THE FREE ASSETS OF THE COMPANY AND WHEN THEY ARE FREE TO TAKE: EQUITABLE SUBROGATION AND THE SECURED CREDITOR

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Sections 433 and 561 of the Corporations Act 2001 *(Cth) preserve the circulating assets of a company or their proceeds for the benefit of priority creditors including employee creditors. A number of recent decisions have contemplated or recognised a right of equitable subrogation available to secured creditors whose security has been diminished by the application of ss 433 or 561. However, it remains unclear whether ss 433 and 561 impose trust obligations and whether a breach of a trust obligation is necessary for equitable subrogation to be available. This article argues that a statutory right of subrogation should be enshrined in legislation whereby a secured creditor may recover from the free assets of the company to the extent that his or her security has been diminished.*

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I INTRODUCTION

A longstanding principle in insolvency law is that the proceeds from preference recoveries[1] are available for distribution in accordance with the statutory priorities set out in s 556 of the *Corporations Act 2001* (Cth) ('*Corporations Act*'). Assets distributed under s 556 of the *Corporations Act* are sometimes called the 'free' assets of the company because they are not subject to any security interest.

The first priority for payment from the free assets is the payment of the various expenses of the winding up. After those expenses are paid, ss 556(1)(e)–(h) of the *Corporations Act* provide for the payment of employees' wages, superannuation contributions, workers' compensation, leave entitlements and retrenchment payments. When all priority debts have been paid, any remaining assets may be distributed to the unsecured creditors in accordance with the pari passu principle enshrined in s 555.

However, in some circumstances, priority debts may also be paid from the secured assets of the company. Sections 433 and 561 of the *Corporations Act* provide for the payment of debts including the debts set out in ss 556(e), 556(g) and 556(h) from circulating (or floating charge) assets. Conversely, courts have recognised an equitable right of subrogation by which a secured

[1] Payments or transactions made in the six month period prior to a company going into administration or liquidation may be set aside by a liquidator under pt 5.7B of the *Corporations Act 2001* (Cth) on the basis they put some creditors in a more favourable position than other creditors in the liquidation. The funds recovered by the liquidator in respect of preference claims are known as preference recoveries.

creditor may sometimes be entitled to payment of a secured debt from the free assets of the company.

This article considers the application of ss 433 and 561 of the *Corporations Act* and the effect of recent case law regarding secured creditors and equitable subrogation. Consideration is given to whether secured creditors should be entitled to the free assets of the company, including the proceeds of preference recoveries, and whether a right of subrogation should be recognised. This article also considers whether the right of secured creditors to share in the free assets of the company should depend on whether those assets are moneys or specific property. Finally, this article reflects on the kind of right of subrogation that might be recognised and whether a right of subrogation should be enshrined in legislation.

In this article, those debts under ss 556(e), 556(g) and 556(h) are referred to as the 'employee debts' because they generally comprise employee wages, superannuation, workers' compensation, leave entitlements and retrenchment payments. The people owed those debts are referred to as the 'employee creditors'.

II Background to 'Free' Company Assets and ss 433 and 561

A *The 'Free' Assets*

The principle that the proceeds of preference recoveries belong to the unsecured creditors of the company has existed for over several hundred years in English law.[2] In the decision of *N A Kratzmann Pty Ltd (in liq) v Tucker [No 2]* ('*Kratzmann*'),[3] the High Court considered whether the proceeds of a preference recovery were subject to a charge in favour of the secured creditor. The High Court held that a conveyance of land or transfer of specific property could be subject to a charge in favour of a secured creditor.[4] On the other hand, a transfer of money was not available to secured creditors. The rationale for this view was that, although a money transfer may have been subject to a

[2] Garry J Hamilton, 'The Italiano Family Fruit Company Case: Some Differing Perspectives' (2011) 19 *Insolvency Law Journal* 202, 207.

[3] (1968) 123 CLR 295.

[4] Ibid 300, 302 (McTiernan, Taylor and Menzies JJ).

charge at the time of the transfer, the money recovered by court order is not the same money.[5]

The finding in *Kratzmann* was in line with English authority at the time and in particular the decision in *Re Yagerphone Ltd* ('*Yagerphone*') where Bennett J found that the proceeds of a preference recovery did not become part of the general assets of the company but was a sum of money received by the liquidators and available for distribution to the unsecured creditors.[6] However, the English case law did not make a distinction between the transfer of land or specific property and the transfer of money.

The decision in *Kratzmann* has been approved and followed by Australian courts[7] until the recent decision of Finkelstein J in *Cook v Italiano Family Fruit Co Pty Ltd (in liq)* ('*Cook v Italiano*') which challenged the findings in *Kratzmann*.[8]

B *Fixed Charges and Floating Charges*

Prior to the *Personal Property Securities Act 2009* (Cth) ('*PPSA*'), a secured creditor usually held either a fixed or floating charge over a company's assets. A fixed charge was generally held over specific assets of the company while the other assets of a company, such as stock, inventory and receivables, were subject to a floating charge.[9]

Whether a secured creditor's charge was a fixed charge or a floating charge usually depended on the level of autonomy that the company had in relation

5 Ibid 300–1.

6 [1935] 1 Ch 392, 396.

7 See, eg, *Bayley v National Australia Bank Ltd* (1995) 4 Tas R 226, 230, 235 (Wright J); *Re Fresjac Pty Ltd (in liq); Campbell v Michael Mount PPB* (1995) 65 SASR 334, 340–1, 344 (Doyle CJ); *G & M Aldridge Pty Ltd v Walsh* [1999] 3 VR 601, 614 [35] (Phillips JA); *SJP Formwork (Aust) Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2000) 34 ACSR 604, 607–8 [18]–[20] (Santow J); *Tolcher v National Australia Bank Ltd* (2003) 174 FLR 251, 256 [17] (Palmer J). For a discussion of these decisions, see Andrew Poulton, 'Fruitful Unfair Preference Actions — What's a Liquidator to Do?' (2012) 20 *Insolvency Law Journal* 195, 196–201.

8 (2010) 190 FCR 474, 488–9 [52]–[62].

9 Gerard McCormack, *Secured Credit under English and American Law* (Cambridge University Press, 2004) 211–13.

to the particular asset.[10] If the company could not deal with the asset except by reference to the secured creditor, the charge over that asset was likely to be characterised as a fixed charge.

