3 Useful Principles for Insolvent Trading Claims

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It is important for liquidators and creditors to understand the true value of potential claims in the winding up of a company in order to make commercially sound decisions about whether to commence litigation.

The quanta of insolvent trading claims can be difficult to assess. In Re Swan Services Pty Ltd (in liq) the New South Wales Supreme Court gave consideration to the manner in which the loss occasioned by creditors from insolvent trading ought to be calculated. We have distilled from the Court’s comprehensive judgment three key principles with respect to that assessment which insolvency practitioners and creditors may find useful.

Background

Prior to its liquidation, Swan Services Pty Limited (in liquidation) and various related entities conducted a large cleaning business with operations throughout Australia. The liquidators brought insolvent trading proceedings against the director and also his wife on the basis that she was a de facto director of the company. Ultimately the Court was satisfied that the director (but not his wife) had breached the duty to prevent insolvent trading in contravention of section 588G of the Corporations Act 2001 (Act).

1. Vesting of Secured Debt by Operation of the PPSA

Section 588M of the Act provides that, for the purposes of determining the compensation for loss resulting insolvent trading, the debts incurred by the company (whilst it was insolvent) to which the section applies must be unsecured when the loss was suffered by the creditor.

In this case the company incurred a number of debts during the relevant period with creditors who had or claimed to have security interests which had not been registered on
the PPSR. As a consequence of those interests having not been registered on the PPSR, by operation of the Personal Property Securities Act 2009 (PPSA), the securities vested in the company upon the commencement of the winding up and the relevant debts at that time became unsecured.

In determining whether the debts were unsecured at the time the loss or damage was suffered for the purposes of section 588M, the Court reasoned that the time the loss was incurred by the creditor was not upon the company becoming insolvent, but rather upon the company’s winding up when the debts became unsecured and the creditors would not receive 100c in the dollar in respect of the debts.

The result was that the debts were unsecured at the relevant time for the purpose of determining the loss suffered by creditors from the insolvent trading.

2. Running Account Credits

The Court was also asked to determine whether credits to a “running account” during the period of insolvent trading ought to be taken into account for the purposes of assessing the loss to a particular creditor.

The company’s running balance account with the Commissioner of Taxation had, during the relevant period, been reduced such that the Commissioner’s position had improved overall. During that period however, the company had incurred debts in respect of which the Commissioner had received no payment. The question of whether the Commissioner had suffered any loss or damage arose given that it had improved its position overall but also new unpaid debts had accrued.

The Court determined that the credits to the running account were to be taken into account when assessing the loss required to be compensated by the director of the company, as the loss is not necessarily assessed strictly with respect to the debts incurred during the period of insolvent trading which remain unpaid. The concept of loss or damage in section 588M must be calculated after taking into account reductions and accruals affecting the loss suffered in relation to the debt.

3. Distributions to Creditors in the Winding Up
A related issue was whether the loss resulting from insolvent trading is taken to be reduced by any distribution made to creditors in the winding up. In this particular case the liquidators had made a significant recovery from the Commissioner of Taxation through an unfair preference action such that a distribution would be made to creditors.

After an analysis of the relevant case law, and consistently with its determination with respect to running account credits, the Court determined that in calculating the loss or damage from insolvent trading regard ought to be had to any recoveries which would allow a dividend to creditors in reduction of the debts owed to them. The Court acknowledged that this approach required liquidators to make an assessment of the likely future recoveries and costs in the liquidation such that an estimate of the return to creditors could be made and deducted from the compensation payable in respect of the insolvent trading.

That task, whilst complex, was not impossible and was determined to be necessary to prevent the risk of judgments requiring defendants to compensate for loss or damage not suffered by creditors once other recoveries are made in the winding up.

**Points to Remember**

It is important to have regard to the circumstances affecting a creditor’s overall position in relation to debts incurred during a period of insolvent trading. It may be inaccurate in determining the quantum of an insolvent trading claim to simply calculate the amount of unsecured debt incurred during the relevant period in isolation.

The key determinations in Swan illustrating this principle are that:

1. a secured creditor whose debts become unsecured by operation of the PPSA upon the commencement of the winding up may be unsecured for the purposes of an insolvent trading action;
2. credits to a running account ought to taken into account when determining the loss or damage sustained with respect to debts incurred during a period of insolvent trading; and
3. the estimated distributions to creditors in the winding up ought to taken into account when determining the loss or damage sustained with respect to debts incurred during a period of insolvent trading.
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