ARTICLE

Unfair Preferences in Australia and Letters of Credit

Nicholas Dunstone, Senior Associate, Henry Davis York, Sydney, Australia[1]

This article considers the regime for challenging preferences in Australia and in particular the ability of Australian liquidators to challenge as preferences letters of credit issued by an insolvent company to one of its creditors prior to liquidation. The issue has recently been the subject of judicial consideration in Australia. As discussed below, the courts have held that the Australian legislative provisions enabling a liquidator to challenge preferences are sufficiently wide to encompass the provision of a letter of credit by a bank to a creditor of an insolvent company in respect of pre-existing debt.

Preferences

Australian insolvency law, in common with most insolvency regimes, provides a liquidator with the ability to unwind certain transactions entered into by an insolvent company prior to the winding up. A preference (or 'unfair preference' as it is referred to in the Australian legislation) is one type of antecedent transaction which a liquidator typically has the ability to avoid, unwind or otherwise remedy in certain circumstances.

A preference occurs where a creditor has received more from a debtor before liquidation than that creditor would otherwise have received in the liquidation. It will involve a transaction between an insolvent company and one of its creditors that has the effect of favouring that creditor over the company's other creditors. The key rationale for unwinding a preference is to uphold the primacy of the *pari passu* principle (equality of division among creditors). It is also intended to have the effect of deterring the disorganized scramble for assets which results from creditors chasing payment from a company in financial difficulty.

Although the concept of a liquidator being able to unwind an otherwise valid transaction between the insolvent company and one of its creditors as a preference is common amongst many jurisdictions, there are significant differences in the way in which this concept has been embodied.

The unfair preference regime in Australia

Compared to many jurisdictions, it is relatively straightforward for an Australian liquidator to establish that a payment made to a creditor prior to the liquidation is a preference and liable to be repaid to the insolvent company for distribution by the liquidator to creditors generally.[2] Accordingly, the pursuit of preferences by Australian liquidators is frequently a significant element of a liquidator's administration of the estate.

The test for establishing a preference is an objective test. In broad terms, in order to establish a preference, an Australian liquidator need only show that a 'transaction' occurred between a creditor and a company at the time the company was insolvent, and that this had the effect of the creditor receiving more for its unsecured debt from the company than it would have had the debt been proved for in the company's winding up.[3] It does not prima facie require proof of the intention of either the insolvent company or the creditor in entering into the transaction. Section 588FA(1) sets out the key elements:

> [Where transaction unfair preference] A transaction is an unfair preference given by a company to a creditor of the company if, and only if:
>
> (a) the company and the creditor are parties to the transaction (even if someone else is also a party); and

Notes

1 The views expressed in this article are the author's own and do not represent those of Henry Davis York.

2 The provisions dealing with preferences are contained in section 588FA to section 588FI of the Corporations Act 2001 (Cth).

3 Section 588FA of the Corporations Act 2001 (Cth) defines a preferential transaction. Per s 588FE, the transaction must have occurred within 6 months of the 'relevant date' (or 2 years if it is a related party). The relevant date is normally the date of the order for winding up or, if the liquidation was preceded by an administration, the date of commencement of the administration.

(b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company;

even if the transaction is entered into, is given effect to, or is required to be given effect to, because of an order of an Australian court or a direction by an agency.

The creditor's intention only becomes relevant if the creditor attempts to rely upon the statutory 'good faith' defence that, amongst other things, it had no reasonable grounds for suspecting the company was insolvent, and that a reasonable person in the creditor's circumstances would also have had no such grounds.[4] This can be a difficult onus for a creditor to discharge, as the creditor must prove a negative which is based on objective criteria (i.e. a reasonable person in their circumstances).

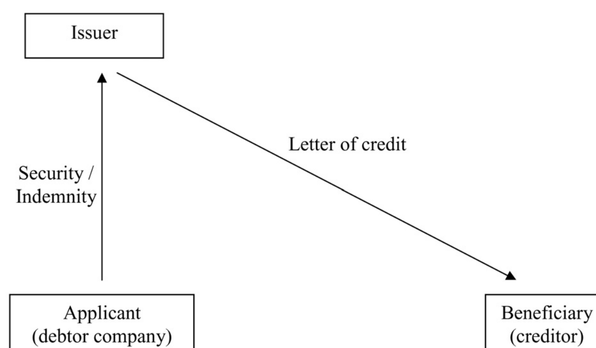
It should also be noted that the definition of 'transaction' is very broad.[5] It is sufficiently extensive to embrace a wide range of means by which property of an insolvent company may be disposed of in favour of a creditor. As discussed below, it also covers the situation where there are a series of steps, even involving third parties, which are linked together to achieve a discharge of indebtedness of the creditor.

The objective test for a preference is in contrast to the position in England, for example, where the preference provisions require a liquidator to prove that the intention of the company was to enter into a transaction with a preferential effect. Such an intention is, in most normal commercial situations, very difficult to establish, and it is arguable that this is the reason for the apparent relatively infrequent use of preference provisions by English liquidators.[6]

Letters of credit

Letters of credit are a frequently used means of guaranteeing payment. They are used particularly in international trade, financing transactions, and the construction and reinsurance industries. Letters of credit are typically drafted to be irrevocable and unconditional. The issuer of the letter of credit is typically a bank or other financial institution of good standing.

The debtor company has a relationship with the issuer of the letter of credit whereby typically it will provide some form of security or indemnity to the issuer so that the issuer can reimburse itself if the letter of credit is drawn upon. The relationship between the creditor and the issuer is entirely independent, and the creditor can call on the letter of credit regardless of the financial situation of the debtor company. The following diagram shows the relationship between the parties.



