WHEN INSOLVENCY MEETS LEASEHOLD AND THE LESSONS OF DICK SMITH

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INTRODUCTION

1. There are few Australian companies that truly embody the Australia identity such as the likes of Dick Smith or Dickies as it was affectionately known. The Australia-wide chain of retail stores having been founded in Sydney 1968 occupied the psyche of many of its loyal customers as the source of high quality consumer electronic goods, hobbyist electronic components and electronic project kits. It was for many the store you could go to for clone computers, such as the Commodore 64 and the Super-80, answering machines and novelty phones. The store went from strength-to-strength during the 70's, 80's, 90's and 2000's.
2. Having been taken over by Woolworths in 1980 and 1982 and then sold to Anchorage Capital Partners in September 2012, the company was later floated in December 2013. At the time of its listing, "Dickies" market capitalisation was valued at $520 million. Being nothing short of impressive, such success can only be attributed to the man himself. Richard Harold "Dick" Smith – businessman, entrepreneur and political activist. A man renowned for his tenacity, audacity and larger-than-life personality. Indeed, in the lead up to 1 April 1978 (i.e. April fool's day), Smith touted to all and sundry his intention to transport an iceberg from Antarctica to Sydney Harbour. The angle? To provide small ice cubes of pure Antarctic water to Sydneysiders for ten cents each and marketed – in true Dick Smith style – as "Dicksicles".
3. Although without the purported precious cargo, Smith emerged on a barge in Sydney Harbour on 1 April 1978 with a significant amount of firefighting foam and shaving cream. Once the rain set in the structure slowly disintegrated.
4. It would seem that the history of Dickies has, at least in recent times, taken on a similar fate to the Smith foam-berg having been liquidated on 26 July 2016. By the time of its liquidation, the Dick Smith Companies, concerned some 11 wholly owned subsidiary companies such as Dick Smith Sub-Holdings and Dick Smith Electronics. The Dick Smith Group operated consumer electronics both in retail outlets and online in Australia and New Zealand which totalled 390 locations with in excess of 3,000 employees.
5. On 4 January 2016, Dick Smith Holdings and its Australian subsidiaries were placed into Voluntary Administration. Following that appointment, the companies' Banks appointed Receivers and Managers to recover assets of which were subject to their security.

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6. The Receivers and Managers marketed the Dick Smith businesses for sale in early 2016 without success, due in part, to considerable losses during the 2015/2016 financial year, difficult trading conditions influenced by the highly competitive electronics market and the failure to address product mix and fully stock stores. The failure of the franchise was collectively due to the company losing its market share, problems with the over supply of obsolete or inactive stock, cash pressures and an inability to obtain favourable credit terms in its lenders.

7. The Creditor's Report into the Dick Smith Companies of 13 July 2016 reveals that the total shortfall to creditors will be in excess of $260 million. In respect of unsecured creditors, the Report commented that there is no expectation that unsecured creditors will receive a return unless recoveries during the liquidation process are significant. Included in that list of unsecured creditors were gift cardholders, shareholders and most importantly for our purposes, landlords.

8. The Dick Smith Group was regarded as being insolvent from at least 23 December 2015.

9. In respect of the landlords as unsecured creditors, many have commented that they are confident of the potential for the stores to be re-let. As but one of many landlords to Dick Smith, AMP Capital has indicated that their worst case scenario would be $30 million converted to a loss if the stores were left vacant. Although some of that debt will be relieved by automatic rent increases, exit payments and occupancy costs, it sends a salutary message to all landlords of the risks associated with corporate tenants becoming insolvent, even for those seemingly most impervious corporate juggernauts such as Dick Smith.

10. With that in mind, this paper will examine the statutory framework of the *Corporations Act 2001* (Cth.) concerning the meaning and indicators of insolvency, external administration of corporations, mechanisms available to secure debts owed under leasehold and practical measures to implement for landlords to avoid losses from an insolvent tenant.

CORPORATIONS ACT 2001 – WHAT DOES IT MEAN TO BE INSOLVENT?

11. The meaning of insolvency as defined antithetically under section 95A of the Corporations Act provides that:

> "(1) A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.
> (2) A person who is not solvent is insolvent."

12. In broad terms, the commercial realities of a debtor need to be considered with respect to the issue of tests of insolvency. For example, in *Sandell v Porter* (1966) 115 CLR 666, Barwick CJ remarked that the assessment of a debtor's insolvency is not limited to funds immediately available to pay a debt (at 671):

> "The conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity. It is the debtor's inability, utilizing such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates insolvency."

