



Law Council  
OF AUSTRALIA

*Business Law Section*

Senator the Hon Mathias Cormann  
Assistant Treasurer  
P O Box 6100  
The Senate  
Parliament House  
Canberra Act 2600  
**Via email: [financeminister@finance.gov.au](mailto:financeminister@finance.gov.au)**

26 March 2014

Dear Assistant Treasurer,

**Submission in relation to the case of *Cook v Italiano Family Fruit Company Pty Ltd (in liq)* [2010] FCA 1355 and ss 588FF and 561 *Corporations Act 2001 (Cth)***

**Introduction**

- 1 This Submission is made by the Insolvency & Reconstruction Law Committee of the Business Law Section of the Law Council of Australia (“the **Committee**”) and with the support of the Section’s Corporations Committee.

**Summary**

- 2 The decision of Finkelstein J in *Cook v Italiano Family Fruit Company Pty Ltd (in liq)* [2010] FCA 1355 (2010) 190 FCR 474 (*‘Italiano’*) was handed down on 6 December 2010, and stands for two principles:
  - a. First, that there is a distinction as between the recovery of money and the recovery of property, and that “preference” recoveries of money are not subject to charges over the company’s future property, as per the decision of the High Court in *N A Kratzmann Pty Ltd (in liq) v Tucker (No 2)* (1968) 123 CLR 295 (*‘Kratzmann’*);
  - b. Second, that employee entitlements are not to be paid out of floating charge assets pursuant to s 561 until it is clear that the ‘free assets’ of the company are insufficient to meet those entitlements.
- 3 In respect of the first point, the Committee disagrees with the comments of his Honour in *Italiano*, and submits that the distinction in *Kratzmann* should be retained,
- 4 In respect of the second point, the Committee submits that *Italiano* illustrates that *Kratzmann* in combination with the ‘free asset’ rule creates a disincentive for liquidators to pay out employee entitlements promptly in circumstances of pending

GPO Box 1989, Canberra  
ACT 2601, DX 5719 Canberra  
19 Torrens St Braddon ACT 2612

Telephone +61 2 6246 3788  
Facsimile +61 2 6248 0639

Law Council of Australia Limited  
ABN 85 005 260 622  
[www.lawcouncil.asn.au](http://www.lawcouncil.asn.au)

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voidable preference recoveries, and that this is a position that ought to be ameliorated by amendment of s 561 of the *Corporations Act 2001* (Cth) ('the Act').

### **The Facts in *Italiano***

- 5 Italiano Family Fruit Company Pty Ltd ('the company') was placed in voluntary liquidation and the creditors resolved that the company be wound up. The administrators of the company became its liquidators.
- 6 The company had, prior to administration, granted a fixed and floating charge over its assets to the NAB. The liquidators realised the company's assets and distributed them to priority creditors and to the costs of liquidation.
- 7 The liquidators also pursued claims against two former creditors in respect of payments said to be unfair preferences. The claims were ultimately settled and \$50,000 recovered. The liquidators sought the direction of the Court in relation to whether they ought to distribute the \$50,000 to the NAB (which was owed about \$1.2 million) under the charge, or whether the NAB ought to merely rank *pari passu* with the other general creditors (who were owed, collectively, approximately \$3.8 million).
- 8 The operative question was whether monies recovered through voidable preferences are recovered for the benefit of the general creditors or whether they are available to secured creditors. This required consideration as to whether section 588FF, inserted in 1992, altered the effect of the general law.