On the other hand, if the company was permitted to deal with the asset in the ordinary course of business, a charge over that asset was likely to be characterised as a floating charge.[11] For example, receivables have generally been characterised as floating charge assets because a company is usually free to collect the receivables and deal with the proceeds in the ordinary course of its business without reference to the charge holder. Similarly, a charge over future (or not yet acquired) property was usually considered a floating charge.[12] The floating charge only attaches to the particular assets on crystallisation — usually on the appointment of receivers and managers or administrators, or on the default of the company.[13]

Under the *PPSA*, the terminology of 'fixed charge' and 'floating charge' has been replaced by the concept of the security interest in circulating or non-circulating assets.[14] Section 51A of the *Corporations Act* defines a 'security interest' as a *PPSA* security interest or a charge, lien or pledge. Section 51C(b) of the *Corporations Act* confirms that a circulating security interest includes a security interest that is a floating charge. Collateral that is the subject of a circulating security interest is a circulating asset. Correspondingly, collateral that is the subject of a non-circulating security interest is a non-circulating asset.

Similar to the distinction between fixed and floating charge assets, a security interest is a circulating security interest if the company has the authority to deal with the relevant assets in the ordinary course of business.[15] Under the *PPSA*, some kinds of assets such as receivables and inventory are deemed

[10] Lionel Meehan, 'Circulating Security Interests under the *Personal Property Securities Act 2009* (Cth) Compared to Floating Charges' (2011) 22 *Journal of Banking and Finance Law and Practice* 322, 325.

[11] *Re Spectrum Plus Ltd (in liq)* [2005] 2 AC 680, 722 [111], where Lord Scott held that the essential characteristic of a floating charge 'is that the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event. In the meantime the chargor is left free to use the charged asset and to remove it from the security'.

[12] See *B & B Budget Forklifts Pty Ltd v CBFC Ltd* (2008) 216 FLR 294, 303 [33] (Barrett J).

[13] *Luckins v Highway Motel (Carnarvon) Pty Ltd* (1975) 133 CLR 164, 173–4 (Gibbs J).

[14] *PPSA* s 339. See generally Meehan, above n 10.

[15] *PPSA* s 340(1).

circulating assets unless the secured party meets certain *PPSA* registration and control requirements.[16]

C *Section 433*

Sections 433(2)–(3) of the *Corporations Act* preserve the circulating assets of a company or their proceeds for the benefit of the employee creditors in circumstances where the secured creditor has exercised its rights under the security agreement and where the winding up of the company has not commenced. Section 433 is the successor to s 331 of the various *Companies Acts* passed in 1981 ('*Companies Code*') and s 196 of the uniform *Companies Acts* of the early 1960s ('*Uniform Companies Acts*').[17]

Section 433 is a remedial provision designed to favour employee creditors by giving them a statutory entitlement to assets that would not otherwise have been available to them.[18] The section allows certain employee debts to have priority to the claims of other creditors. In *Korda v Silkchime Pty Ltd*, Le Miere J explains that:

> The purpose and effect of s 433 and its statutory predecessors is to protect the position of preferential creditors by giving preferential claims priority over the claims of floating chargees who would have otherwise "scooped the pool" of the chargor's assets.[19]

Two criteria must be met for s 433 to apply. First, there must be a receiver appointed or a person must have taken possession of or assumed control of the circulating assets.[20] This may occur where the secured creditor has appointed a receiver. Alternatively, there may be an administrator, liquidator

[16] Ibid ss 340(1)–(5).

[17] For further details on the history of s 433, see *McEvoy v Incat Tasmania Pty Ltd* (2003) 130 FCR 503, 506–12 [8]–[16] (Finkelstein J); *Korda v Silkchime Pty Ltd* (2010) 243 FLR 269, 279 [44]–[46] (Le Miere J).

[18] *Re CMI Industrial Pty Ltd (in liq); Byrnes v CMI Ltd* (2015) 105 ACSR 635, 646 [45] (Mullins J).

[19] (2010) 243 FLR 269, 279 [46].

[20] *Corporations Act* s 433(2)(a). See also *Re Great Southern Ltd (in liq); Ex parte Thackray* (2012) 260 FLR 362, 369 [23] (Master Sanderson), citing *Whitton v ACN 003 266 886 Pty Ltd (mgr apptd) (in liq)* (1996) 42 NSWLR 123, 137, 146–7 (Bryson J).

or agent of the secured creditor who has taken possession of or assumed control of the circulating assets.

The employee debts must be paid from the circulating assets or their proceeds before the possessor can use those assets to pay out the secured creditor. The obligation extends only to circulating assets in the possessor's possession or control. In *Cook v Italiano*, Finkelstein J describes the obligation as follows:

> the section relevantly requires the receiver or agent to pay out of property coming into his/her hands certain debts in priority to any claim for principal or interest by the debenture holder. The priority debts include most of the priority debts payable out of floating charge assets under s 561 and in particular the employee entitlements.[21]

There is authority that, if the secured creditor takes possession of the circulating assets, he or she has an obligation to comply with s 433.[22]

Secondly, the receiver's appointment or the taking possession or control of the assets must occur prior to the winding up of the company. Section 433 does not apply where the winding up of the company has commenced.[23]

Section 433 will still apply if the company is in voluntary administration. For example, in *White v Norman*,[24] receivers and managers were appointed on the same day as voluntary administrators. Besanko J accepted that s 433 imposed a statutory duty on the receivers and managers which had been breached. The receivers and managers were ordered to pay the plaintiff his unpaid employee entitlements.

D *Section 561*

By s 561 of the *Corporations Act*, where the property of a company available for payment of creditors other than secured creditors in a winding up is insufficient to meet payment of the company's employee debts, property subject to a circulating security interest must be used to pay those employee debts before paying out the relevant secured party.

[21] (2010) 190 FCR 474, 490 [66].

[22] *Perrins v State Bank of Victoria* [1991] 1 VR 749, 759–60 (Gobbo J).

[23] *Corporations Act* s 433(2)(b); *Cook v Italiano* (2010) 190 FCR 474, 490 [66] (Finkelstein J).

[24] (2012) 199 FCR 488.

The section has its history in s 2 of the *Preferential Payments in Bankruptcy Amendment Act 1897* 60 & 61 Vict c 19, the successor to which is s 175 of the *Insolvency Act 1986* (UK). The Australian provision is the successor to s 446 of the *Companies Code* and s 292(4) of the *Uniform Companies Acts*.

Section 561 is silent as to the payer but presumably applies to the person holding the circulating assets or their proceeds. That person or entity is required to make an assessment of the property in order to determine whether the free assets of the company are sufficient to meet the employee debts.

