CREDIT ISSUES

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UNFAIR PREFERENCES IN A LIQUIDATION – WHEN IS A DEBT UNSECURED?

Introduction

Section 588FA(1) of the *Corporations Act* 2001 ("the Act") defines an unfair preference, that is a transaction which is potentially voidable upon a company being wound up. Relevantly, the transaction is between the company and a creditor and, for an unrelated creditor, occurs when the company is insolvent during a period six months before a formal insolvency event. The transaction results in the creditor receiving from the company, in respect of an unsecured debt, more than it would have received as a dividend, in the winding-up of the company, if the transaction were set aside.

There has been little judicial attention as to when a debt is an unsecured debt for the purposes of that Section. Section 588FA(2) of the Act states that for the purpose of Section 588FA(1) only "that a secured debt is taken to be unsecured to the extent of so much of it, if any, as is not reflected in the value of the security."

The South Australian District Court endeavoured to determine when a secured debt is, in fact, unsecured in *Matthews v The Tap Inn Pty Ltd* [2015] SADC 108. In that case the parties agreed to have the Court determine, as a preliminary question, whether the time for assessing the value of a security in an unfair preference action was :

- at the date the security was created; or,
- the date when each payment to the creditor was made; or,
- the date of the winding up; or,
- some alternative date.

A differently constituted District Court, in a separate judgment, had previously ruled against an application to have the dispute mediated before trial in order to have this issue determined.

The truncated facts were that the Defendant had a second ranking security, behind a financier, over all assets of the company, now in liquidation. At the time of taking that security the company was solvent but it was insolvent at the time of making payments to the Defendant, within the six month period before it went into voluntary administration. At the time of winding up the Defendant's security was worthless and it was a substantial creditor of the company.

Chivell DCJ considered the text of Section 588FA(2) and the words "For the purpose of Section 588FA(1)" as limiting the application of subsection(2), so that it has no application elsewhere within the Act.

The Court held that the phrase "a secured debt is taken to be unsecured" creates a statutory fiction whereby, even though a debt is secured in that it is covered by a valid security, it is to be treated as unsecured in the specified circumstance. The prerequisite circumstance creating that fiction is that the debt is deemed "unsecured to the extent of so much of it, if any, as is not reflected in the value of the security". This means that the debt will be deemed unsecured, to the extent of the shortfall between the value of the security and the debt.

The Court considered that Section 588FA(2) reinforced the pari passu principle. This is the principle of equality between creditors. It applied the Victorian appellate decision in *Walsh v Natra Pty Ltd* [2000] VSCA 60, which held that in applying Section 588FA(1) the date for determining the extent to which a creditor received a preference, that is, the quantum of the advantage, was not on a hypothetical winding-up date being the date of payment, but the actual date of liquidation. Chivell DCJ followed this authority in construing Section 588FA(2) because that subsection is stated to be 'For the purposes of subsection (1)". He rejected the Defendant's argument that the Defendant was fully secured for its loan because, at the time the security was created, it was intended by the creditor that the value of the assets provided sufficient security for the loan, which avoided application of Section 588FA(2).

He also rejected the policy argument that, if creditors' securities were to be at risk of competing with unsecured creditors, they would likely lend less and be more likely to enforce their securities earlier. He thus concluded that for the purposes of Section 588FA(2), the time for assessing the value of the security was the date of the winding up of the debtor company.

Appeal

The Defendant appealed the decision in *The Tap Inn Pty Ltd v Matthews* [2015] SASCFC 188. The Full Court of the Supreme Court of South Australia recounted the disputed pleaded facts and rebuttals, which were of much greater complexity than those stated by the trial judge in his judgment. The Full Court determined that it was appropriate that the complex factual dispute be resolved, before construing and applying the statutory provisions. The trial judgment was based on hypothetical facts and could not assist the efficient administration of justice, when the facts determinative of the legal dispute remained open. The Full Court was not prepared to entertain the appeal and the judgment was set aside.

Thus the very important issue of determining whether a debt, which was originally fully secured, was unsecured in an unfair preference context in a liquidation, remains an open question. This is a concern to all secured creditors, but particularly those with second or lower ranking priorities.

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