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The Voidable Transaction Regime – A summary

Authors: Lesly Ann Cho & Richard Chalik

The voidable transaction regime under Part 5.7B of the *Corporations Act 2001* (Cth) (**the Act**) provides a framework for liquidators to pursue recovery action against parties who have received property or some form of benefit from an insolvent company. In turn, the mechanisms and processes under the regime often provide uncertainty in commercial dealings and other transactions of a company and provides a further layer of anxiety when navigating through cashflow problems. An understanding of when the voidable transaction provisions will apply and operate will assist in structuring legitimate transactions of a company and ensure that they do not fall foul of the regime.

What are voidable transactions and why?

Voidable transactions are those that can be undone or recovered by a liquidator that unfairly favour certain creditors over others or undermine the equitable distribution of assets in the administration of an insolvent company's affairs. The purpose is to prevent unsecured creditors from being prejudiced by the disposal of an insolvent company's assets or that company from incurring liabilities in a period shortly before liquidation commenced that would favour certain creditors.

The types of transactions covered under the voidable transaction regime includes:

1. Unfair preference transactions
2. Uncommercial transactions
3. Insolvent transactions
4. Unfair Loans
5. Unreasonable director-related transactions
6. Creditor-defeating disposition of property

What is a "transaction"?

For the purposes of the voidable transaction regime, a transaction is one in which the relevant company is a party to. Examples include a conveyance, a security interest granted by a company in its property, a guarantee given by the company, a payment made by the company, or an obligation incurred by the company. A transaction may also include a series of steps taken over a period of time involving several parties and not always with contractual consequences, such as mergers and acquisitions. It also includes transactions that are completed, given effect to, or have terminated.

For a transaction to be caught under the regime, it must have also occurred or been given effect to within specific timeframes around the liquidation of the company. These timeframes vary depending on the circumstances and type of transaction, and range from 6 months of the relation-back day (generally, the date on which liquidators are appointed to the company) to no time limit at all.

Unfair preference

A transaction is an unfair preference given by a company to its creditor if and only if:

1. the company and the creditor are parties to the transaction (even if someone else is also a party); and
2. the company is insolvent at the time of the transaction, or giving effect to it resulted in the company becoming insolvent; and
3. the transaction results in the creditor receiving from the company, in respect of an unsecured debt which the company owes to the creditor, more than the creditor would receive from the company if the transaction were set aside and the creditor were to prove for the debt in the winding up of the company.

It does not matter if the relevant transactions were entered into because of an order of an Australian Court or a direction by a government agency (e.g. the ATO). Such transactions can still be voided as an unfair preference if it meets the above criteria. A payment is also considered to be given by a company if it is made by its agent and the company owns or is otherwise entitled to the money paid by its agent.

Where there is a genuine pre-payment made in accordance with the terms of an applicable underlying agreement, a debtor-creditor relationship will not exist. Thus, there can be no preference given when a company makes an allowance for, or gives effect to, a pre-payment.

A series of transactions that form an integral part of a continuing business relationship between the company and a creditor, such as a running account, can also be treated as a single transaction. Whether or not a transaction is an integral part of a continuing business relationship, and how the "single transaction" ought to be calculated from that relationship, are specific to and dependent on the circumstances of each case.

Uncommercial transactions

A transaction of a company is an uncommercial transaction if and only if:

1. it occurs, or is given effect to, when the company is insolvent or the company becomes insolvent because of the transaction or its being given effect to; and

2. it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to various matters, including:

    a. the benefits (if any) to the company of entering into the transaction;
    b. the detriment to the company of entering into the transaction; and
    c. the respective benefits to other parties to the transaction of entering into it.

While the reasonable person test is an objective test, the elements that need to be considered when assessing an uncommercial transaction are not precise. It is necessary to look at the overall circumstances of each case and assess if the transaction provided any genuine benefit to the company, and balance that against the detriment caused to the company's creditors. This involves weighing factors relevant to the company's financial position, the timing and circumstances of the transaction, and the impact on creditors' rights.

The overall objective of voiding an uncommercial transaction is to prevent companies disposing of their assets or other resources through transactions that results in the recipient receiving a gift or obtaining a bargain of such commercial magnitude that it could not be explained by normal commercial practice. That is, to prevent a debtor company unjustly enriching a particular party at the expense of the general pool of creditors (this is in contrast to voiding an unfair preference, which aims to prevent the unequal distribution of unsecured assets of a company amongst the pool of creditors).

One significant difference between the provisions governing unfair preferences and uncommercial transactions is that a transaction may be an uncommercial transaction whether or not a creditor of that company is a party to the transaction. Similar to an unfair preference, a transaction may still be an uncommercial transaction even if it is giving effect to an order of an Australian Court or a direction by a government agency.

Examples of transactions that may be characterised as uncommercial includes transactions that:

- strip the company of all of its assets;
- forgive a debt for nominal or no consideration; and
- provide payments to related companies without evidence of these payments being referable to, or in consideration of, any service or benefit rendered to the company.