According to the decision in *Cook v Italiano*, the assessment should be made at a single point in time when there is sufficient information about the company's affairs. In that case, Finkelstein J explained that:

> In my view, 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 realisations. That 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.[25]

His Honour warned that assessment on an interim basis may result in 'arbitrary or even perverse results'.[26]

A person aggrieved by an act, omission or decision of a liquidator may appeal to the court for relief under s 1321(1)(d) of the *Corporations Act*. Presumably, a breach of s 561 would also attract the penalty provisions under s 1311 of the *Corporations Act*.

E *Consideration of ss 433 and 561*

Sections 433 and 561 are very similar in that both provisions operate to preserve circulating assets for the benefit of employee creditors, and both sections impose obligations on the party who holds the circulating assets, whether that person is a receiver or agent of the secured creditor, or an administrator or liquidator.

25 *Cook v Italiano* (2010) 190 FCR 474, 491 [70].

26 Ibid 491 [71].

Sections 433 and 561 are intended to alleviate the hardship that might otherwise be caused by additional delay in paying employee debts or failure to pay those debts at all.[27] Employees are given special treatment because 'they are in a particularly vulnerable position if their employer becomes bankrupt or is wound up'.[28] Employees, unlike shareholders, cannot 'diversify their investment portfolio to eliminate or hedge against risk' and they often bear the personal and social costs of business failure.[29]

However, employees are not entitled to priority over fixed or non-circulating assets such as real estate subject to a mortgage. Instead, the entitlement relates only to the circulating assets — generally being the property which the company deals with in the normal course of business. One explanation for the principle that circulating assets should be preserved for employee creditors is that employees of a company are likely to have helped produce those assets.[30] However, this distinction appears to be weak given that employees may also have helped to produce company assets that are treated as non-circulating assets. For example, it is possible for a secured creditor to hold a non-circulating security interest over the receivables or book debts of the company if the secured party has a sufficient level of control over the assets.[31]

One of the main differences between ss 433 and 561 is that s 433 creates a positive obligation on the holder of the circulating assets or their proceeds to pay the employee debts in priority out of those assets. The obligation created by s 433 is also an 'ongoing liability' to pay the preferential creditors.[32] On the other hand, the obligation under s 561 is to make an assessment of the assets and only to pay the employee debts in priority where the asset pool is insufficient. In *Re ExDVD Pty Ltd (in liq)* ('*ExDVD*'), White J explains that:

> There is one pertinent difference between s 433 and s 561. The latter operates when the free assets of the company in liquidation are insufficient to meet the

[27] See Thomson Reuters, *McPherson's Law of Company Liquidation* (at 23 April 2014) [13.1300].

[28] Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988) vol 1, 294 [721].

[29] Justice Simon Whelan and Leon Zwier, 'Employee Entitlements and Corporate Insolvency and Reconstruction' (Research Paper, Centre for Corporate Law and Securities Regulation, University of Melbourne, 2005) 4.

[30] Thomson Reuters, *Company Receivers and Administrators* (at 17 November 2014) [11.4710].

[31] *Re Spectrum Plus Ltd (in liq)* [2005] 2 AC 680.

[32] See *Re CMI Industrial* (2015) 105 ACSR 635, 639 [15] (Mullins J).

> identified liabilities. This implies that the obligation it imposes arises when that circumstance becomes known. Section 433 is not qualified in that way. The obligation it imposes arises as soon as the receiver or controller has possession or control of the company's property. The receiver or controller is not entitled to defer payment because of the possibility that free assets may later become available to be used to discharge the identified liabilities.[33]

Although s 433 creates an ongoing obligation, the property that is caught by s 433(3) (and s 561) does not include profit generated by a receiver after his or her appointment. In *Re CMI Industrial Pty Ltd (in liq)* ('*Re CMI Industrial*'),[34] the receivers generated some profit in the course of selling various assets through going concern sale campaigns. The secured creditor argued that the profit should be distributed to it in accordance with its security. The liquidators questioned whether the profit should be paid to the employee creditors pursuant to ss 433 or 561.

Mullins J found that both ss 433 and 561 create a priority that 'revolves around the date of the appointment of the receivers'.[35] The priority operates in respect of assets identified on the basis that they would have been the subject of the floating charge (or circulating security interest) at the time of the appointment. The sections did not refer to conferring any statutory entitlement to the priority creditors in respect of trading profit made by receivers.

Another difference between ss 433 and 561 is that s 588 (which deems that employment is terminated at the commencement of winding up) applies for the purposes of s 561 and not s 433. Where s 433 applies, it may be necessary for the employee to prove that payments are due and payable.[36]

Finally, there is some controversy as to whether s 433 continues to apply after the appointment of liquidators.[37] In *Re Great Southern Ltd (in liq); Ex*

33 (2014) 223 FCR 409, 415 [26].

34 (2015) 105 ACSR 635.

35 Ibid 646 [46].

36 *Re Great Southern Ltd (in liq); Ex parte Thackray* (2012) 260 FLR 362, 367 [12] (Master Sanderson), citing *McEvoy v Incat Tasmania Pty Ltd* (2003) 130 FCR 503, 515 [26] (Finkelstein J); *Vickers v Challenge Australian Dairy Pty Ltd* (2011) 190 FCR 569, 579 [62]–[63] (Barker J).

37 See, eg, *Re Custom Card (NSW) Pty Ltd* [1979] 1 NSWLR 241, 251, where Needham J considered that the predecessor to s 433 continued to operate despite a subsequent winding up. See also *Stein v Saywell* (1969) 121 CLR 529, 545, where Barwick CJ (considering the

parte Thackray (‘*Great Southern*’),[38] receivers and managers were appointed two days after the appointment of voluntary administrators. The voluntary administrators were appointed as liquidators a few months later. The liquidators argued that they were only required to comply with s 561 and that s 433 did not apply since the company had been wound up. Master Sanderson concluded that both ss 433 and 561 continued to operate given that there was no reason why s 433 would cease to act.[39] This view was adopted in the subsequent decision of *Re CMI Industrial* where Mullins J considered that both ss 433 and 561 applied to receivers who were appointed on the same day as the administrators (who later were appointed liquidators).[40]

This view was consistent with the approach taken by Finkelstein J in *Cook v Italiano* where his Honour stated:

> Section 433 becomes enlivened upon the appointment of a receiver or agent in possession prior to the commencement of a winding up. Section 561 is triggered upon the company being wound up, regardless of whether s 433 already applies. The operation of s 433 continues notwithstanding the subsequent winding up of the company.[41]

F *Equitable Subrogation*

Equitable subrogation is a remedy in equity by which the rights of one person are transferred to another person without assignment or consent. The underlying basis of subrogation is somewhat unclear and there are conflicting views as to whether a right to subrogation arises through contract or unjust enrichment or whether subrogation is purely a creature of equity.[42]

Traditionally, subrogation is available where a third party advances money to pay out a mortgage on the understanding that the security will be maintained to secure the third party's advance.[43] However, the courts have found

predecessors to ss 433 and 561) found that the predecessor of s 561 would prevail once winding up had commenced.