### **The General Law**

- 9 Generally, causes of action accruing to the company (for example, actions for breach of contract etc) and the proceeds of those causes of action are property of the company and caught by a charge over the company's present and future property: *Re Anglo Austrian Printing and Publishing Union* [1895] 2 Ch 891; *Movitor Pty Ltd (recs and mgrs apptd) (in liq) v Sims* (1996) 64 FCR 380 ('*Movitor*'); *Re Oasis Merchandising Ltd* [1998] Ch 170 ('*Oasis*').
- 10 However, the right to bring a preference or similar action, as distinct from the proceeds recovered in such an action, cannot be brought by any person other than the liquidator. Thus, it has been held that money recovered in preference actions that can only be brought by the liquidator are not caught by a charge over the company's current and future assets. The basis for this 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 recover the "preference" property.
- 11 In *Kratzmann* the High Court drew a distinction between two types of preferential transactions. The first, a conveyance of specific property, was said to be recoverable *in specie*. In the second case, a transfer of money, it was held that there was no claim to specific or identifiable property, and thus the creditor had to prove in the respondent's liquidation. In this context, the Court also observed that while it may be that money paid was subject to a charge at the time of payment, the money recovered is not the same money, and therefore preference recoveries on this basis cannot be said to form part of the assets of the company.

- 12 The liquidator's right to recover property was said to be independent of any right belonging to the insolvent company, and therefore cannot be said to be subject to any prior charge. However, preference recoveries of specific property were said in *Kratzmann* to be subject to a prior charge. The High Court in *Kratzmann* pointed out that recovered preference money does not vest in the liquidator.
- 13 The South Australian case of *Re Fresjac Pty Ltd (in liq); Campbell v Michael Mount PPB* (1995) 65 SASR 334 affirmed the *Kratzmann* distinction between the recovery of specific and identifiable property (to which a charge could attach) and the recovery of money (which would not be covered by a charge). Though, as in *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360, the appropriate order upon a preference recovery is an order of payment of money to a company, this does not entail the result that the money is caught by a floating charge.<sup>1</sup> Doyle CJ explained:
- Once the money of the company was paid to the defendant, the money of the company had lost its identity. At the time of the payment and immediately thereafter the company had no rights in relation to the money paid to the defendant. Upon the making of the winding-up order the payment by the company to the defendant as avoided, having been made after the commencement of the winding up, and the result of that avoidance is that a new right to compel repayment of an equivalent amount of money arose. ... [I]t is not possible, as it seems to me, to analyse the matter as if the payment had never taken place.
- 14 In 1992, the Corporations Law was amended so as to include a new self-contained voidable transaction regime. One of the provisions included was section 588FF, which enables the court to make a variety of remedial orders in respect of what are defined as 'voidable transactions'. Property may be transferred 'to the company'. The provision no longer refers to preferential transactions as being 'void as against the liquidator'.
- 15 A question arises whether this language had the effect of reversing or overturning the decision in *Kratzmann*. The argument, essentially, is this:
- a. A charge may capture future assets of a company acquired after the charge crystallises;
  - b. A charge could therefore capture preference recoveries if those recoveries are property of the company;
  - c. The *Kratzmann* approach assumes that preference recoveries are not property of the company, and therefore cannot be subject to a charge; and
  - d. The new amendments, by stipulating that recoveries are to be paid or transferred to the company, have the effect of either confirming or deeming the recoveries to be the company's property, hence making them charged assets.<sup>2</sup>

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<sup>1</sup> *Italiano* (2010) 80 ACSR 680, 690.

<sup>2</sup> *Ibid*, 692 [49].

