March 2006 MF met with his solicitor, external accountant, an insolvency practitioner and others. On Sunday, 12 March 2006 MF met with another insolvency practitioner, his external accountant and others. Following those meetings, MF determined that MGB would sell the Revesby property and the Kemblawarra property and that Herd and MGB would cease trading.

On Monday, 13 March 2006 MF instructed MGB's solicitor to prepare contracts for the sale of the Revesby property and the Kemblawarra property. The two properties were sold to an unrelated third party for $6M, excluding G.S.T. Settlement of the contracts for sale occurred on Friday, 17 March 2006. On the same day MGB and Herd ceased trading.

On settlement of the sale of the Kemblawarra property and the Revesby property, the Fs' loan from C of $2.593M was discharged, along with MGB's loan of $3.36M. The balance of

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the proceeds of sale was applied to legal fees and in part-payment of rates. The Fs obtained discharges of their mortgages over the Fs' Revesby property and the Abbotsford property.

On 5 April 2006 MGB lodged caveats on the Fs' Revesby property and the Abbotsford property. In November 2006 HF served lapsing notices in respect of the caveats. MGB and Woodgate then made an Interlocutory Application to the Supreme Court of New South Wales to extend the caveats. By consent, the Court Ordered that the caveats be extended until further notice and that MGB and Woodgate file a Statement of Claim. In December 2006 a Statement of Claim was filed in the Supreme Court of New South Wales seeking recovery from the Fs of the sum of $2.593M as an unfair preference or alternatively as an unreasonable director related transaction.

Section 588FA of the Act states that a transaction is an unfair preference if:

(a) the company and the creditor are parties to the transaction; and,

(b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in the winding up of the company.

Section 588FDA of the Act states that a transaction is an unreasonable director related transaction if:

(a) the transaction is a payment made by the company, a conveyance, transfer or other disposition by the company of property of the company, the issuing of securities by the company or the incurring by the company an obligation;

(b) the payment, disposition or issue is made to a director or a close associate of a director of the company; and,

(c) it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction having regard to:

  (i) the benefits, if any, to the company of entering into the transaction; and,

  (ii) the detriment to the company of entering into the transaction; and,

  (iii) the respective benefits to other parties to the transaction of entering into it; and,

  (iv) any other relevant matter.

A close associate includes a relative or a defacto spouse. A relative is defined in Section 9 as including parents, grandparents, children, grandchildren, siblings or a spouse.

Pursuant to Section 588FC of the Act, the company must be insolvent to recover an unfair preference. There is no requirement for the company to be insolvent to have an unreasonable director related transaction.

On 14 December 2006 an Offer of Compromise in the sum of $2.583M was served on HF. Subsequently, the Statement of Claim was amended to include two additional claims against HF amounting to $181,500.

After much prevarication and delay, the proceedings were heard by Justice Hammerschlag on 13 and 14 August 2008. During the trial HF accepted liability for the smaller claims totalling $181,500.

His Honour found that the payment of the Fs' loans to C was an unfair preference.

Even though there was a benefit to MGB in that it was able to sell its properties and discharge its debts to C and the Fs, his Honour found that the payment of the Fs' loans to C was an unreasonable director related transaction because:

(a) the detriment to MGB was that it was left in a position where it was unable to satisfy its other creditors amounting to $2.752M;

(b) the benefit to the Fs was that they received payment of their unsecured obligation in full, in preference to the claim of other unsecured creditors; and,

(c) the fact that MGB was a company under the control of a son, which produced a substantial benefit to his parents and to the prejudice of unsecured creditors, was a factor that the Court would consider.

The Court Ordered judgment against HF in the sum of $2.593M and interest of $639,195. Costs were Ordered on an indemnity basis from 10 January 2007. Woodgate's costs of the legal proceedings were subsequently calculated to be $330,000.

Because the principle component of the judgment debt arose from an unfair preference, once HF repaid the unfair preference, she was entitled to prove in the winding up of MGB as an unsecured creditor, pursuant to Section 588FI of the Act. The dividend to ordinary unsecured creditors was estimated to be 50 cents in the dollar.

Three years after the appointment of a Voluntary Administrator, HF paid to the Liquidator $2,443,340, so as to enable a dividend of 50 cents in the dollar to be paid to ordinary unsecured creditors. Her own legal expenses were estimated by Woodgate to be $550,000.

Had she receive the right advice from the beginning, and proposed a Deed of Company Arrangement, HF could have made a contribution of no more than $1,350,000, so as to enable to same dividend to be paid.

It is imperative that directors and stakeholders receive independent, competent and uncoloured advice so as to avoid costly losses. Otherwise, the cost to directors and their relatives of unsustainable last minute dispositions of assets can be considerable.

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