CREDIT ISSUES

WOODGATE & CO.

Chartered Accountants

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RECENT INSOLVENCY CASES – OLD ISSUES RETURN, NEW ISSUES EMERGE

Introduction

Three recent cases demonstrate that the concept of proving insolvency in order to recover antecedent transactions, such as unfair preference payments and claims against directors for insolvent trading, remains misunderstood by some insolvency practitioners and lawyers.

In all three cases the Liquidators failed to:

(a) prove insolvency in its entirety; or,
(b) prove insolvency for a substantial part of their claim; or,
(c) properly plead their claim with adequate particulars of the alleged insolvency.

Hussain v CSR Building Projects Limited; in the matter of FPJ Group Pty Ltd (in liq) **("Hussain's case") [2016] FCA 392**

Justice Edelman, of the Federal Court of Australia, determined that the entirety of the Liquidator's expert evidence as to insolvency in an unfair preference case was based on a false assumption. The Liquidator failed to adduce evidence concerning the likely realisations from stock and trade debts. He also incorrectly applied the cash flow test for insolvency. The test applied by the Liquidator was whether the company was able to pay its debts when they became due and payable from its cash resources. There was no evidence before the Court of the company's relationship with its bankers, the likely realisations from trade debts and stock and whether the directors were likely to support the company with loans or advances.

There was evidence that the company met its revised taxation obligations when due and paid the Defendant's invoices when promised. There was no basis to infer insolvency on the date stated by the Liquidator or that the Defendant had reasonable grounds to suspect insolvency.

Carrello as liquidator of Perrinepod Pty Ltd v Perrine Architecture Pty Ltd **("Carrello's case") [2016] WASC 145**

This case involved claims by a Liquidator for insolvent trading against a company's directors and its parent company under Sections 588G and 588V of the *Corporations Act 2001* (Cth) ("the Act"), respectively. The Liquidator's claim for insolvent trading amounted to $5.7M, plus interest.

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There were also claims to recover unfair preferences, uncommercial transactions and unreasonable director-related transactions. The Liquidator failed to prove that the company was insolvent at the time that most of the alleged debts were incurred, because financial statements tendered did not enable conclusions to be drawn as to the company's inability to pay its debts as and when they fell due. It was only when the company had an adverse adjudication determination awarded against it of $1.06M, that the company was found to be insolvent by Justice Chaney, of the Supreme Court of Western Australia. The total debts incurred by the company whilst insolvent and remaining unpaid at the date of liquidation amounted to $1.3M, of which $1.27M was owed to related parties. None of the other claims were recoverable.

***Blakeley and Australian Music Pty Ltd v Yamaha Music Australia Pty Ltd* ("Blakeley's Case") [2016] VSC 231**

This case involved an Amended Statement of Claim filed by a Liquidator seeking to recover alleged unfair preference payments received by the Defendant. The Defendant sought to stay or dismiss the claim. Alternatively, it sought summary judgment on the basis that the pleadings did not disclose a claim and were an abuse of process.

Associate Justice Gardiner, of the Supreme Court of Victoria, held that the assertions of insolvency were incorrectly pleaded as to their factual basis. However, that was not to say that the Liquidator could not put forward evidence of insolvency, by way of discovery of documents or by expert report. He ordered that the pleadings be amended.

What is an "unsecured debt" for the purposes of Section 588FA of the *Corporations Act 2001* ("the Act")?

Assuming that insolvency at relevant times can be established, Section 588FA(1) states that a transaction is an unfair preference if the company and the creditor are the parties to the transaction and the creditor receives more in respect of an unsecured debt that the company owes the creditor, than if the transaction were set aside and the creditor proved for the debt in the winding up of the company.

Both Defendants in the Hussain's and Blakeley's cases supplied goods subject to retention of title clauses, whereby the Defendants retained title to those goods, until all moneys owing to the Defendants were paid in full. Both Defendants supplied goods before and after the commencement of the *Personal Properties Securities Act 2009* (Cth) ("the PPSA"), and registered their security interests upon implementation of the PPSA.