- 16 That is, an explanation proffered as to why secured creditors cannot presently have the benefit of recovered assets is that the action is vested in the liquidator rather than the company and thus is not property of the company the subject of a charge. By stipulating that monies recovered are to be paid to the company, the legislation, some have argued, reverses this principle. Against this, it is noted that there was no suggestion to this effect in the explanatory memorandum.<sup>3</sup>
- 17 This argument was raised before Jones J in *Jonsson Milner & Riaps Pty Ltd (in liq) v Tim Ferrier Pty Ltd* [2001] QSC 10. Jones J suggested in obiter (at [16]) that the 1992 amendments did indeed reverse *Kratzmann*, with the effect that preference recoveries would be subject to a charge over future assets.
- 18 The opposite approach was taken by Santow J in *SJP Formwork (Aust) Pty Ltd (in liq) v DCT* (2000) 34 ACSR 604. Santow J noted that in *Kratzmann*, the amount recovered was ordered to be paid to the company, and that this was confirmed as the correct order in *Octavo*. Section 588FF, therefore, in allowing payment directly to the company, was consistent with these earlier authorities rather than conflicting, and therefore the 1992 amendments were said not to have had the effect of overturning *Kratzmann*.
- 19 Santow J's approach was preferred over *Jonsson Milner in Tolcher v National Australia Bank* (2003) 44 ACSR 727 and in *New Cap Reinsurance Corp Ltd v Faraday Underwriting Ltd* (2003) 47 ACSR 306, 325 (reversed on appeal in *AssetInsure Pty Ltd v New Cap Reinsurance Corp Ltd* (2004) 61 NSWLR 451, though on grounds unrelated to the present matter).
- 20 The present position therefore is that there is a distinction as between the recovery of money and the recovery of property, and that preference recoveries of money are not subject to charges over the company's future property. It was this position that Finkelstein J described in *Italiano* as 'rest[ing] on uncertain and, perhaps, unsound rules and distinctions'.

### Competing Policy Considerations

- 21 Though Finkelstein J decided *Italiano* consistently with *Kratzmann*, his Honour expressed misgivings in relation to the policy underlying that decision, saying at [62] as follows:
- The question whether a charge should attach to preference recoveries ought not depend on the nature of the property recovered. Saying that money recoveries are held on some kind of trust for creditors explains the mechanism by which that money is excluded from the company's general assets, but does not explain why it should be excluded in the first place.*
- 22 This followed a summary (from [52]–[61]) of the factors that his Honour considered as being relevant to the question of whether *Kratzmann* was correct as a matter of principle or policy.
- 23 The Committee, having considered these competing policies, takes the opposite view to his Honour, and submits that the position that recovered preference monies

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<sup>3</sup> *Ibid* [48].

are not available to secured creditors is the correct and preferable position as a matter of policy.

- 24 Finkelstein J cites a number of articles at [52] which give reasons as to why this is the case. In particular, Andrew Keay, "Preference Recoveries: Who is Entitled to Them?" (1996) 14 *C&S LJ* 442 suggests that the doctrine contributes to the equality of creditors, and deters the dismemberment of the company in circumstances of impending liquidation.
- 25 This second argument is difficult to understand, in that it seems to ignore the fact that there is incentive for unsecured creditors to pursue payment under the existing *Kratzmann* distinction because, even if a payment is clawed back, the unsecured creditor has still increased the quantum of funds available to the general body of creditors at the expense of the secured creditor. On this basis, removing the *Kratzmann* distinction and making recovered funds available to secured creditors as they would have been but for the antecedent transaction will surely *decrease* the incentive of unsecured creditors to pursue early payment.
- 26 Perhaps Keay's meaning is that, if unsecured creditors know that once a corporation is insolvent, they will receive next to nothing, then they will pursue payment from a corporation as early as possible so that payment occurs before the period during which transactions can be clawed back begins. However, this incentive exists irrespective of whether the *Kratzmann* distinction does also.
- 27 The direct correlation between quantum of clawed-back funds and quantum of the pool of funds available to general creditors (instead of secured creditors) that exists by reason of the doctrine that clawed-back monies are available only to unsecured creditors provides clear incentive for unsecured creditors to pursue and bring about as many unfair preferences and other voidable transactions as possible. This quite clearly runs contrary to the deterrence principle. Accordingly, the Committee views this as being a consideration against retention of the *Kratzmann* doctrine, as apparently did Finkelstein J (at [61]).
- 28 Keay also suggests that charges over future property should only capture future property that comes into existence in the ordinary course of business, and that preference recoveries cannot be said to constitute the ordinary course of business.<sup>4</sup>
- 29 Further, Finkelstein J noted the concern that unsecured creditors should not have to bear the cost of unsuccessful preference recoveries when the proceeds would be subject to a charge.<sup>5</sup>
- 30 The Committee would add to these considerations a further two: first, that absent a benefit to unsecured creditors, the unfair preference provisions are difficult to justify; and, second, that the chargee would twice benefit were it the case that recovered preference monies were subject to a charge.
- 31 Payments that constitute unfair preferences are neither inherently unlawful nor inherently immoral. They constitute the payment of money that is in fact owed to a person who has rendered some form of service or provided a good. The recipient is

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<sup>4</sup> Ibid, [59]

<sup>5</sup> Ibid, [60].

entitled to the money. The payment occurs, ordinarily, in the ordinary course of business. Absent conditions of insolvency, the transaction would stand unquestioned.