13. There are two available tests of insolvency to determine whether a person is solvent or otherwise – the "cash flow" test and the "balance sheet" insolvency test.

Cash Flow

14. A person or company will be regarded as insolvency if they are unable to pay their debts when they fall due and payable. Reflecting the *Sandell* position, this will mean insufficiency of cash or other realisable assets available to pay creditors when demands are made.[1]

Balance Sheet

15. By contrast, the balance sheet metric concerns the total liabilities outweighing assets therefore meaning there are insufficient assets to discharge the company's liabilities. There has been criticism that the balance sheet test is inadequate as a means of determining insolvency by virtue of it lacking the necessary commercial realities of trade.[2]

16. The prevailing standard has therefore become the cash flow test. It has been said that it is not appropriate to base an assessment of insolvency on the prospect of the debtor being able to pay at some later date. The issue is simply whether the debtor can pay their debts as they become due.[3]

17. The Victorian Supreme Court made the observation that the focus of the cash flow test of insolvency is the liquidity and viability of the company's business: *Crema Pty Ltd v Land Mark Property Developments Pty Ltd* (2006) 58 ACSR 631; [2006] VSC 338 at [141].

18. In *Smith v Boné* [2015] FCA 319, Gleeson J at [24] wrote that:

> "Section 95A adopts a 'cash flow' test of insolvency which is directed to income sources that are available to the company and expenditure obligations it has to meet, rather than a balance sheet test which focuses on the value of the company's assets and liabilities reflected in the company's books, although a balance sheet test can provide context for the application of the cash flow test."[4]

19. Further, in *Lewis v Doran* (2004) 50 ACSR 175; [2004] NSWSC 608, at 198 [106], Palmer J said:

> "I think that I must approach the application of s 95A of the CA with two considerations in mind. First, the words of s 95A must be construed as they stand, without addition or subtraction. Second, the law both before and after the enactment of s 95A is unequivocally and emphatically clear that insolvency is, first and last, a question of fact 'to be ascertained from a consideration of the company's financial position taken as a whole. In considering the company's financial position as a whole, the Court must have regard to commercial realities. Commercial realities will be relevant in considering what resources are available to the company to meet its liabilities as they fall due, whether resources other than cash are realisable by sale or borrowing upon security, and whether such realisations are achievable': *Southern Cross Interiors Pty Ltd (in liq) v DCT* [2001] NSWSC 621; (2001) 53 NSWLR 213 at 224".

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[1] *Crema Pty Ltd v Land Mark Property Developments Pty Ltd* (2006) 58 ACSR 631; [2006] VSC 338 at [141] and [142].
[2] *Re Tweed Garage Ltd* [1962] Ch 406, 410.
[3] *Crema Pty Ltd v Land Mark Property Developments Pty Ltd* (2006) 58 ACSR 631; [2006] VSC 338 at [141] and [142]; *Smith v Boné* [2015] FCA 319.
[4] *Campbell Street Theatre Pty Ltd (recs and mgrs apptd) (in liq) v Commercial Mortgage Trade Pty Ltd* [2012] NSWSC 669 at [23], citing *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213; 188 ALR 114 ; 39 ACSR 305; [2001] NSWSC 621 (Southern Cross); *Plymin (No 1); Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1; 70 ACSR 1; [2008] WASC 239.

INDICATORS OF INSOLVENCY

20. In order to arrive at the conclusion of whether a company is insolvent requires the court to examine common indicators of insolvency. A non-exhaustive list was summarised in *Australian Securities and Investment Commission v Plymin (No 1)* [2003] VSC 123 by Mandie J and concerned the following:

    20.1. Continuing losses;

    20.2. Liquidity ratios below one;

    20.3. Overdue Commonwealth and State taxes;

    20.4. Poor relationship with present bank, including inability to borrow further funds;

    20.5. No access to alternative finance;

    20.6. Inability to raise further equity capital;

    20.7. Suppliers placing company on cash on delivery or otherwise demanding special payments before resuming supply;

    20.8. Creditors unpaid outside trading terms;

    20.9. Issuing of post-dated cheques;

    20.10. Dishonoured cheques;

    20.11. Special arrangements with selected creditors;

    20.12. Solicitors' demands, summonses and the like

    20.13. Payments to creditors of rounded amounts not reconcilable to specific invoices; and

    20.14. Inability to produce timely and accurate financial information to indicate trading performance and financial position, and to make reliable forecasts.