The purpose of the letter of credit is to, in effect, 'secure' the payment obligation; however, it is not security per se. Whilst there may be security to secure drawings under the letter of credit in favour of the issuer, it does not secure any of the assets of the debtor company in favour of the creditor, but rather creates an independent obligation upon the creditworthy issuer to effect payment. Accordingly, in many regards, it will provide a higher degree of payment security to the creditor than an actual security over the debtor company's assets.

Letters of credit and insolvency

Given that the primary purpose of a letter of credit is to ensure a creditor can obtain payment even where the debtor company cannot make payment (for example, because of insolvency), the possibility of letters of credit being challenged under preference laws has drawn concern from some commentators.[7]

The principle concern is that the Australian preference regime has the potential to undermine the efficacy of this essential tool of commence. It is argued that the tri-partite nature of a letter of credit arrangement, and the relationship between the issuer and the

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4 See 588FG(1).

5 Section 9 of the Corporations Act 2001 (Cth).

6 A..R. Keay, 'The Avoidance of Pre-Liquidation Transactions: An Anglo-Australian Comparison', (1998) JBL 515-549 (Nov) at 531.

7 See P. Cornwell, 'Letters of Credit in Financing Transactions Are they safe?' 9 JBFL 222 (Sept 1998).

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creditor on the one hand, and the independent relationship between the issuer and the debtor company on the other, should render letters of credit immune to challenge as preferences.

However, in light of the primary purpose of a letter of credit, it is not surprising that an existing creditor who becomes concerned about a debtor company's financial capacity might seek to obtain a letter of credit in relation to that indebtedness. Accordingly, it is also unsurprising that the provision of a letter of credit, if provided at a time when the company was insolvent, might come under legitimate scrutiny from the preference regime.

In principle, there is no logical reason why a creditor who received a letter of credit at a time when the debtor company was insolvent, and then subsequently drew on that letter of credit to receive payment in discharge of its indebtedness, should be treated any differently to a creditor who instead received a direct payment from the debtor company. The effect is the same: even though the payment to the creditor is effected by the issuer of the letter of credit, the creditor has received payment in respect of the debt and the debtor company's assets will usually be depleted in order to reimburse the issuer for the draw down on the letter of credit.

This issue has recently been considered by the New South Wales Supreme Court and subsequently the New South Wales Court of Appeal in *New Cap Reinsurance Corporation v Somerset Marine Incorporated*.[8]

New Cap Reinsurance Corporation v Somerset Marine Incorporated

The Court considered whether letters of credit provided to a creditor during the six months prior to the relation back day, and then subsequently drawn upon, could constitute a 'transaction' for the purposes of section 588FA, and thereby be subject to challenge as an unfair preference.

The defendants applied to strike out the proceedings on the basis that there could be no 'transaction' between the parties in the circumstances of a letter of credit. They argued that as the payment received in discharge of the debt was made by the issuer of the letter of credit, it was not received 'from the company' as required by section 588FA(1)(b).

The Court considered the myriad of Australian authorities dealing with the application of the preference provisions to situations involving third parties. In concluding that the provision of the letter of credit may arguably constitute a preference, the Court relied upon the breadth of the definition of 'transaction' and the decision of *Re Emanuel (No 14) Pty Ltd (in liq)*[9] where the Full Federal Court of Australia concluded that:

> a course of dealing initiated by a debtor that is intended to, and does, extinguish a creditor's debt can in its totality be a transaction for the purposes of Part 5.7B of the *Corporations Law* notwithstanding that the achievement of that end can only be realized through the participation of a third party in a particular dealing (or dealings) within the overall transaction, being a particular dealing (or dealings) to which the debtor is not or may not be a party.[10]

The Court found that, as part of the operation of the letters of credit, assets of the insolvent company sufficient to cover the issuer bank's payment under the letters of credit were deposited into an account to secure the bank's reimbursement from the company. In those circumstances, the assets of the company were depleted through the mechanism of the issue of the letter of credit, and the effect of the entire transaction was to discharge the indebtedness to the creditor. The involvement of the issuer bank in this process did not prevent the transaction from being a 'transaction' for the purposes of section 588FA.

In this case, the Court of Appeal found that the 'transaction' was constituted by:

(a) the creditor's request for the letters of credit in respect of the past indebtedness;
(b) the insolvent company's request to the issuing bank to establish letters of credit;
(c) the establishment of those letters of credit;
(d) the creditor's call on those letters of credit and payments of them by the bank; and
(e) the bank reimbursing itself at the expense of the insolvent company.

Concluding remarks

Any concern that this decision undermines the efficacy of letters of credit is misplaced. If a letter of credit was established outside of the six-month period before the relation back day, or at a time when then company was not insolvent, then it could not be challenged as a preference. In that circumstance, a letter of credit remains an effective tool to protect creditors from a debtor company's credit risk.

Notes

8 [2003] NSWSC 540 at first instance; and [2003] NSWCA 338 in the Court of Appeal.

9 (1997) 147 ALR 281.

10 Ibid., at 289.

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Conversely, if the letter of credit has been established within that period, and at a time when the credit risk of the debtor company has effectively crystallized through its insolvency, then a letter of credit should be capable of challenge as much as any other mechanism or transaction entered into or intended to reduce the debtor company's liability to the creditor. The effect of the letter of credit, notwithstanding the involvement of a third party, is to prefer that creditor over other creditors.

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