- 32 It is only because the company making the payment happens to be insolvent at the time the payment is made that the legislature has made a policy decision (based on the principles of protecting the general body of unsecured creditors and deterring the dismemberment of the company) that it would be 'unfair' in the circumstances for a creditor to receive full payment of a debt from an insolvent company where other unsecured creditors are receiving significantly less than the full amount owed them. This is what justifies the unwinding of an otherwise lawful and irreproachable transaction.
- 33 If, therefore, the *Kratzmann* distinction is abolished and secured creditors would get the benefit of the recovery, much of the rationale for unwinding the transaction—the protection of unsecured creditors—vanishes. Floating charges necessarily contemplate that transactions will occur in the ordinary course of business. The unwinding of the transaction cannot therefore be justified on the basis that it is necessary for the protection of unsecured creditors (because they will not benefit from it) nor because it was contrary to the terms of the charge.
- 34 Next, as the holder of a fixed and floating charge over the undertaking of the relevant company will have first recourse to the assets of the company in a winding up, that chargee will ordinarily already have the benefit of the asset or service in respect of which the money is paid. By way of example, if the payment constitutive of the unfair preference was paid in respect of a printing press provided by the unsecured creditor to the company, then the secured creditor will have the benefit of the proceeds of the sale of that printing press in the winding-up of the company. If the chargee is also able to recover the monies paid to the unsecured creditor in respect of the printing press, then the chargee has benefitted twice in respect of the same asset.
- 35 It might fairly be said against this that the secured creditor, like the unsecured provider of the printing press, has provided something (ordinarily money or some other form of credit) in respect of which it has not received full repayment, and thus it is not particularly objectionable that the chargee (who has taken the opportunity of bargaining for security) receives the benefit of any and all payments and assets until the value of its provision of credit to the company is met, and that it should not matter whether the payment in question is a payment in respect of something that the chargee has already had the benefit of.
- 36 The answer, perhaps, is that the *Kratzmann* doctrine constitutes the middle ground: the chargee, having bargained for security, has first recourse to the assets of the company, save to the extent that in the ordinary course of business the company pays to an unsecured creditor a sum that is identifiable as being in respect of an asset or service provided by the unsecured creditor.
- 37 Finally, it is ordinarily the case that the payment of a particular sum to unsecured trade creditors is unlikely to be particularly prejudicial to a chargeholder or secured creditor, particularly as that chargeholder can have first recourse to the remaining assets of the company. Indeed, in *Italiano*, the amount in question was sufficiently small that the bank did not even appear at the hearing of the matter. While it is not

clear how much weight should be given to this consideration, it is quite clear that the removal of even a comparatively nominal sum (\$50,000, in *Italiano*) from the asset pool available to unsecured creditors is far more likely to have a deleterious effect on those unsecured creditors than its effect on the secured creditor should that secured creditor be prevented from accessing the sum.