21. The list was referred to with approval by Mansfield J in *Lewis, Re Damilock Pty Ltd (in liq) v VI SA Australia Pty Ltd* [2008] FCA 1801; (2008) 252 ALR 533 at [16]. Mansfield J noted that:

> "[i]n any particular case, one or more of those factors, or other factors, may have particular significance and one or more of them may not exist. The absence of one or more of those factors does not, of itself, establish solvency."

22. Although the indicia of insolvency is relevant to the court's assessment process, they serve as helpful indicators to those working in trade and commerce who are concerned about their customer paying outstanding debts or those corporate tenants who are just a little bit behind in their rent. As the case may be, it is usually the power of hindsight that demonstrates the financial ruin of company when it is all too late. That being said, the writing can often be on the wall for creditors who choose to ignore those facts. The advice at the outset is to consider the warning signs outlined in *Plymin,* above.

EXTERNAL ADMINSTRATION – WHAT IS IT AND HOW DOES IT AFFECT THE PAYMENT OF RENT?

23. To understand your client's position as a landlord when attempting to protect them against insolvent tenants, it is useful to understand the mechanics of external administration.

24. In keeping with the story of Dick Smith, common forms of external administration concern the appointment of Voluntary Administrators, privately appointed Receivers and Managers and Liquidators. Each will be dealt with in turn, but in no way comprehensively.

Voluntary Administrators

25. Viewed in practice as the most common form of external administration, voluntary administration allows a company in financial distress the opportunity to maximise the chances of its continuing existence via restructuring or, if not possible, to result in a better return for the company's creditors and members than would result from an immediate winding up of the company.[5] For example, such administration may more readily facilitate the sale of a business as a going concern than otherwise.

26. The essential role of an administrator is to control an company's business, property and affairs, terminate of dispose of business of that company, and perform any function that the company or any of its officers could exercise in the position as an officer of the company.[6]

27. The impact of the appointment of administrators is that the company's business, property and affairs fall within the control of the administrators.[7] During this period the administrator has legal title to the company's property acting as agent in that position.[8] Further, the appointment of an administrator places on the company a statutory moratorium in respect of legal proceedings that are current or proposed.[9]

28. In respect of pre-existing contractual arrangements, administrators will not be liable for the continued performance of such contracts. Similarly, administrators do not have powers to disclaim or disavow contracts, unlike their liquidator counterparts. Rather, any repudiatory conduct of an administrator, subject to the type of contract, may be met with a claim for damages. Administrators will however be liable when entering into new contracts during their period of appointment.[10]

29. For creditors who hold security interests under the *Personal Properties Securities Act 2009* (Cth.) ('**PPSA**") such as a PPS Lease, which is discussed in more detail below, the appointment of administrators may mean the difference between your landlord client ranking as a secured creditor or being cast adrift with the rest of unsecured creditors. If the security interest is not perfected, it will mean the

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[5] *Corporations Act 2001* (Cth.), part 5.3A.
[6] *Corporations Act 2001* (Cth.), section 437A(1).
[7] *Corporations Act 2001* (Cth.), section 437A.
[8] *Corporations Act 2001* (Cth.), section 437B.
[9] *Corporations Act 2001* (Cth.), section 440D.
[10] *Corporations Act 2001* (Cth.), section 443A.

security interest will vest in the insolvent company under section 267 of the *PPSA*.[11]

30. Restrictions also apply in respect of secured lessors and thirds parties who are prevented from taking possession during administration or seeking distress for rent, subject to the consent of the administrator or leave of the Court.[12] So, unfortunately, detaining items to cover unpaid rent is not an option.

31. An administrator is personally liable for debts incurred during the administration period in respect of goods purchased, property hired, leased or occupied.[13] This provides some comfort for landlords, as these debts will concern the payment of rent for a pre-existing lease.[14] That period of occupations begins five (5) business days from his or her appointment. Of course that liability can be avoided if the administrator gives notice within that five (5) business day period that the company does not wish to exercise its rights in relation to the property.[15]

Receivers and Managers

32. Receivership may apply to corporations, partnerships and individuals. The most common receivership applies to corporations and follows as a result of a secured creditor appointing a receiver to a company that has, for example, defaulted on loan repayments or other such security agreements. The purpose of the appointment is usually narrow and designed to recover the loan from the sale of its security.