38 (2012) 260 FLR 362.

39 Ibid 370 [28].

40 (2015) 105 ACSR 635, 646 [44].

41 (2010) 190 FCR 474, 492 [74].

42 But see *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269, 299–302 [85]–[98] (Gummow, Hayne, Heydon, Kiefel and Bell JJ).

43 *Cochrane v Cochrane* (1985) 3 NSWLR 403.

that subrogation is available in other circumstances as well. For example, in *Boscawen v Bajwa*, the Court found that subrogation was available to a plaintiff whose money had been wrongfully paid out and used to discharge a mortgage on the defendant's land.[44] In *Cook v Italiano*, Finkelstein J found that subrogation is available as a remedy where funds have been misapplied in breach of trust and it would be unconscionable for another party to benefit from the windfall obtained by a breach of trust.

Generally, subrogation may be awarded by a court where a party has 'paid a debt under compulsion for which a second party was primarily answerable and which, in equity and good conscience, should have been discharged by the second party'.[45] Equitable subrogation is generally not available where the payment giving rise to subrogation is made voluntarily.[46]

III The Secured Creditor's Right to Equitable Subrogation

The effect of the application of ss 433 and 561 of the *Corporations Act* is that property (being circulating assets) that would have been available to satisfy a secured debt may be used to pay out employee debts instead. The critical question arising from recent case law is whether secured creditors, whose circulating assets have been diminished by operation of ss 433 or 561, should be permitted to look to the free assets of the company.

A *Section 561 and Equitable Subrogation*

1 Cook v Italiano

The landmark decision of *Cook v Italiano* is said to have 'mortally wounded' the traditional view that secured creditors do not participate in the proceeds of preference claims.[47] In that decision, Finkelstein J found that the secured

[44] [1996] 1 WLR 328.

[45] *Gordon v Leon Plant Hire Pty Ltd (in liq)* [2015] NSWSC 397 (10 April 2015) [71] (Black J), citing *Ogilvie v Ferry* [2010] NSWSC 379 (30 April 2010) [79]–[80] (Hamilton AJ).

[46] *Saffron Sun Pty Ltd v Perma-Fit Finance Pty Ltd (in liq)* (2005) 65 NSWLR 603, 608–9 [14] (Windeyer J); *Ogilvie v Ferry* [2010] NSWSC 379 [79]–[81] (Hamilton AJ); *Re Dalma No 1 Pty Ltd (in liq)* (2013) 279 FLR 80, 88 [25], 90–2 [33], [37], [40] (Brereton J).

[47] Martin Hirst, 'On the Beat — (Yet) Another One Bites the Dust' (2012) 12 *Insolvency Law Bulletin* 142, 142.

creditor was entitled to preference recovery funds because it was entitled to be subrogated to the position of the employee creditors.

The company had granted a circulating and non-circulating security interest over the present and future assets of the company in favour of the secured creditor, National Australia Bank Ltd ('NAB'). Following the commencement of the winding up, the liquidators realised the company's assets and received a return of approximately $500 000. The liquidators applied that amount to the employee debts and the costs of liquidation. Those payments were made without notice to NAB.

About a year later, the liquidators received a small fund of approximately $50 000 from unfair preference recoveries. At this time, NAB was owed approximately $1.2 million. The liquidators applied to the Court for directions as to whether the proceeds of the unfair preference recoveries should be paid to NAB or the unsecured creditors of the company.

The liquidators acknowledged that the traditional view is that preference recoveries are not available to secured creditors. However, they pointed out that, had the preference recoveries been available earlier, the employee debts and the costs of liquidation would have been paid in part from the preference recoveries. NAB would then have received a greater amount from the realisation of the circulating assets. In their report to the creditors, the liquidators noted that 'it would seem inequitable that this outcome should be altered by timing issues'.[48]

Finkelstein J considered whether the proceeds of preference recoveries were caught by NAB's security interest over the company's present and future property. This was a difficult question, and having considered a number of authorities in both the United Kingdom and Australia, his Honour reluctantly concluded that the view in Australia is in line with *Kratzmann*.[49] His Honour confirmed that whether a security interest attaches to preference recoveries appears to depend on the nature of the property recovered.[50]

Ultimately, Finkelstein J did not decide whether the preference recovery funds were caught by NAB's security interest. However, his Honour considered that 'preference recoveries ought not depend on the nature of the property recovered' and the law should instead examine the competing

48 *Cook v Italiano* (2010) 190 FCR 474, 478 [7] (Finkelstein J).

49 Ibid 489 [62].

50 Ibid.

interests of secured and unsecured creditors.[51] In his Honour's view, the position was unsatisfactory and required resolution by the High Court or, preferably, Parliament.

Notwithstanding these difficulties, Finkelstein J found that NAB was entitled to the preference recovery funds because it was entitled to be subrogated to the position of the employee creditors.

The basis of this right of subrogation was that s 561 of the *Corporations Act* creates an obligation on a receiver or liquidator to hold circulating assets on trust in favour of the secured creditor and employee creditors, until an assessment can be made of that property to determine whether there are sufficient assets to meet the employee debts.[52] The holder of circulating assets, who has not yet made an assessment under s 561, holds the assets on trust for the purposes of s 561 where the secured creditor and the employee creditors are contingent beneficiaries.[53]

The liquidators owed a duty to NAB to retain the funds until it was known whether the condition in s 561 had been satisfied. His Honour observed:

> An alternative basis on which the bank might have a superior entitlement to the preference recoveries is, as the liquidators suggest, if the bank can be subrogated to the employees' priority claims, which were paid out of floating charge assets on the belief that the property of the company was insufficient. The basis for this suggestion is that if the employees' claims had been paid after receipt of the settlement proceeds from the preference actions, the employees would have been paid out of those proceeds.[54]

Had the liquidators obtained the fully informed consent of NAB prior to paying out the employee creditors from the funds, the duty owed to NAB to retain the funds would not have been breached.