Insolvent transactions

A transaction is an insolvent transaction of a company if, and only if:

1. it is an unfair preference given by the company or an uncommercial transaction; and

2. at the time the company was insolvent, the transaction was entered into or an act was done, or an omission was made, for the purpose of giving effect to the transaction, or the company became insolvent because of matters relating to the transaction.

The act or omission giving effect to the transaction does not need to be the sole or dominant purpose. It is sufficient if one of the purposes of the doing of an act or making of an omission is for the purpose of giving effect to the transaction. Similarly, it is not necessary that the act or omission give effect to the whole transaction; a substantial part of the transaction will suffice.

These principles were explored by the Full Federal Court in the case of *Demondrille Nominees Pty Ltd v Shirlaw* (1997) 25 ACSR 535. The case concerned an agreement for the sale of a residential unit for $180,000 (**Original Agreement**). The deposit payable under that agreement was $120,000. The parties acknowledged the deposit as paid even though monies were not actually exchanged on account of it. Instead, the vendor company had a pre-existing debt to the buyer in the amount of $120,000, which was effectively extinguished by virtue of the deposit payable under the Original Agreement. The vendor company then became insolvent. The parties subsequently entered into a separate deed to rescind the Original Agreement (**Deed of Rescission**). The Court later found the Original Agreement as an uncommercial transaction that caused the insolvency of the vendor company. The Court saw the Deed of Rescission as an act done to give effect to a substantial part of the Original Agreement because it gave effect to a credit in favour of the buyer under that agreement. It did not matter that the Deed did not give effect to the entirety of the Original Agreement. On this basis, the totality of the transaction in relation to the Original Agreement and the Deed of Rescission was an insolvent transaction.

The insolvency should be *quite closely* related to the entry into or the act or omission giving effect to the transaction. Therefore, it will be necessary for a liquidator to be able to present clear evidence as to the way in which the transaction affected the company's solvency. In the event there is a pattern of fluctuating cashflow or a general decline in solvency prior to the transaction, mere correlation between the transaction and the company's insolvency will not suffice – the precise effect of the transaction will need to be isolated and shown to cause the insolvency.

Unfair loans

A loan to a company is unfair if, and only if, the interest on the loan or the charges in relation to the loan were extortionate, or have since become extortionate because of a variation. The loan in question may be considered unfair even if the interest is, or the charges are, no longer extortionate. It is also not relevant whether or not the company is insolvent. The following factors should be considered when assessing unfair loans:

1. the risk to which the lender was exposed;
2. the value of any security in respect of the loan;
3. the term of the loan;
4. the schedule for payments of interest and charges and for repayments of principal; and
5. the amount of the loan.

Courts have said that a loan will be extortionate if it is "*exorbitant, or grossly excessive or characterised by extortion*". Furthermore, it is not sufficient that the interest rate charged is simply higher, even substantially higher, than the market rate for similar transactions.

Unreasonable director-related transactions

Section 588FDA of the Act permits liquidators to reclaim 'unreasonable' payments or other disposal of property (such as granting a real property mortgage) made to a director or their close associate up to four years prior to the date the company was placed in liquidation or after that day but on or before the day when the winding up began. In this context, close associates of directors include a relative or a de facto spouse or a relative of a director's spouse or de facto spouse. Third parties who have entered into a transaction for the benefit of a director or their close associate are also caught by this provision. The Supreme Court of NSW has explained that the benefit held by a third party must be a direct benefit and not a derivative benefit such as that caused by an increase in the value of shares in a company or units in a trust.

The objective of unwinding an unreasonable director-related transaction is to restore the assets and other property to companies in liquidation for the benefit of employees and other creditors where unreasonable payments were made to directors of the company in the lead-up to liquidation.

In contrast to the uncommercial transactions and unfair preferences provisions, the liquidator is not required to establish that the company was insolvent at the time the payment or disposal was made by a director in order to reclaim the amount paid or property disposed. The test for whether the transaction was unreasonable will be satisfied if a reasonable person in the company's circumstances at the time of the transaction would not have entered into the transaction, having regard to the respective costs and benefits of the transaction. In this sense, section 588FDA is analogous to the uncommercial transaction provisions.

Where to next?

Understanding the voidable transaction regime assists in navigating a company through cashflow difficulties, while ensuring that any planned transactions given effect to cannot be unwound by a liquidator. Timing, forward planning, and structuring all play a part. It is also important to note that certain defences may be available with respect to any allegation that a transaction is void. For example, a transaction is not void if it is shown that a person received a benefit in good faith and that person, as well as a reasonable person in that person's circumstances, would not have any reasonable grounds to suspect the company's insolvency. In our next Insight, we will explore these defences in more detail.

In the meantime, if you would like further information or require assistance with respect to any voidable transaction issues or disputes that you may be facing, please contact **Lesly Ann Cho**, Partner, or your usual ClarkeKann contact.