33. Under section 51E of the *Corporations Act,* a secured creditor is a creditor whose debt is secured by a security interest. Security interest is then defined under section 51A as a PPSA security interest, defined below, or a charge, lien or pledge.

34. Part 5.2 of the *Corporations Act* regulates receivers and managers who are collectively known as "controllers" under section 9 of the Act. A controller for the purposes of section 9 is defined as a receiver, or receiver and manger of company property and anyone else who is in possession or has control of that property for purpose of enforcing a security interest.

35. Receivers may be privately appointed under a security agreement/instrument/debenture[16] or appointed by the Court. Only private appointments will be discussed, although the powers and responsibilities of a controller are much the same. The appointment is usually something done as a consequence of a creditor when assets of a company are under threat of the company impending or current insolvency. In accordance with the security agreement certain events of default may be defined to trigger a secured creditor's moment to take action.

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[11] See: *Re Carpenter International Pty Limited* [2016] VSC 118 at [158] – [166] per Cameron J.
[12] *Corporations Act 2001* (Cth.), section 440B.
[13] *Corporations Act 2001* (Cth.), section 443A(1)(a)-(c).
[14] *Corporations Act 2001* (Cth.), section 443B.
[15] *Corporations Act 2001* (Cth.), section 443B(3); *In the matter of Mothercare Australia Limited (administrators appointed)* [2013] NSWSC 263 at [2] per Black J.
[16] A debenture is defined as an undertaking to repay money lent which may or may not involve a security interest over property owned by the borrow: section 9, *Corporations Act 2001* (Cth.).

36. The distinction between a receiver and a receiver and manager is somewhat academic given that the powers of both pursuant to a security agreement or debenture is also widened by virtue of sections 420 and 90 of the Act.

37. The powers of a receiver are found within the debenture/security agreement which gives rise to the appointment. Such powers are also expanded by virtue of section 420 of the Act which broadly provides under subsection (1) that:

> "a receiver of property of a corporation has power to do, in Australia and elsewhere, all things necessary or convenient to be done for or in connection with, or as incidental to, the attainment of the objectives for which the receiver was appointed."

38. The power of the receiver to carry on business must be used to fulfil the purpose of his or appointment. As discussed by the learned authors of Keay's Insolvency (9th edn):

> "in the case of the 2015 receivership of Dick Smith group of companies, the receiver carried on the business through the numerous company outlets while a buyer was sought. During that process, the receiver nevertheless decided to close various outlets and other parts of the business that were found to be unprofitable, and to terminate relevant employees."[17]

39. Although the receiver owes duties to the company its primary duty is to the party who appointed the receiver to undertake tasks outlined within the debenture or security agreement. There is no obligation on the receiver to carry on the business, however the continuation of such trade will mean the receiver is liable for all debts incurred as outlined under section 419 of the Act.

40. Under the general law, a receiver is not liable in respect of pre-existing contracts between the company and creditors if the receiver has not consented to liability.[18] Despite being in occupation of the premises, a receiver will not be regarded as having accepted or endorsed the terms of the lease.

41. By virtue of section 419A of the Act however, a receiver is will be liable for rent payable under a pre-receivership lease if the receiver remains in occupation for more than five (5) business days from appointment. As in the case of a voluntary administration, a receiver can notify the lessor that they do not propose to occupy the premises and will therefore be relieved of any liability.[19]

42. Receivership does not create a moratorium on proceedings meaning that unsecured creditors may recover their debts through traditional legal channels or commence winding up proceedings. That being said, litigation during a period of receivership is often a case of throwing "*good after bad*".

Liquidation

43. As discussed, having resolved to wind up the electronics retailer, the creditors of Dick Smith sought to place the company into liquidation. In this context administrators will transition into the role of liquidators, which is not an uncommon event.

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[17] M. Murray and J. Harris, *Keay's Insolvency: Personal and Corporate Law and Practice* (9th edn, 2016), 641.

[18] *ASIC v Letten (No 13)* [2011] FCA 1151 at [34].

[19] *Corporations Act 2001* (Cth.), section 419A(3) and (4); *De Vries & Anor v Rapid Metal Developments (Australia) Pty Ltd* [2011] NSWCA 100.

44. Liquidation will cause a company to cease trading – be it by way of compulsory or voluntary liquidation.[20] Although the property of a liquidated company will not vest in the liquidator the company can no longer deal with such property.[21]

45. As in the case of voluntary administration, legal claims by creditors are stayed by virtue of section 471B of the Act. In addition, liquidation for creditors will leave their debts untouched despite the clear bar on recovery action.[22] The kind of enforcement action is a procedure that results in what is known as *pari passu* distribution[23] (i.e. where payments made by a liquidator to unsecured creditors with a proportional amount to all creditors).