Given that the liquidators had paid the employee debts from the circulating assets before an appropriate assessment of the company's assets could be made, and without the consent of NAB, Finkelstein J concluded that there had been a breach of trust.[55] The appropriate remedy for the breach of trust was

[51] Ibid.
[52] Ibid 492–3 [79].
[53] Ibid.
[54] Ibid 489–90 [63].
[55] Ibid 493 [80].

that NAB be subrogated to the rights of the employee creditors against the company's free assets.[56] His Honour explained that:

> In the present case, the bank's funds have been misapplied in breach of trust. To the extent that the bank has suffered loss, it should be subrogated to the rights of priority creditors who have been paid out with the bank's funds. Absent subrogation, it would be unconscionable for the company (and its unsecured creditors) to benefit from a windfall produced by the breach of trust.[57]

Finkelstein J therefore directed that the sum of $50 000 be paid to the secured creditor.

In obiter, his Honour also indicated that equitable subrogation may have been available even if the breach of trust had not occurred:

> In my view, equity would permit the chargee to be subrogated to the extent that floating charge assets have been used to pay priority claims which otherwise could have been paid out of the company's free assets. The claim for subrogation might be thought of as novel in some respects, but is supported by analogous, well-established categories in which a right of subrogation is recognised.[58]

His Honour considered that an equitable right of subrogation was not excluded by the *Corporations Act*. In fact, the intention of the *Corporations Act*, and in particular the intention of ss 433, 556, 560 and 561, was to 'facilitate the payment of employee entitlements and other priority claimants'.[59] His Honour noted that '[r]ecognising a right of subrogation under an "early payment" arrangement is consistent with this intention'.[60]

2 Damilock

In the later decision of *Carter; Re Damilock Pty Ltd (in liq)* ('*Damilock*'),[61] the liquidators applied to the court for directions as to whether they should pay the proceeds of unfair preference recoveries to the company's unsecured creditors or to the first ranking secured creditor, the Australia and New

56 Ibid 496 [98].

57 Ibid.

58 Ibid 498–9 [108].

59 Ibid 497 [104].

60 Ibid.

61 [2012] FCA 1445 (17 December 2012).

Zealand Banking Group Ltd ('ANZ'). ANZ had a circulating and non-circulating security interest over the company's assets.

With the consent of ANZ, the liquidators paid the employee debts in the sum of $612 000 from the circulating and non-circulating assets. Some time later, the liquidators investigated various transactions and successfully recovered $342 000 from unfair preference recoveries.

Mansfield J referred to *Cook v Italiano* and determined that the facts were 'on all fours'.[62] His Honour stated:

> In [*Cook v Italiano*] the Court was confronted with a similar set of circumstances. As here, the liquidators of that company had conscientiously realised the available assets of the company, and there were extensive secured and unsecured creditors. At issue was how the liquidators of that company should apply the relatively small amount available from the assets, including assets represented by recovered preference payments. That amount would have meant a very small distribution to the unsecured creditors, or alternatively a reduction of the liability of the company to its secured primary creditor.
>
> I do not think it is necessary to recite in detail the reasoning of Finkelstein J in that case relevant to the present issue. In my view, it is on all fours with the present circumstances.[63]

His Honour ordered that the remaining funds should be paid to ANZ, subject to the payment of the liquidators' expenses.[64]

3 Dalma No 1

In *Re Dalma No 1 Pty Ltd (in liq)* ('*Dalma No 1*'),[65] a third party related to the company in liquidation voluntarily paid the employee creditors. The third party then argued that it had a right to be subrogated to the priority position of the employees.[66] Brereton J found that subrogation was not available under s 560 of the *Corporations Act* as that section required the payments in question to be made by the company.[67] However, s 560 and the

[62] Ibid [14].
[63] Ibid [13]–[14].
[64] Ibid [14]–[15].
[65] (2013) 279 FLR 80.
[66] Ibid 83 [7] (Brereton J).
[67] Ibid 84–5 [11], 92 [39].

provisions of the *Corporations Act* generally did not exclude an equitable right of subrogation.[68]

His Honour then considered where equitable subrogation might be available where a benefactor discharges priority liabilities of a company in liquidation.[69] His Honour noted that there was no general test for subrogation but that subrogation may be available where it is unconscionable for one party to deny another party's entitlement to subrogation. His Honour found that a voluntary payment on its own does not necessarily entitle a person to equitable subrogation:

> It is true that the doctrine of equitable subrogation has on occasion been described in general terms as an entitlement of a person who pays off a creditor's debt. Thus Ashburner described the doctrine in the following terms:
>
>> A payment by A to B may have the effect of swelling the assets or diminishing the liabilities of C, but it may not give A in law any direct remedy against C. In such a case a court of equity allows A to stand in the shoes of B to enforce against C in equity corresponding rights to those which B would have against him at law or in equity. A is treated as the assignee of B's claim against C, and can enforce it, subject to all equities and rights of set-off which C may have against B.
>
> However, there is no all-embracing theory that explains when subrogation will be permitted; the equity arises from the conduct of the parties on well-settled principles *and in defined circumstances* which make it unconscionable for the defendant to deny the plaintiff's right …[70]

Brereton J accepted that the third party did not intend for the company's assets to be enlarged for the benefit of unsecured creditors.[71] Notwithstanding this, equitable subrogation was not available. Unlike in *Cook v Italiano* and *Damilock*, there had been no misappropriation of a third party's property so that it would be unconscionable for the company to deny a right to equitable

68 Ibid 87 [21]–[22].

69 Ibid 85 [16].

70 Ibid 87 [23]–[24] (emphasis in original) (citations omitted).

71 Ibid 90 [33].

subrogation.[72] Brereton J concluded that 'there was in the circumstances nothing to affect the company's conscience'.[73]

4 Saker

In *Saker, Re Great Southern Ltd* ('*Saker*'),[74] McKerracher J considered the application of s 561. His Honour rejected the reasoning in *Cook v Italiano* and found that s 561 does not create a trust relationship.

In that decision, the company had granted circulating security interests to a group of banks. When the company began experiencing financial difficulty in 2009, the banks appointed receivers who assumed control over all of the assets of the company. Over several years, the receivers recovered the debts due to the group of banks as well as over $6 million which was expended on their own fees and disbursements. The receivers and the group of banks were fully paid out with some surplus moneys remaining.

In the earlier related decision of *Great Southern*, the receivers applied to the Court for directions as to how to deal with the surplus moneys. In particular, the receivers questioned whether they were required to pay moneys to employee creditors under s 561. The employee debts were in the sum of $1.2 million. In that earlier case, Master Sanderson applied the decision in *Cook v Italiano* and found that the receivers held the surplus funds on trust for the secured creditor until it was determined whether the funds should be used to pay the employee debts pursuant to s 561.[75] The receivers considered that they were not in a position to make such an assessment for the purposes of s 561 and they transferred the surplus moneys to the liquidators.

