

Charges and their Effectiveness Against Liquidators

▶ Shane Grant | Rudkin Hitchcock | Queensland

Charges are an effective tool to make specific property answerable for payment of a debt by a company. The creation and types of charges are far too broad a topic to be covered here, but what is particularly topical at the moment is their effectiveness against liquidators or administrators once a company is placed into liquidation or administration.

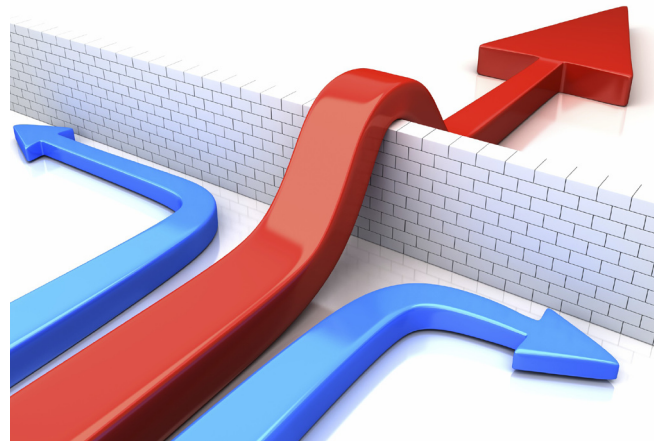
The focus of this article is the various powers enabling insolvency practitioners to attack the enforceability of charges.

Registration

In scrutinising charges, one of the first considerations of a liquidator or administrator is whether the charge has been registered with ASIC.

Section 266 of the Corporations Act provides that a registrable charge is void as a security against a liquidator or administrator unless it is lodged for registration with ASIC within either:

- i) The relevant period (normally 45 days from creation of the charge); or



- ii) 6 months of being wound up or placed into administration.

This same rule holds true where the charge is varied, for instance to increase the amount to be secured.

It is important to remember that in this context, the failure to register a charge (or a variation to a charge) does not invalidate that charge, but rather it leaves it open to attack by a liquidator or administrator.

Whilst this may seem like a standard administrative task by a charge holder, experience shows that registration of charges or subsequent variations can often be delayed for administrative reasons, thereby affecting their enforceability against a liquidator.

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Property Law Act Fraud Decision: Regal Castings Limited

▶ Tony Johnson & Philip Shackleton
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The issue was whether the transfer of the home to the family trust was an alienation of property with intent to defraud creditors pursuant to the *Property Law Act 1952* ('the Act'). The Supreme Court unanimously determined that there was a fraud under the Act. In doing so, the Court overturned the earlier decision of the Court of Appeal.

The relevant facts were:

- November 1998 the home was transferred by L to a Trust;
- The consideration for the transfer was a debt back to L of \$230,000 (to be repaid in one sum in November 2005);
- Gifting by L commenced in November 1998 and continued progressively until the debt was extinguished in December 2002;
- At the time of the transfer, L had personally guaranteed debts owed by his business (Capro) to Regal Castings. The details of the debt being:
 - A long outstanding debt had been restructured in 1995 into a term loan of \$356,000 (interest had been waived) with monthly instalments to be paid and with the balance owed to be paid in 2000.
 - By November 1998 the term loan had been reduced to \$220,000 but the monthly instalment payments had risen to \$4,000 per month.
 - Regal Casting had continued to supply Capro on normal terms and its current account debt stood at some \$90,000 (\$65,000 of which was in arrears);
 - Despite the arrears, no demand had been made upon L as guarantor.
- Regal Casting was not told of the transfer of the home or of the gifting programme;
- Capro was placed into liquidation in April 2003. At that time Regal Casting was owed \$15,000 on the term loan and \$149,000 for further supplies; and
- L was subsequently bankrupted.

The dissenting judgment in the Court of Appeal came from Justice William Young. His view was that it was perfectly clear the debt was in the mind of L at the time of the transfer. He indicated that knowledge of consequence could be equated with intent. He indicated Capro was insolvent at the time of

the alienation, that there was a clear intention to gift all the debt and the fact that it took time to do so was irrelevant. He also confirmed his view that L acted dishonestly when he made away with assets during the period of an extension of time granted to him and his company.

The Supreme Court Justices to varying degrees, supported Justice William Young's judgment.

All Justices accepted that "intent to defraud" included intending to hinder, delay or defeat a creditor in exercising any right of recourse of the creditor in respect of property of the debtor. This is how the concept is now expressed in section 345(1)(a) of the *Property Law Act 2007*.