46. In respect of the *PPSA*, the failure to perfect a security interest or to ensure that it is registered within time (i.e. 20 business days) may mean the security interest vests within the company under section 267 of the *PPSA* or section 588FL of the *Corporations Act*.[24]

47. A liquidator is primarily tasked with the protection of the interests of unsecured creditors. In the process of distributing company assets among its creditors and investigating the circumstances of the liquidation, a liquidator is empowered to disclaim or disavow contracts under section 568 of the Act.

48. A contract for the purpose of this power has been held to concern a leasehold interest in real property. If the company has occupied premises the subject of a lease, the continued occupation will cause the company to incur further debt. In *Willmott Growers Group Inc v Willmott Forests Ltd* [2013] HCA 51; (2013) 251 CLR 592 the High Court held that a lessor company in liquidation may disclaim a lease that it is a party to. Section 568 calls for leave of the court unless the lease is unprofitable.[25]

49. The impact of a disclaimer to a lease is to bring to an end the contractual relationship between a lessor and lessee and their respective rights and liabilities.[26] With respect to the loss sustained by a landlord to a disclaimer they can prove in the winding up of the company,[27] assuming that the landlord has been unsuccessful in setting aside a disclaimer issued by a liquidator.[28] Any lodged proof of debt may result in a substantial reduction in monies owed to the landlord, assuming the proof is accepted.

HOW TO PROTECT THE LANDLORD'S POSITION FROM INSOLVENCY

50. Having traversed the various topics of external administration and the definition of insolvency, it is only fitting to discuss ways in which landlords can avoid outcomes such as those felt in the *Dick Smith* scenario. The principal forms of protection to landlords against insolvent tenants can be achieved in varying

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[20] See: sections 493(1) and 477(1)(a) of the *Corporations Act 2001* (Cth.).
[21] *Commissioner of Taxation v Linter Textiles Pty Ltd* [2005] HCA 20; (2005) 220 CLR.
[22] *Corporations Act 2001* (Cth.), section 468(4).
[23] *Wight v Eckhart Marine GmbH* [2004] 1 AC 147 at 155-156 per Hoffmann LJ.
[24] *Re Appleyard Capital Pty Ltd* [2014] NSWSC 782; (2014) 101 ACSR 629.
[25] *Corporations Act 2001* (Cth.), section 568(1A).
[26] *Willmott Growers Group Inc v Willmott Forests Ltd* [2013] HCA 51; (2013) 251 CLR 592 at [76] per Gageler J.
[27] *Corporations Act 2001* (Cth.), section 568D(2).
[28] *Corporations Act 2001* (Cth.), section 568C(1). With respect to the relevant procedure see section 568A of the Act and regulation 1.0.03A of the *Corporations Regulations.*

ways. Four common forms include: a PPS Lease, security from a tenant for payment in the form of bank guarantee, cash bond/security deposit and personal guarantee.

PPSA and PPS Lease

51. The concept of a PPS lease concerns leased premises holding personal property such as plant and equipment or furniture and will permit a landlord to register an interest over the property's owner. As with this security and security deposits, the PPSA has significant presence in this arena.

52. By virtue of the enactment of the PPSA the definition of a security interest has broad reach.[29] A security interest that concerns an interest in personal property created in a transaction, which secures payment or performance of an obligation.[30] Personal property in this context is defined as property but that which does not include land.[31] Land is also defined as leasehold interests meaning that the PPSA does not apply to the leases of land.[32]

53. What is unique about the Act however, is the introduction of a concept known as the PPS lease which refers to the lease of property for a period 1 year or more.[33]

54. The application of the PPSA to leases however covers those conditions that permit a landlord to deal with a tenant's property, which is left in the premises after the end of tenant's lease. The implication is that a clause which allows a landlord to realise property of a tenant after the property is left at the end of the lease to either reduce the tenant's debt or use those proceeds in satisfaction of any such obligations is likely to constitute a security interest for the purpose of the PPSA.

55. In order to ensure that the security interest is protected it is important that any lease entered into be perfected to ensure that the security interest is protected in the event of any external administration. The most common form of perfection is by the registration of the security interest on the Personal Property Security Register ("**PPSR**"). As alluded to earlier, a failure to perfect the security interest upon external administration (such as the appointment of a receiver or within liquidation) means that those interests that are unperfected will vest in the company giving the security interest (i.e. the tenant upon the insolvency of that corporate entity). The impact of that is simply that the security interest is unperfected, the landlord is unsecured and simply ranks as any other unsecured creditor in the distribution of assets *pari passu*.