The liquidators applied to the Court for directions as to whether they held the surplus moneys on trust pursuant to s 561. This question was critical because, if the surplus moneys were held on trust, it appeared that the employee creditors were entitled to it. On the other hand, if there was no trust relationship, the surplus moneys would be available to pay out the liquidator's fees and disbursements.

[72] Ibid 91 [36].

[73] Ibid 91 [37].

[74] (2014) 32 ACLC ¶14-043.

[75] Ibid 550 [6] (McKerracher J), citing *Great Southern* (2012) 260 FLR 362.

McKerracher J found that neither the receivers nor the liquidators held the surplus moneys on trust.[76] Rather, the receivers and the liquidators had a statutory obligation to apply the surplus funds for the benefit of the employee creditors. His Honour considered that the statutory provisions did not purport to create a trust relationship. His Honour also relied on the High Court decision in *Visbord v Federal Commissioner of Taxation* ('*Visbord*')[77] that a statutory obligation to apply moneys for the benefit of a particular person does not necessarily create a trust relationship.[78] In *Visbord*, Latham CJ stated:

> The fact that a person who has control of moneys is bound by statute to apply those moneys for the benefit of particular persons does not result in making him a trustee for those other persons as his *cestuis que trust* …[79]

McKerracher J concluded that since there was no trust, the liquidators should apply the surplus funds in accordance with s 556.[80] As a result, the liquidators were entitled to pay their own expenses and disbursements in priority to the payment of the employee creditors.

5 Leon Plant Hire

In *Gordon v Leon Plant Hire Pty Ltd (in liq)* ('*Leon Plant Hire*'),[81] Black J considered whether equitable subrogation was an appropriate remedy in circumstances where the directors of a company had breached their fiduciary duties to the company by causing it make mortgage repayments. While s 561 was not relevant, the case did consider equitable subrogation as a remedy in an insolvency context.

The breach of directors' duties was made out because there was no benefit to the company in making the mortgage repayments in respect of land owned by another party. Black J noted that this was not a traditional application of equitable subrogation, however, equitable subrogation was a remedy that

[76] Ibid 555 [33].
[77] (1943) 68 CLR 354.
[78] *Saker* (2014) 32 ACLC ¶14-043, 556 [34].
[79] (1943) 68 CLR 354, 369.
[80] *Saker* (2014) 32 ACLC ¶14-043, 557 [49].
[81] [2015] NSWSC 397 (10 April 2015).

would compel the lender to account to the company for any recovery under the mortgage in excess of the debt owed to it.[82]

After considering various authorities including the decisions in *Cook v Italiano* and *Dalma No 1*, his Honour noted that 'there is no occasion for equity to intervene by way of subrogation where there is available to the third party a remedy at law or in equity sufficient to avoid an unconscionable result'.[83] His Honour considered that an equitable charge over the relevant real property was a sufficient remedy in the circumstances. Subrogation was also inappropriate because it would affect the interest of the lender who would be required to account to the company.[84]

B *Section 433, Recoupment and Equitable Subrogation*

1 Cook v Italiano

In *Cook v Italiano*, Finkelstein J indicated that payments made under s 433 from circulating assets could result in a right of recoupment. His Honour explained that:

> The right of recoupment is an important part of the statutory scheme: it allows for employees to be paid quickly when a receiver is appointed while at the same time ensuring that haste does not come at the expense of the wrong source of funds being used to pay the employees.[85]

His Honour pointed out that predecessors to s 433 such as s 196(3) of the *Uniform Companies Acts* provided that payments could be 'recouped as far as may be out of the assets of the company available for payment of general creditors'.[86] When s 331 of the *Companies Code* (the successor to s 196) was introduced, the right of recoupment was moved for no apparent reason. Finkelstein J inferred that Parliament had not intended to remove the right and therefore it has 'survived the statutory amendments'.[87] His Honour also

[82] Ibid [70].

[83] Ibid [72], quoting *Cochrane v Cochrane* (1985) 3 NSWLR 403, 405 (Kearney J).

[84] Ibid.

[85] (2010) 190 FCR 474, 492 [76].

[86] Ibid.

[87] Ibid 492 [77].

noted that the right to recoupment still exists under the United Kingdom's equivalent of s 433.[88]

2 ExDVD

The rights of recoupment and equitable subrogation in respect of payments made under s 433 were considered in detail in *ExDVD*. In that case, the secured creditor, the Commonwealth Bank of Australia ('CBA'), exercised its power under a circulating and non-circulating security interest agreement to appoint receivers. The receivers paid employee debts in the sum of approximately \$1 million from the circulating assets in accordance with s 433 of the *Corporations Act*. The company went into liquidation and the liquidators recovered approximately \$1.4 million from unfair preference claims. CBA argued that it was entitled to be paid approximately \$1 million in priority to the unsecured creditors because its security had been diminished by that amount.

White J acknowledged that the facts gave rise to a different issue than in *Cook v Italiano* where Finkelstein J found that the liquidators' payments under s 561 amounted to a breach of trust.[89] However, his Honour noted that Finkelstein J's judgment had contemplated a right of recoupment under s 433.[90] White J explained that:

> In relation to the right of recoupment, Finkelstein J noted that predecessors of s 433 had, like the present s 433, provided that payment was to be made to the priority debtors regardless of the state of the company's assets but, in turn, also provided that the payments could be 'recouped' as far as may be out of the assets of the company available for payment of general creditors, referring in this respect to s 196(3) of the *Uniform Companies Acts 1961*. His Honour noted the good sense of this provision as it allowed employees to be paid quickly when a receiver is appointed, while at the same time ensuring that, ultimately, the correct source of funds was used for that purpose.[91]

Although there was no statutory recognition of the right to recoupment in the *Corporations Act*, White J found that there was a non-statutory right of

[88] Ibid 492 [76], citing *Insolvency Act 1986* (UK) s 40.

[89] *ExDVD* (2014) 223 FCR 409, 421 [53].

[90] Ibid 421 [55].

[91] Ibid 421 [58], citing *Cook v Italiano* (2010) 190 FCR 474, 492 [76].

recoupment.[92] However, his Honour also noted that such a right of recoupment would not necessarily give CBA any priority over unsecured creditors.[93]

White J then considered whether CBA should be entitled, by way of equitable subrogation, to a priority over the ordinary unsecured creditors. His Honour noted the earlier decision of *Re Sara Properties Pty Ltd (in liq)*,[94] where the Court found that secured creditors who had voluntarily paid land tax on the secured property of the company did not have a right to be paid in priority to the general creditors of the company.