The lessons to take from the decision are that fraud under the Act is much wider than might be anticipated, the state of a disposer's financial position is crucial in determining the legitimacy of the disposition, and a consistent program of gifting does not of itself protect a disposition from challenge.

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How Much Knowledge Amounts to Liability for Knowing Receipt?

▶ James Graham | Madgwicks | Victoria

Lenders and investors in commercial transactions involving multiple parties should beware the risk of claims for “knowing receipt” (ie. liability arising from knowingly receiving trust property that has been tainted by another party’s wrongdoing). Whilst claims usually emerge following a corporate failure, it is the failed entity’s solvent lenders and partners against whom relief is usually sought.

Long established as the “first limb” of the English case *Barnes v Addy* (1874) (Barnes), a party can become a constructive trustee (and liable to third parties that have lost the benefit of their property) if the party receives the property in the knowledge that it related to some misuse of the trust property or another’s breach of fiduciary duty owed to the wronged third party.

By way of background, the “second limb” of Barnes creates liability where a party knowingly assists in a dishonest breach of duty by a trustee who owes a duty to a wronged third party. The corresponding statutory provisions (s.79 *Corporations Act 2001* and s.75B *Trade Practices Act 1974*) prohibit being a knowing party to any contravention by direct or indirect act or omission, which is of narrower scope as it requires actual knowledge of wrongdoing by the lender or investor.

When determining knowing receipt claims, Courts have traditionally focussed on determining the extent of the party’s knowledge rather than evaluating the effect of the party’s actions. In *Farah Constructions Pty Ltd v Say-Dee Pty Limited* [2007] (Farah) the High Court reiterated that notice and knowledge are essential in knowing receipt, but did not settle the question of how much is too much knowledge for lenders and investors who receive tainted proceeds.

Arising from the collapse of Opes Prime Stockbroking, the Federal Court case *Imobilari Pty Ltd v Opes Prime Stockbroking Ltd* (2008) (Imobilari) dealt with financiers’ liability for knowing receipt associated with losses arising from alleged misconduct by the failed company. In Imobilari, Finkelstein J noted that after Farah, as a minimum, it is sufficient to prove knowledge of facts “that would put an honest and reasonable person on notice (but not merely inquiry) of a real and not remote risk that the transfer

“knowledge of facts that would put an honest and reasonable person on notice (but not merely inquiry) of a real and not remote risk that the transfer was in breach of trust or fiduciary duty or involved the misapplication of trust property”.

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Finkelstein J also suggested that an even simpler test of knowledge, whereby a defendant would be deemed to have knowledge if they acted recklessly in receiving trust property that was misapplied or transferred in breach of trust or fiduciary duty.

It is disturbing to note that the Imobilari decision was handed down within weeks of another Barnes case against banks in Western Australia, *The Bell Group Ltd* (in liq) judgment, which heralds from Australia’s last recession in 1990. The cases are a reminder for lenders and investors to beware involvement in transactions where others could be seen to be acting against fiduciary obligations to third parties.



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Other Avenues of Challenge

Whilst registration of charges provides significant protection for charge holders, there are still other considerations which enable a Liquidator to challenge a charge as a voidable transaction, including:

1. Unfair Preferences (s588FA)

A charge may be voidable by a Liquidator where it is given in favour of a creditor within the relevant period (normally 6 months from when the winding up application is filed) and it can be shown that:

- (a) The transaction provides a preference/advantage to the charge holder over other unsecured creditors; and
- (b) The company was insolvent at the time of creating the charge or became insolvent as a result.

2. Uncommercial Transactions (s588FB)

A charge will be an uncommercial transaction and therefore voidable by a liquidator if it can be shown that it was not reasonable for the company to create the charge, having regard to the benefits provided to the company and its obligations. In other words, a reasonable person in the position of the company would not have given the charge, having regard to the company's position and the benefits that it would derive from it.

3. Floating Charges (s588FJ)

A floating charge created by a company during the 6 months ending on the 'relation back day' will be void as against the liquidator unless it can be shown that fresh consideration was given to support the charge, or it can be shown that the company was solvent at the time immediately after the time the charge was created.

4. Charges in Favour Relevant Persons (s267)

Where a charge is created by a company in favour of an officer of the company or other relevant person and that person takes a step to enforce that charge without the leave of the Court (eg appoint a receiver) within 6 months of its creation, then that charge is void.

Given the many potential points of challenge by a liquidator, it is important that practitioners consider the implications of all of the above issues upon the creation of the charge, to best ensure that they are enforceable in the immediate future should the chargor company become insolvent.

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