How a Security Interest is Perfected

56. The means by which a security interest is perfected under the PPSA are varied. The options are as follows:

    1. The security interest must firstly attach to the collateral (i.e. the property). That is where the grantor of the security (i.e. the tenant) has rights in the collateral or the power to transfer rights in the collateral to the secured party

[29] *Personal Properties Securities Act 2009 (Cth)*, section 12(1).
[30] *Personal Properties Securities Act 2009 (Cth)*, section 12(1).
[31] *Personal Properties Securities Act 2009 (Cth)*, section 10.
[32] *Personal Properties Securities Act 2009 (Cth)*, section 10.
[33] *Personal Properties Securities Act 2009 (Cth)*, section 13.

and value is given in consideration for that security. Value in this context means consideration sufficient to support a simple contract which clearly takes place in respect of a lease between the landlord and tenant.[34]

2. The security interest must be enforceable against the third party. That is, it is necessary to either have possession or control of the collateral or that the collateral is underpinned by a written security agreement. In the context of a lease arrangement that would satisfy the definition of a written security agreement.[35]

3. What is then required in the third step is simply the way in which the security interest is perfected. As discussed earlier, registration is capable of perfecting a security interest as is the secured party being in possession of the collateral or certain types of collateral of which the secure party has control. In the context of goods possessed by the tenant during the period of leasehold, perfection will take place by virtue of registration.[36]

57. The most sensible approach would be performance by registration. The benefit of course of registration of a security interest means that the secured party does not lose its priority amongst other secured parties and ensures that the interest survives any period of insolvency or external administration. Further, by being on a public register, the existence of such an interest is publicly known.

Bank Guarantee

58. With respect to small or medium-sized business tenants it may also be practical to obtain a written unconditional guarantee from a bank in favour of the landlord and to the effect that the bank will pay the landlord if required on an unconditional basis. The entry into a bank guarantee by the tenant will usually be as a specified sum often equivalent to a certain period of a rental payment.

59. Despite the comparative costliness in obtaining a bank guarantee and the associated paperwork, the bank guarantee sits in a distinctively advantageous position to that of security deposits purely in the context of insolvency events. Given that a bank guarantee is an agreement between the landlord and the bank/lender it *may* avoid the unfair preference regime if called upon prior to the appointment or during the external administration of the potentially insolvent tenant. This is because such a transaction *may* not be regarded as an unfair preference for the purposes section 588FA(1)(b) of the *Corporations Act,* which favours one creditor over another in the payment of any outstanding debts that are due and payable.

60. The word "may" has been used in a cautionary sense as there is available case law which suggests, by analogy, that the payment of a bank guarantee is capable of constituting an unfair preference if the transaction between the debtor and the bank is one in the same. In other words, if it is possible to say that the whole course of the dealing or transaction, initiated by the debtor and involving the third party (for example, a bank) is intended to extinguish a debt owed to a creditor, then the overall transaction can be seen as an unfair preference.

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[34] *Personal Properties Securities Act 2009 (Cth),* section 19(2).
[35] *Personal Properties Securities Act 2009 (Cth),* part 2.3.
[36] *Personal Properties Securities Act 2009 (Cth),* sections 21, 147 and 160.

61. Although not dealing with a bank guarantee, the above circumstances were discussed and supported by the Full Federal Court in *Commissioner of Taxation v Kassem and Secatore* [2012] FCAFC 124 but of particular interest are the following comments made by the Court (at [41] – [42]):

> *"The position as between [the debtor] and [the third party] was no different from a drawing by [the debtor] on an overdraft from its bank with a direction to the bank to pay the creditor directly. Such a payment constitutes a loan by the bank to its customer: see eg Andrews v ANZ Banking Group Ltd [2011] FCA 1376; (2011) 86 ACSR 292 at [82] per Gordon J.*
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> *Moreover, even if it is not correct to describe the transaction between [the debtor] and [the third party] as a loan, what is important is the finding that the payment by [the third party] to the Commissioner was a payment that was made by or on behalf of [the debtor]. So much is plain from the evidence to which we were taken."*

62. This position tends to contradict the historical position that a payment by a bank to a creditor would fall outside the voidable transactions regime. What this means is that until the courts definitively rule on this issue, landlords should be conscious of the less than impervious composition of the bank guarantee.