The registration of security interests under the PPSA renders the creditor "secured" for the purposes of the Act and under the PPSA. Transitional security interests are security interests which arose prior to implementation of the PPSA and which continue thereafter. Such security interests became perfected from immediately before the commencement of the PPSA on 30 January 2012. The question that arose in both cases was whether the payments to the creditors were payments of "secured" debts within Section 588FA(1) of the Act.

In Blakeley's case, Associate Justice Gardiner stated that it was clear that the PPSA terms of trade only operated

prospectively and did not purport to create any security interest in the stock which was supplied prior to the introduction of the PPSA.

In Hussain's case, Justice Edelman considered the retention of title provision constituted security for the purposes of Section 588FA of the Act and stated that it satisfied traditional notions of security. Further, other provisions in the Act regarded such a clause as security. He considered the alternative interpretation, that the clause was enforceable, but not a security within Section 588FA(1)(b) of the Act, would produce the odd result that a creditor could recover the goods, but remain an unsecured creditor for the full value of the debt.

When is the value of the security determined for the purposes of Section 588FA(2) of the Act – at the time of the transaction or the date of liquidation?

This issue was recently considered in the South Australian case of *Matthews v The Tap Inn Pty Ltd* [2015] SADC 108 but remains unresolved. Blakeley's case assumed the appropriate date was the date of liquidation. Hussain's case considered the issue without determining it, the Liquidators having failed to properly plead their case on this issue.

An argument in favour of the date of liquidation is that this is consistent with the rationale of the unfair preference legislation, being to ensure equality between creditors of the same class at the date of liquidation. A contrary argument is that the section, which awards compensation for an unfair preference, requires repayment of the benefit the person has received because of the transaction. If the focus is on the benefit the person has received, then symmetry requires that the security held should also be assessed at the time of the transaction. This important issue still remains to be judicially determined.

The running account when defending unfair preferences

Section 588FA(3) of the Act states that if a transaction is commercially an integral part of a continuing business relationship between the company and the creditor and in the course of the relationship, the company's net indebtedness increases and decreases, then Section 588FA(1) operates to treat all of the transactions that forms part of that relationship, as if they were a single transaction for the purposes of determining whether there is an unfair preference.

Carrello's case considered whether the existence of knowledge or suspicion of insolvency by the creditor deprived the relationship of the vital characteristic of a continuing business relationship. Justice Chaney followed an earlier judgment that reasonable grounds to suspect insolvency did not of itself destroy a relationship of mutual benefit. Hussain's case followed Carrello's case in this regard. However, Justice Edelman raised another issue, without determining it, being whether the statutory set-off provision applicable to liquidations under Section 553C of the Act applied to the running account defence.

Insolvent trading

Carrello's case found that the parent company was liable for insolvent trading, pursuant to Section 588V of the Act, primarily due to intercompany indebtedness incurred, whilst the subsidiary company was insolvent.

Justice Chaney considered this gave rise to a harsh outcome, because the recoverable amount was measured by the loss suffered by the entity. Therefore, the holding company suffered the loss and then was ordered to pay that loss to the Liquidator. However, this is consistent with the aim of the Act, being to discourage insolvent trading. Had the parent company forgiven the debts incurred, the majority of the claim for insolvent trading would have fallen away. The Liquidator was fortunate that the Defendants were not alive to this issue.

Conclusions

The cases of Hussain, Blakeley and Carrello emphasise the importance of insolvency practitioners proving insolvency when seeking to recover antecedent transactions and claims for insolvent trading. They also consider important questions regarding whether retention of title clauses are securities for the purpose of the Act, at what date the security is to be assessed for the purpose of determining an unfair preference, and parent company indebtedness in an insolvent trading claim.

Proving insolvency on a cash flow basis is complex. If confronted by such a claim from a Liquidator, do not take the Liquidator's word that the company was insolvent. Engage an independent expert, such as Woodgate & Co., to review the Liquidator's evidence on insolvency and provide objective advice.

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