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A call for law reform

Secured creditors entitlement to preference recoveries

Overview

His Honour Justice Finkelstein has found that a secured creditor is entitled to proceeds of preference recoveries. This finding was based on a right of subrogation to priority claims which had been paid from floating charge assets. In the course of the judgment, his Honour was critical of the *'uncertain and, perhaps, unsound rules and distinctions'* on which the current commonly held view that secured creditors cannot share preference recoveries is based. His Honour also adopted an interpretation of s 561 of the *Corporations Act 2001* (Cth) (**Corporations Act**) which is a challenge to current practice and will defer payments to priority creditors.

Introduction

It is a commonly held view that the proceeds of preference recoveries are not available to secured creditors but are only available to meet the costs of the liquidation and for distribution to unsecured creditors.

Justice Finkelstein considered this view in relation to the *Italiano Family Fruit Company Pty Limited (In Liquidation)* (**Italiano**).[1]

In this article I discuss that case, his Honour's call for law reform and the uncertain lessons for controllers.

The facts

Voluntary administrators were appointed to *Italiano Family Fruit Company Pty Limited (In Liquidation)* (**Company**) and, in due course, the Company's creditors appointed them as liquidators.

There were a number of fixed charges. The fixed charge assets were realised and the proceeds repatriated to the chargeholders. The National Australia Bank (**NAB**) also held a fixed and floating charge over the Company, which it had not sought to enforce.

Following repatriation of the proceeds of the realisation of fixed charge assets, there was still a significant shortfall owing to NAB and a number of employee creditors entitled to priority under paras 556(1)(e), (g) or (h) of the Corporations Act.

The liquidators with the approval of NAB realised the assets that were the subject of the Bank's floating charge.

The liquidators considered that it was their professional obligation to pay the employee claims at the earliest opportunity and proceeded to do so from the realisation of the floating charge assets. The liquidators did not inform NAB of their intention to pay the employees as they assumed that creditors such as banks are aware that preferential creditors rank ahead of distributions of recoveries under floating charge assets.

Approximately one year later, the liquidators were successful in recovering some unfair preferences from former creditors of the Company.

The issue

The liquidators raised for directions the issue of whether NAB is to rank *pari passu* with the ordinary unsecured creditors in relation to the distribution of the preference recoveries or, whether it has a higher claim to those recoveries which will prevail over the claims of ordinary unsecured creditors.

1 *In the Matter of Italiano Family Fruit Company Pty Limited (In Liquidation) ACN 107 879 096 [2010] FCA 1355*

Does a charge capture preference recoveries?

His Honour noted the generally accepted position that recoveries in preference actions which can only be brought by a liquidator are not caught by a charge over the Company's current and future assets.

The basis for this acceptance seems to be that because the chargee cannot sue to recover the preference, it is not entitled to benefit from the liquidator's ability to bring that claim.

His Honour then investigated this acceptance.

The key Australian authority is the High Court decision in *Kratzmann v Tucker* (**Kratzmann**).[2] The High Court observed that while money preferentially paid was subject to the charge at the time of payment, the money recovered by the liquidator is not the same money because the statute does not revest the money in the company – it requires the creditor to pay the liquidator an amount equal to the value of the preference.

His Honour then analysed the uncertainties and unintended results which arose from strictly applying such analysis. For example:

- it is accepted that the liquidator has power to *'sell'* the proceeds of preference claims but, if the proceeds of those claims are not the property of the company, then they could not be sold;
- if a liquidator is only entitled to recover his costs and expenses out of the company's assets or property then, if preference actions are not the property of the company, the liquidator is not entitled to recover his costs out of those recoveries.

Obviously it would appear that notwithstanding the accepted basis upon which secured creditors are not entitled to the benefit of preference recoveries, the Australian position in fact accepts that the preference recoveries are the property of the company.

His Honour then considered the 1992 amendments to the then Corporations Law and noted that s 588FF which enables the Court to make remediable orders in respect of *'voidable transactions'*, allows the Court to order a person who has benefited from such a transaction to make payment or to transfer property *'to the company'*. This section therefore no longer refers to the transaction being *'void as against the liquidator'*. This changed wording may have the unintended consequence of overturning *Kratzmann* but at the time of the amendment and before that, the Harmer Report did not make any suggestion that *Kratzmann* should be overturned.

Following an extensive analysis of the Australian and English cases and a number of relevant articles and relevant arguments, his Honour concluded (at paragraph 62):

> The present position rests on uncertain and, perhaps, unsound rules and distinctions ... What is required is a careful consideration of the true role of the avoidance provisions, and, for the purpose of deciding who should benefit from them, an analysis of the competing interests of secured and unsecured creditors as well as an analysis of the liquidator's ability to seek protection for his/her costs and expenses. As the cases show these are difficult issues not easily solved. The High Court hinted ... that it may reconsider *Kratzmann*. If the High Court does not do so, Parliament should resolve this matter. In any event, it is preferably for Parliament to do so, because in no small measure, questions of policy rather than legal principle are involved.