63. Further, particular focus should be made in relation to the scope of the guarantee in terms of the obligations that are relevant to the tenant under the lease, its expiry date and the location of the relevant branches and what steps have to be undertaken to draw down on the subject funds.

64. In respect of unconditional bank guarantees, the courts have generally stated that they will not injunct parties from calling upon guarantees, save for special circumstances. A helpful distillation of the principles is contained in the decision of *Ceresola TLS AG v Thiess Pty Ltd & John Holland Pty Ltd* [2011] QSC 115 which provides the following:

> *On the basis of those authorities, it is sufficient for present purposes to note that the general rule is that a Court will not enjoin the issuer of a performance guarantee from performing its unconditional obligation to make payment. A number of exceptions to that general rule have been identified. They are identified in Clough Engineering at [77] as:*
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> *(1) An injunction will issue to prevent a party in whose favour the performance guarantee has been given from acting fraudulently.*
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> *(2) An injunction will issue to prevent a party in whose favour the performance guarantee has been given from acting unconscionably in contravention of the Trade Practices Act 1974 (Cth) [Competition and Consumer Act 2010 (Cth)].*
>
> *(3) While the Court will not restrain the issuer of a performance guarantee from acting on an unqualified promise to pay if the party in whose favour the guarantee has been given has made a contract promising not to call upon the bond, breach of that contractual promise may be enjoined on normal principles relating to the enforcement by injunction of negative stipulations in contracts. Their Honours drew in that regard from the judgment of Austin J in Reed Construction Services v Kheng Seng (Australia) Pty Ltd (1999) 15 BCL 158 at 164.*

65. That position may have been departed from in the decision of *Universal Publishers Pty Ltd v Australian Executor Trustees* [2013] NSWSC 2012, where the Court granted an *ex parte* injunction from a landlord calling on a bank guarantee. The decision came down to the wording of the unconditional bank guarantee

provision in the lease which effectively required there to be an actual breach before the landlord could come to a view as to the amount due and payable.[37] The risk allocation contained within the clause was not broad enough to cover any expenses incurred resolving the dispute, meaning the landlord could not draw down on the guarantee. The simple lesson is to ensure that the terms for drawing down on a bank guarantee are clearly articulated in the lease, rather than rely on the notion that the bank guarantee is unconditional or the right to draw down is underpinned by the common law.

Security Deposit

66. A final form of security in contrast to the above is a security deposit that is also known as a cash bond. It is an amount of money equivalent to a period of rent that is paid to a landlord at the commencement of a lease. The provision of such cash or security is for the purposes of the PPSA security, for the performance by the tenant of its obligations under the lease. It therefore gives rise to a security interest meaning that a landlord should be registering its interest over both the tenant and the account in which the cash bond is held in order to secure its priority.[38] Following on from the comments above, it is simply not enough that a landlord controls the account in which the cash bond is held. A landlord should undertake the same process outlined above in respect of the PPS Lease. That will also avoid any prospect of the security interest vesting in the liquidator or administrator upon their appointment.

67. Support for the importance of registering a security interest in a security deposit was highlighted in the Victorian Supreme Court of Appeal decision of *Dura (Australia) Constructions Pty Ltd v. Hue Boutique Living Pty Ltd* [2014] VSCA 326 which involved the payment of funds which were required to be paid into a joint account held in the name of solicitors for each of the parties as a requirement of a Court order. The case turned upon the issue of whether the payment gave rise to a security interest. A finding in the affirmative the case required that the transaction between parties be consensual for it to give rise to a security interest.[39] As the funds in *Dura* were required to be paid in accordance with the Court order the transaction was not considered to be a consensual and therefore no security interest arose.[40] By analogy it could be argued that:

    67.1. That the consensual payment of a security deposit in respect of a leasehold agreement entered into between parties would give rise to a security interest;[41]

    67.2. The security interest is a charge over that property or collateral of the tenant;[42]

    67.3. By virtue of the landlord controlling the funds in an account it is enforceable against a third party;[43] and

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[37] *Universal Publishers Pty Ltd v Australian Executor Trustees* [2013] NSWSC 2012 at [25].
[38] *Personal Properties Securities Act 2009 (Cth),* section 12(1).
[39] *Dura (Australia) Constructions Pty Ltd v. Hue Boutique Living Pty Ltd* [2014] VSCA 326 at [121].
[40] Ibid at [126].
[41] *Personal Properties Securities Act 2009 (Cth),* section 12(1).
[42] *Personal Properties Securities Act 2009 (Cth),* section 8(1)(c).
[43] *Personal Properties Securities Act 2009 (Cth),* section 19(2).