Notwithstanding this, his Honour considered that there was no all-embracing theory that explains when equitable subrogation is available.[95] The facts were analogous to the circumstances in *Ghana Commercial Bank v Chandiram* where subrogation was available to a person who had paid out a prior ranking secured creditor.[96]

Further, his Honour noted that there was a related right of subrogation under s 560 where a person who advances money for the purposes of a company making payments of wages, superannuation contributions, leave entitlements and termination entitlements has the same rights of priority as the employees receiving the payments.[97] His Honour confirmed the conclusions in *Cook v Italiano*, *Damilock* and *Dalma No 1* that the *Corporations Act* 'does not evince an intention that the equitable right of subrogation be excluded'.[98] Rather, the intention of the *Corporations Act* is to facilitate the payment of employee creditors and an equitable right of subrogation is consistent with that intention.

92 *ExDVD* (2014) 223 FCR 409, 422 [61], citing Keith Mason, J W Carter and G J Tolhurst, *Mason and Carter's Restitution Law in Australia* (LexisNexis Butterworths, 2nd ed, 2008) 243–52 [625]–[636]. White J notes at 422, [61], quoting *Moule v Garrett* [1872] LR 7 Ex 101, 104 (Cockburn CJ), quoting Stephen Martin Leake, *Principles of the Law of Contracts* (Stevens & Sons, 1867) 41:

> Where the plaintiff has been compelled by law to pay, or being compellable by law, has paid money which the defendant was ultimately liable to pay, so that the latter obtains the benefit of the payment by the discharge of his liability; under such circumstances the defendant is held indebted to the plaintiff in the amount.

93 Ibid 422 [62].

94 [1982] 2 NSWLR 277.

95 *ExDVD* (2014) 223 FCR 409, 424 [75]–[76].

96 [1960] AC 732, 745 (Lord Jenkins), cited in ibid 424 [77].

97 *ExDVD* (2014) 223 FCR 409, 423 [66].

98 Ibid 423 [67].

Although the facts might be a 'new class of case', White J found that an equitable right of subrogation should be recognised.[99] In his Honour's view, it would be 'opportunistic and unconscionable' for the company or the unsecured creditors to have the benefit of the payments made in accordance with s 433.[100]

The decision in *ExDVD* has been followed in *Currie v Auto Electrical Distributors (Aust) Pty Ltd (in liq)*[101] and in *Re Weston* ('*7 Steel Distribution*').[102] In *7 Steel Distribution*, Foster J found that the secured creditor was entitled to equitable subrogation because payments made to employee creditors by operation of s 433 were involuntary payments and it would be unconscionable for the unsecured creditors to have the windfall benefit of those involuntary payments.

C *Reconciliation of the Authorities*

The decisions subsequent to *Cook v Italiano* appear to have left the law in a confused and unsatisfactory position. The decision in *Cook v Italiano* found a right of subrogation arising from a breach of a trust obligation but also contemplated a right of subrogation arising independently of a breach of a trust obligation. On the other hand, the decision in *Saker* denied that s 561 creates a trust relationship. This appears to undermine the reasoning in *Cook v Italiano*.

The decision in *Saker* also contrasts with an earlier case, *Lumsden v Long*, where Murphy JR considered that s 433 was analogous to a trust obligation.[103] As a result, it is unclear what kind of obligations are imposed by ss 433 and 561 on the relevant holder of company assets and whether the obligations are characterised as obligations under a trust or mere statutory duties.

With respect, the decision in *Damilock* is not particularly useful because it applied the principles in *Cook v Italiano* without sufficiently identifying the nature of the right of subrogation. Mansfield J makes the sweeping statement that the facts in *Damilock* are 'on all fours' even though there was no breach of

[99] Ibid 424 [79].

[100] Ibid 424 [78].

[101] [2014] FCA 885.

[102] [2015] FCA 724.

[103] (1998) 16 ACLC 1743, 1749.

duty by the liquidators in *Damilock* as there was in *Cook v Italiano*. His Honour appears to have applied the comments that Finkelstein J made in obiter in *Cook v Italiano* in relation to a right of equitable subrogation being available regardless of whether a breach of a trust obligation had occurred.

On the other hand, the Court in *Dalma No 1* refused to recognise an equitable right of subrogation independent of a misappropriation of property or circumstances that would affect the company's conscience. The circumstances in that case were very different because the party seeking a right of subrogation was not a secured creditor but a third party that had voluntarily made payments to the employee creditors. Sections 433 and 561 had no application in that case. Nonetheless, the decision in *Dalma No 1* casts doubt over whether a right of subrogation is available to a secured creditor arising independently of a breach of a trust obligation or some other misappropriation of property.

The decision in *Leon Plant Hire* illustrates that equitable subrogation may not be awarded where another remedy would do justice between the parties. Although the fact scenario was very different, the decision serves as a reminder that equitable subrogation is a discretionary remedy and courts may look to other remedies that are less likely to affect the rights of other parties.

White J in *ExDVD* recognised an equitable right of subrogation in the context of payments made by receivers to employee creditors. His Honour's approach was welcomed by secured creditors and insolvency practitioners because he acknowledged that the categories of equitable subrogation are not closed. His Honour confirmed that it would be unconscionable for the unsecured creditors of the company and the company itself to have the benefit of retaining the funds.

The effect of these decisions is that it is now unclear whether ss 433 and 561 impose obligations under a trust relationship or mere statutory duties. It is also unclear whether equitable subrogation is available to a secured creditor whose security has been diminished by application of ss 433 or 561, independent of a breach of a trust obligation or outside of the established categories of subrogation.

IV Determining the Rights of Secured Creditors

A *Recovery of Specific Property and Money*

Two preliminary questions to consider are whether a secured creditor's security interest should apply to preference recoveries, and whether the distinction between specific property and moneys set out in *Kratzmann* should be maintained.

The justification of the priority of a secured creditor over an unsecured creditor has traditionally rested upon principles of bargain, value and notice:

> In general, the secured creditor is entitled to look to the debtor's assets in preference to other creditors because he bargained for that right; it was the basis upon which he granted or continued credit to the debtor. If another creditor chose to lend money or supply goods unsecured, that is his affair; he has no right to complain of being subordinated.[104]

The traditional position in *Kratzmann* is that monetary recoveries are reserved for the unsecured creditors, although, the conveyance of land or a transfer of specific property may be caught by a secured creditor's charge.[105] Australian law diverges from English case law which has held that all preference proceeds belong to unsecured creditors.[106] The explanation for the rule in *Kratzmann* is that:

> monetary recoveries are due to the company under a distinct and separate cause of action, unrelated to the company's previous title to the money, and as such, should be held for the general creditors.[107]

In *Cook v Italiano*, Finkelstein J did not decide whether the preference recovery funds were caught by NAB's security interest. However, his Honour made some important points, including the conclusion that whether a security interest attaches to preference recoveries 'ought not depend on the nature of the property recovered'.[108] His Honour considered that there is no justification for distinguishing between the recovery of money and the recovery of specific property.