Subrogation

Justice Finkelstein then considered whether or not NAB could be subrogated to the employees' priority claims which were paid out of the floating charge assets at a time the liquidators believed the property of the Company was insufficient to meet those claims.

His Honour noted that the only circumstances under which employees are to be paid out of floating charge assets is pursuant to ss 561 and 433 of the Corporations Act. Section 561 states that:

> So far as the property of the company available for payment of creditors other than secured creditors is insufficient to meet payment of:
>
> (a) any debt referred to in paragraph 556(1)(e), (g) or (h);
>
> ...
>
> Payment of that debt ... must be paid in priority over the claims of a chargee in relation to a floating charge ...

Section 433 applies a similar principle in circumstances where a controller is appointed and a winding up has not commenced.

His Honour expresses the view that s 561 only mandates payment of priority claims when it is clear that the liquidator will not realise free assets sufficient to meet these claims. Significantly, he comments (at paragraph 70):

> In my view, there is to be only one assessment of the sufficiency of a company's assets and that is to be made when enough is known about the company's affairs. The assessment must take into account all actual and potential realisations. That is to say, the liquidator should not, as has occurred here, make an interim assessment of the company's financial position, an assessment which only looks at the position at a single point in time.

It therefore follows that the controller must withhold funds from the secured creditor that are sufficient to pay the priority creditors but, should not actually pay those priority creditors until the controller is able to make *'only one assessment of the sufficiency'* of the company's assets.

2 *N A Kratzmann Pty Ltd (In Liq) v Tucker (No 2) (1968) 123 CLR 295*

Justice Finkelstein observed (at paragraph 100)that his view of s 561 may result in delays in payment of a dividend to priority creditors:

> As a matter of policy, this may be an undesirable outcome given that it could delay the payment of money owing to employees, which may cause real hardship to them and their families. Equally, chargees may for good reason wish to see the employees paid as soon as possible, but not if this would mean that the payments are at the chargee's expense even if it turns out that the Company has sufficient free assets available.

In *Italiano* it was twelve months after the employees' priority claims were paid that the liquidators made their successful preference recoveries. Although the liquidators were making demands for the preference claims at the time of payment to the employees, they could not say with any confidence what those preference claims were worth until they were settled.

In order to find that the secured creditor was entitled to the preference recoveries, his Honour did make a finding that the liquidators had paid those monies to the priority creditors 'in breach of trust'

In this case, the liquidators paid out the employees on the basis of their interim assessment with the result that in his Honour's view, the liquidators *'committed a breach of trust'* and that because NAB's funds had been misapplied in breach of trust, and to the extent that it had suffered loss, NAB should be subrogated to the rights of priority creditors. His Honour also noted that it would be unconscionable for the unsecured creditors to benefit from a windfall produced by that breach of trust.

The consequence of the liquidators' breach of trust was that NAB suffered a loss. That loss however was equal to the value of the free assets that eventually became available to meet the priority claims, which were the very funds in relation to which the liquidators were seeking directions, meaning that there was no personal exposure on the part of the liquidators.

If, unlike the situation in *Italiano* the chargeholder gave informed consent to the priority creditors being paid promptly there would be no breach of trust. This breach formed the basis for his Honour accepting that the chargeholder has a right of subrogation in the *Italiano* case. His Honour expresses the view that absent the breach, the chargeholder should be entitled to subrogation. However, this view is only obiter and not free from doubt.

Conclusion

Justice Finkelstein has emphasised the *'uncertain and, perhaps, unsound rules and distinctions'* which support the accepted position that secured creditors are not entitled to the benefit of preference recoveries. He notes that this raises questions of policy and not just issues of legal principle, which must be resolved by Parliament.

In order to find that the secured creditor was entitled to the preference recoveries, his Honour did make a finding that the liquidators had paid those monies to the priority creditors *'in breach of trust'*. If there is no breach of trust, the obiter suggests that the secured creditor would be entitled to share in the preference recoveries by way of subrogation in any event.

The finding of a *'breach of trust'* is based on an interpretation of s 561, which should be of concern to controllers. It is not unusual for a controller to sympathise with the hardship faced by the former employees and, in order to promptly pay them, to make an interim assessment of the company's assets for the purpose of s 561. The effect of his Honour's view of the law is that controllers should not act upon any such sympathy by way of early payment to the employees. In fact, his Honour acknowledges that his interpretation *'may be an undesirable outcome given that it could delay the payment of money owing to employees, which may cause real hardship to them and their families'*.

The decision, in challenging the commonly held view that preference recoveries are not available to secured creditors, has highlighted a number of legal and practical concerns for practitioners and secured creditors as well as policy issues for Parliament.