67.4. The leasehold agreement giving rise to the security is capable of registration.

68. This should put the impetus on the landlord to register that interest lest they be exposed to the vesting of that security interest subsequent to the appointment of external administrators.

69. An issue that can arise with respect to cash bonds is that if they are drawn upon or paid to the landlord in respect of rental arrears prior to the winding up of a company is that of antecedent transactions or voidable transactions in the form of unfair preferences.[44] An unfair preference requires certain ingredients which are:

69.1. A transaction[45] between the creditor and the company;

69.2. The transaction relates to an unsecured debt owed by the company to the creditor; and

69.3. What the creditor receives is more than what the creditor would ordinarily receive if required to prove the debt in a wind up.[46]

70. An important concept to understand with respect to the liquidator's power to claw back unfair preferences is the "relation-back day". The relation-back day is the landmark matter to determine when times run in relation to any purported voidable transaction. For example, in the context of a voidable transaction, the relation-back day where a winding up was preceded by the voluntary administration, the relation-back day will be the date of the voluntary administration. Insofar as unfair preferences are concerned, any transaction for the purposes of the Act that is made 6 months prior to the relation-back day will be considered voidable transactions.

71. If considered unfair preferences liquidators have the power to claw back the monies paid under the security deposit. Exceptions to this would include the categorisation of the transaction as a pre-payment or an upfront payment, which the case law demonstrates is not capable of being considered a preference.[47] Similarly, registering the security interest on the PPSR and perfecting the interest would avoid the issue of voidable transactions. If the debt or transaction the subject of the security interest is not unsecured it will not satisfy the basic element of an unfair preference, as it is not an unsecured debt. Where the debt paid, for example, exceeds the value of the security, the payment is taken to be unsecured to the extent of the surplus.

Personal Guarantees

72. The final form of security and one which is commonly used is that of personal guarantees by third parties or indeed directors of the companies which will provide another avenue of recourse should the company enter into financial difficulty or be placed under external administration. It is important that during negotiations the personal guarantee be negotiated into the leasing advice given

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[44] Please note that voidable transactions also include uncommercial transactions, unfair loans and unreasonable director-related transactions, but payments in this context are more akin to unfair preferences.

[45] Defined broadly under section 9 of the *Corporations Act 2001* (Cth.).

[46] *Corporations Act 2001* (Cth.), section 588FA(1)(b).

[47] *Tamaya Resources Ltd v Claymore Capital Pty Ltd* [2015] FCA 357.

the difficulty of incorporating one after the transaction has taken place between the parties.

73. The benefit of a guarantee is that as a contract of guarantee is a collateral contract to answer for the debt default or miscarriage of another the event of default by a company as an insolvent entity will mean the obligations underpinning that guarantee are triggered and payment will then be due and payable upon demand of the party receiving the benefit of that guarantee.

74. In circumstances where the landlord cannot recoup arrears and other losses from their insolvent tenant they may have recourse to the guarantor following the tenant's default.

MATTERS FOR CONSIDERATION FOR ANY LANDLORD

75. As a matter of practical business acumen a landlord should regularly follow up rent and payments of its tenants as the ability to act sooner rather than later may avoid the losses that took place in the example of *Dick Smith*.

76. In respect of guarantors, landlords should regularly be reviewing the capacity of the guarantor if they are able to meet any liabilities that are imposed on the guarantor should the principal party enter a period of insolvency. As discussed the implication of the PPSA is significant. What it means is that upon receipt of any security deposit the interest should be registered on the PPSR to avoid issues of vesting with the administrator or liquidator or to avoid allegations that payments immediately prior to a corporate tenant's insolvency the payments were unfair preferences and liable to being clawed back by the liquidator during the period of liquidation.

77. Finally, if all else fails, unsecured creditors are provided with proofs of debt by the liquidator which should be promptly lodged upon any such call by the liquidator. This option can be unsatisfactory if the loss incurred by a landlord could have been avoided by the use of personal guarantees, bank guarantees or security deposits underpinned by the PPSA. Further, the likelihood of unsecured creditors receiving 100 cents in the dollar is a rare occurrence, almost as rare as seeing icebergs from Antarctica in Sydney Harbour.