Using PPSR to defend unfair preference claims

By Ben Sewell and Brooke Payne*

Caroline is a terrific Credit Manager, she is proactive and uses both IT and skill to keep her company's debtor days to acceptable levels (she is an ace really). Her company sells commercial products and the CEO loves Caroline because she always presses for payment and she even keeps the sales force in line. Unfortunately, because Caroline is so good at what she does she gets occasional unfair preference claims from liquidators of debtors. This article discusses how Credit Managers can use the new Personal Property Securities Register to protect their company from unfair preference claims.

Ben Sewell.

Why do Credit Managers worry about unfair preference claims?

The fact is that unfair preference laws penalise the best Credit Managers. The faster and more effective Credit Managers get the best results and they outshine pedestrian Credit Managers. Being preferred to other creditors makes the best Credit Managers vulnerable to unfair preference claims after their debtors go into liquidation. There is nothing more frustrating for a Credit Manager than receiving an unfair preference claim from a liquidator.

Sum it up – what are unfair preference claims?

A transaction is an unfair preference if the creditor received more of an **unsecured debt** than the creditor would receive from the company by proving in the winding up for a dividend. This means a preference over and above what all the other creditors receive after the debtor goes into liquidation. The justification for this law was originally the principle of "*pari passu*", that each creditor of a liquidated company should receive an equal distribution of net assets. Liquidators have a strong incentive to pursue unfair preference claims so they can claw back debt payments made to creditors for redistribution (or put towards costs of the liquidation). The liquidator can claim preferential payments made six months before commencement of a winding up (legal terminology: six months before the 'relation-back date').

How can you fight an unfair preference claim?

Three arguments that can be used to defend an unfair preference claim are:

1. Debtor company solvency
2. No suspicion of insolvency
3. Running balance calculation

If the matter goes to Court the liquidator needs to prove that the debtor company was insolvent at the time the payments were received. It is usually a safe bet that a liquidated company was insolvent but it is a factual matter that needs to be proven by the liquidator. One approach may be to **evaluate** insolvency by seeking evidence, up front, from the liquidator to confirm insolvency at the time the first payment was received.

Otherwise, there is a defence (that the Credit Manager bears the onus of proving) known as the **good faith** defence. The three limbs of the defence to be proven by a preferred creditor are:

1. That the payment was accepted in good faith (nothing smells);
2. That valuable consideration was provided by the creditor (the creditor sold the debtor a product); and
3. That the creditor or a reasonable person in their position had or would have had no reasonable grounds to

suspect the debtor was insolvent (you had no reason for concern regarding repayment).

The problem with the good faith defence is that the "no suspicion" of insolvency test is often burdensome for a preferred creditor to prove. A Court will take into account emails, bounced cheques, part payments, instalment arrangements, deteriorating terms of payment and other factual matters in consideration against the preferred creditor.

A liquidator is required to make a calculation to take into account the **running balance** between a debtor and creditor over the six months before the commencement of winding up. Practically, this means that you should calculate a possible preferential amount as the difference between the highest amount owing during the relation-back period and the amount owing at the time of winding up of the debtor company.

Get a Purchase Money Security Interest!

The Personal Property Securities Register (PPSR) provides an accessible mechanism by which a trade supply can become a secured creditor. Once a creditor becomes a secured creditor, they have a further defence to potential unfair preference claims as a liquidator cannot maintain unfair preference claims against secured creditors. In fact, the PPSR has opened up an opportunity for 'unsecured' creditors to not only gain 'secured' status, but a 'super-priority' over other creditors in the event of insolvency.

A Purchase Money Security Interest (PMSI) is defined broadly in the Personal Property Securities Act (PPSA) to include a security interest granted in exchange for finance or value required to purchase or acquire rights in collateral, and includes the interest of **retention of title** suppliers. Because of the broad definition in the PPSA, a PMSI can be taken over any kind of collateral and result in arrangements not considered to be security interests under the old law. This means that if you trade under a retention of title clause and register your interest on the PPSR, you will gain 'super-priority' in the event of liquidation of a company and you will be protected from potential unfair preference claims by liquidators.

One potential problem if you need to contest litigation

An important qualification to the scope of the defence is that the preferred creditor would need to prove the amount of their security. This may mean demonstrating (for a Retention of Title supplier) the amount of product held by the purchaser at the time the preferential payment was received. There is no case law on this point yet but it is worth being aware of.

How should Caroline start business process improvement:

1. Speak to a lawyer about whether the PPSR applies to her business
2. Look for business process improvement through benchmarking exercises
3. Update customer contracts (such as credit applications and terms of trade)
4. Ensure security interests are perfected (i.e. registered on the PPSR)
5. Ensure that PMSIs are registered within required timeframes (i.e. transitional interest issue)

One methodology for business process improvement is Gap Analysis (5 steps to meet objective of process improvement):

1. What is the current business process and how is that documented?
2. In what way will the PPSR change the business practice?
3. What gaps exist between what is currently being done and what needs to be done?
4. What document changes are needed?
5. What process changes are needed?

What clauses should your lawyer put into the improved customer contract?

1. Purchase money security interest clause
2. Confidentiality clause
3. Waiver of notification clause
4. Waiver of compliance steps in enforcement proceedings clause

Quick list for complying with the PPSR (for commercial product suppliers)

1. Ensure you are trading under retention of title terms and that your terms include a right to register a Purchase Money Security Interest;
2. Register your interests on the PPSR (www.ppsr.gov.au) or upload through an agent and provide necessary information regarding the interest itself, collateral and the grantor's details; and
3. Budget for the registration fees. ■

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