- 38 Against the distinction, it has been said that firstly, liquidators will frequently be in a position where it is possible to choose either a proprietary or personal remedy, which creates the undesirable situation wherein the liquidator's choice has the effect of benefiting one class of creditor at the expense of the other. The liquidator, then, has the ability 'to "deprive", selectively, either a secured creditor or the general body of creditors, of recoveries simply by electing to institute proceedings under a particular section of the Act rather than another.'<sup>6</sup>

### **Conclusion – Policy**

- 39 Considerations arguably in favour of retaining the *Kratzmann* doctrine:
- a. Equality;
  - b. Deterring dismemberment;
  - c. Protection of unsecured creditors generally;
  - d. Increasing the disdain for and disaffection with the insolvency process in unsecured creditors;
  - e. Secured creditors have already received the benefit of the good or service in respect of which the payment is made;
  - f. To change the doctrine would require amendment of the procedure by which preferences are recovered.
- 40 Considerations against the *Kratzmann* doctrine.
- a. Enriches unsecured creditors in insolvency at the expense of secured creditors without clear justification;
  - b. Increases incentive for unsecured creditors to pursue payment prior to insolvency;
  - c. Removes the potential for the liquidator's choices as to how payments are pursued (preference/misfeasance) to affect the eventual distribution of money in insolvency.
- 41 The Committee submits that the arguments or considerations that weigh in favour of the *Kratzmann* doctrine outweigh those that militate against the doctrine, and is therefore of the opinion that the *Kratzmann* doctrine ought to be retained.

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<sup>6</sup> Ibid, [55].

## Employee Entitlements and Free Assets

- 42 Certain entitlements can be paid to employees out of floating charge assets under section 561 or 433. Section 561 provides that so far as the property of the company available for payment of creditors other than secured creditors is insufficient to meet payment of those entitlements, payment of that debt or amount must be made in priority over the claims of a chargee in relation to a floating charge created by the company and may be made accordingly out of any property comprised in or subject to that charge.
- 43 In *Buchler v Talbot* [2004] 2 AC 298, it was said that where a company is wound up and a floating charge over its assets has crystallised, two funds are created. The first comprises charged assets that are the beneficial property of the chargee, subject to the company's equity of redemption. The second fund comprises non-charged or 'free' assets which are the property of the company. As a general rule, each fund bears its own debts.
- 44 Priority claims, such as those under section 561, are only to be made out of the charged fund if the free assets are insufficient to meet them. According to Finkelstein J, '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 realisation, *[t]hat 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.*'<sup>7</sup>
- 45 This is so, according to Finkelstein J, for the following two reasons:
- a. To ignore potential future realisations and to take assets away from a secured creditor only to realise later that the secured creditor was not required to pay out particular creditors is, to say the least, unjust.<sup>8</sup>
  - b. The reference in section 561 to property being 'available' does not connote property 'at hand'. The connotation instead is to property that is available in the sense of being 'free' property rather than 'charged' property.<sup>9</sup>
- 46 Finkelstein J concluded that section 561 mandates payment of priority claims out of charge assets only when it becomes clear that the liquidation will not realise free assets sufficient to meet those claims.<sup>10</sup> This has been followed in *Re Great Southern Ltd (recs and mgrs apptd) (in liq); Ex parte Thackray* [2012] WASC 59 at [11] (2012) 260 FLR 362.
- 47 Section 433, which applies in respect of a receivership rather than a winding up, does not have the same requirement of payment only out of free assets, by reason that payments so made can be 'recouped as far as may be out of the assets of the

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<sup>7</sup> Ibid, 695–6 [70].

<sup>8</sup> Ibid, [71].

<sup>9</sup> Ibid, [72].

<sup>10</sup> Ibid, [73].

company available for general creditors'. The right of recoupment persists notwithstanding its removal from statute.<sup>11</sup>

### The Question of Policy

- 48 If employee entitlements are paid out of funds that are properly the subject of a floating charge, and a sum is later recovered that would have been sufficient to meet those entitlements, but the chargeholder cannot access those funds due to the rule in *Kratzmann*, the result is that the unsecured creditors benefit at the expense of the chargeholder.
- 49 Finkelstein J utilised the doctrine of subrogation to arrive at what he considered to be the just result—namely, that the bank could access the preference recoveries—where this result was otherwise prevented by the rule in *Kratzmann*.
- 50 However, in order that the subject payments could give rise to a right of subrogation, Finkelstein J ruled that the interim payment of priority entitlements constituted a breach of trust, the result of which is the undesirable result that liquidators may, to avoid such a breach, '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 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 the company has sufficient free assets available'.<sup>12</sup>
- 51 As it stands, liquidators are in the difficult position wherein to pay employees before the free asset position is clear may constitute *ex post facto* a breach of trust, and failure to so pay employees may occasion upon those employees substantial hardship.<sup>13</sup>
- 52 The Committee is of the view that there is no reason in principle why a payment of employee entitlements from property comprised in or subject to a charge should not be treated as an advance which, in the event of recovery, would be given priority, similar to the rights conferred under section 560 of the Act.
- 53 Finkelstein J refers in *Italiano* to the principle that when a company is wound up and a floating charge over its assets has crystallised, two funds are created: a fund of charged assets that are the beneficial property of the chargee; and a fund of uncharged assets that is available to unsecured creditors of the company.
- 54 In *Italiano*, the secured creditor was owed \$1.2m and the unsecured creditors about \$3.8m. Employee entitlements were approximately \$250k. The sum of \$250k was paid out of the proceeds of the sale of charged assets which realised around \$500k. The voidable preference in question was \$50k.
- 55 The free asset base ("FAB") of the company is, put simply, the assets of the company minus the amount owed to secured creditors. If the secured creditor is owed significantly more than the worth of the company, and has a floating and fixed charge over all of the assets of the company, then absent voidable preferences, it is

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<sup>11</sup> Ibid, [75]–[76].

<sup>12</sup> Ibid, 701.

<sup>13</sup> Ibid, [100].

quite clear that the FAB will be negative and the employee entitlements will come out of the secured creditor's funds. Where the FAB is clearly positive and exceeds the amount owed to employees, then the entirety of the entitlements will come out of the FAB. Where the FAB is positive but less than the sum owed to employees, then the FAB will be exhausted and the remainder will come out of the sum owed to secured creditors.

- 56 The free asset position will only be unclear, absent *Kratzmann*, where (1) the assets of the company are less than the amount owed to the secured creditor by an amount that is again less than the potential preference recovery, or (2) where the assets outweigh the amount owed to the secured creditor, but by an amount less than is necessary to pay employee entitlements.
- 57 Thus, if neither of those conditions were satisfied—that is, the FAB is negative and would remain so notwithstanding recovery of the voidable preference, or FAB was positive and greater than the amount of employee entitlements—then the free asset position is not unclear. In the first circumstance, the secured creditor will always have to pay the employee entitlements and thus will suffer no prejudice from early payment given that the secured creditor can have the benefit of any subsequent recovery. In the second circumstance, the employee entitlement will always come out of the free asset base.
- 58 This position is complicated by the *Kratzmann* principle. Where money that comes in through voidable preferences is unavailable to secured creditors, it is necessarily the case that recovery of a voidable preference in any amount alters the free asset position. Even if, for instance, the free asset position is be significantly negative—the secured creditor is owed \$1m more than the assets of the company—with *Kratzmann* the recovery of a voidable preference of \$50k creates a fund of \$50k that is available for payment of creditors other than secured creditors where previously there was no such fund, and thus the free asset position is unascertainable until the recovery action either succeeds or fails.
- 59 This is why, in *Italiano*, notwithstanding that it appears the secured creditors would not be paid in full and thus that they would have to bear the cost of employee entitlement payments, the position was altered by recovery of the fairly nominal sum of \$50k.

### **Proposed Amendments**

- 60 Fortunately, the problem that arises due to the necessary uncertainty as to free assets that arises out of *Kratzmann* is fairly easily rectified. A section 561 payment by the secured creditor of employee entitlements could be treated, in circumstances where voidable preferences may be recovered, as a conditional advance in same way as a payment under s 560, where the condition is that to the extent there are thereafter free assets of the company (which accordingly should first have been used to satisfy employee entitlements) they are used to repay the advance by the secured creditor.
- 61 This could be achieved through amendment of s 561, couched in the following terms or similar:

**561 [Priority of employees' claims over floating charges]**

- (1) If the liquidator of a company determines that the property of the company available for payment of creditors other than secured creditors (the free asset base) is insufficient to meet payment of:
  - (a) any debt referred to in paragraph 556(1)(e), (g), or (h); and
  - (b) any amount pursuant to subsection 558(3) or (4) is a cost of the winding up, being an amount that, if it had been payable on or before the relevant date, would have been a debt referred to in paragraph 556(1)(e), (g), or (h); and
  - (c) any amount in respect of which a right of priority is given by section 560Payment of that debt or amount must be made in priority over the claims of a chargee in relation to a floating charge created by the company and may be made accordingly out of any property comprised in or subject to that charge
- (2) A liquidator may make a determination as to the sufficiency of the free asset base of the company at any time during the liquidation.
- (3) A liquidator must not, in making the determination as to the sufficiency of the free asset base of the company, take into account any effect that recovery of preferences under s 588FA may have on the sufficiency of the free asset base.
- (4) If a liquidator makes a payment pursuant to subsection (1) in priority over the claims of a chargee in relation to a floating charge in circumstances where there is at that time or subsequently an amount available for payment of creditors other than secured creditors (whether that amount is the result of recovery of a preference under s 588FA or otherwise) the chargee shall be paid an amount equal to the payment made under subsection (1) out of the assets of the company available for payment of creditors other than secured creditors, or if the amount available for payment of creditors other than secured creditors is less than the payment under subsection (1), the chargee shall be paid the amount available for payment of creditors other than secured creditors.

62 The effect of this section would be such that a liquidator may make a preliminary judgment as to the sufficiency of the assets of the company, without considering the possibility of preference recoveries. If the free asset position appears, absent preferences, to be non-positive, the liquidator may make the payment out of charge assets. The effect of subsection (4) is to provide that to the extent the liquidator's judgment is incorrect and there were free assets at the time the judgment was made, or free assets later come into the property of the company, the liquidator must use those assets to repay the amount to the chargee that should have come out of the free assets of the company.

63 This would allow liquidators to make payments to employees early in a liquidation out of whatever funds happen to be available at the time, and would ensure that to the extent those funds happen to be, or are later revealed to be, properly those of the chargee, the chargee is compensated for the early payment and thus has no reason to object to the making of the early payment.

64 Additionally, should the legislature instead decide to abolish through statute the *Kratzmann* principle, section 561 should nonetheless be amended, as this would provide for those situations (albeit far rarer) where the free asset position could still be altered by recovery of a preference.

### **Conclusion**

65 The Committee accordingly makes the following submissions:

**S1: The rule in *Kratzmann* should be retained, with the effect that secured creditors of a company can have the benefit of property that would be subject to a charge that is recovered in *specie*, but that money recovered pursuant to an unfair preference goes to the benefit of the unsecured creditors. Notwithstanding this retention of the *status quo* it is also recommended that:**

- (a) The effect of the 1992 amendments be clarified
- (b) There be some form of clarification or guide for liquidators to determine which cause of action is appropriate in which circumstances, in order to avoid the situation where liquidators of a company can arbitrarily benefit one class of creditors or another based on selection of cause of action.

**S2: There be legislative amendment in the proposed terms or similar, with the effect that:**

- (a) Liquidators are able to make priority payments of employee entitlements where in their judgment it is appropriate to do so, notwithstanding that the free asset position is not entirely clear;
- (b) To the extent that such priority payments are made out of property that is properly the subject of the floating charge, the secured party should have a statutory right of recoupment similar to s 560 with the effect that secured creditors are not prejudiced by early payment of employee entitlements, and that insolvency professionals are not found to have committed a breach of trust as a result of such early payment.

### **Contact details**

66 If you have any questions in relation to this submission, in the first instance please contact the Committee Chair, Michael Lhuede, by phone on 03-8665 5506 or via email: [mlhuede@piperalderman.com.au](mailto:mlhuede@piperalderman.com.au).

Yours faithfully,



John Keeves  
**Chairman, Business Law Section**