[104] R M Goode, 'Is the Law Too Favourable to Secured Creditors' (1984) 8 *Canadian Business Law Journal* 53, 57.

[105] See above Part II(A). See also Garry J Hamilton, *Invalidation of Securities upon Insolvency* (Federation Press, 2000) 151–3.

[106] *Lewis v Commissioner of Inland Revenue* [2001] 3 All ER 499, 510–11 [37] (Gibson LJ for the Court).

[107] Poulton, above n 7, 205.

[108] *Cook v Italiano* (2010) 190 FCR 474, 489 [62].

A practical problem identified by Finkelstein J was that a liquidator who has the choice between the recovery of specific property and an order for damages will be placed in a very difficult position:

> there will be instances where the liquidator is able to choose between an order for the transfer back of property (a proprietary remedy) and an order for the payment in money to the value of the property (a personal remedy): see for eg s 588FF(1). In those cases, the liquidator is in an invidious position, knowing that the nature of the remedy he/she seeks (or the court chooses to order) will determine whether secured creditors or unsecured creditors benefit from the recovery.[109]

A further issue is that 'some so-called money claims are in reality claims for the recovery of specific property', at least where the money paid can be traced into the hands of the creditor.[110]

Professor Roy Goode has indicated that, logically, a security interest should extend to monetary recoveries and there is no reason for unsecured creditors to have a special status in regard to monetary recoveries.[111] Similarly, Andrew Poulton notes that

> [i]f preference recoveries fall outside the scope of a charge, a perverse result could arise where as more voidable transactions are made, the better off the unsecured creditors will be because the recovered money will not be subject to the charge.[112]

According to Poulton, the end result is that the unsecured creditors have an unfair advantage.

The preservation of the proceeds of monetary recoveries for unsecured creditors appears to undermine the principles of bargain, value and notice. It stands in stark contrast to traditional common law principles that have always jealously protected proprietary rights.

However, the better view appears to be that all preference recoveries should be treated as unavailable to secured creditors because it is the unse-

109 Ibid 488 [55].

110 Ibid 488 [56] (Finkelstein J).

111 Poulton, above n 7, 205, citing Hamilton above n 2, 203–5, quoting Roy Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell, 4th ed, 2011) 625–7.

112 Poulton, above n 7, 206, citing *Cook v Italiano* (2010) 190 FCR 474, 489 [61] (Finkelstein J).

cured creditors who bear the burden of the insolvency.[113] Unsecured creditors will rarely receive more than a small dividend in a winding up (or no dividend at all), while secured creditors are in a better position to suffer their security being diminished. As observed by Professor Goode, the relevant provisions of the *Corporations Act* are 'remedial in character, embodying a policy decision to benefit the general body of creditors and not any individual creditor, and that the claim is accordingly vested by statute in the liquidator, not in the company'.[114]

It is therefore preferable to treat all preference recoveries, whether monetary or specific property, as belonging to the unsecured creditors. The following amendment to s 588FA of the *Corporations Act* proposed by Poulton appears to be appropriate:

588FA Unfair preferences

> (1) A transaction is an unfair preference given by a company to a creditor of the company if, and only if:
>
> (2) …
>
> (3) …
>
> *To remove any doubt, if a transaction is an unfair preference, the recovery proceeds of that transaction are to be held for the general body of creditors and distributed in accordance with Division 6 of this Act.*[115]

B *Should We Recognise a Right of Subrogation?*

A critical question is whether it is appropriate and desirable to recognise a right of subrogation that gives a secured creditor priority over unsecured creditors where that secured creditor's security has been diminished by the effect of ss 433 or 561 of the *Corporations Act*. As Finkelstein J noted in *Cook v Italiano*, deciding whether to recognise a right of subrogation requires an analysis of the competing interests of secured and unsecured creditors.[116]

[113] Andrew Keay, 'In Pursuit of the Rationale behind the Avoidance of Pre-liquidation Transactions' (1996) 18 *Sydney Law Review* 55, 69, citing Morris G Shanker, 'The Worthier Creditors (and a Cheer for the King)' [1976] *Canadian Business Law Journal* 340, 341.

[114] Goode, *Principles of Corporate Insolvency Law*, above n 111, 627.

[115] Poulton, above n 7, 207 (emphasis added).

[116] (2010) 190 FCR 474, 493 [82].

On one view, it is desirable to recognise a right of subrogation because it appears to be inequitable that timing issues should result in the diminishment of a secured creditor's property. For example, in *Cook v Italiano*, had the proceeds of the preference recoveries been available earlier, the secured creditor would never have needed to rely on subrogation.

Recognising a right of subrogation also encourages the early payment of employee creditors because secured creditors may take comfort in the fact that they may be paid out from preference recoveries at a later date.[117] A liquidator can decide to pay the employee creditors before it is known exactly what preference recoveries are available. It also frees a liquidator from the difficulty of making one accurate assessment of the company's assets. In reality, it may be very difficult for liquidators to determine the exact value of a preference claim until that claim is settled.[118]

Relevantly, employees can receive some entitlements relatively quickly under the Fair Entitlement Guarantee ('FEG'). The *Fair Entitlements Guarantee Act 2012* (Cth) provides that employees are entitled to 13 weeks unpaid wages, annual and long service leave and redundancy pay where their employer went into liquidation on or after 5 December 2012.[119] However, the FEG is not comprehensive and does not cover additional unpaid wages, superannuation payments, bonus payments or other irregular payments or commissions.

On the other hand, recognising a right to subrogation disregards the longstanding principles in *Kratzmann* and *Yagerphone*. Unsecured creditors will usually receive a small dividend or no dividend at all and it seems unfair to allow for a further reduction of the company's free assets by making the proceeds of unfair preference recoveries available to secured creditors. These unsecured creditors may include people who are substantially dependent on

[117] See Masi Zaki and Wendy Jacobs, 'Are Secured Creditors Entitled to the (Italiano) Fruits of Successful Unfair Preference Actions?' (2011) 11 *Insolvency Law Bulletin* 129.

[118] Nigel Watson, 'A Call for Law Reform: Secured Creditors Entitlement to Preference Recoveries' (2011) 23(1) *Australian Insolvency Journal* 20, 22.

[119] *Fair Entitlements Guarantee Act 2012* (Cth) pt 3. Prior to the FEG, employees were entitled to assistance under the General Employee Entitlements and Redundancy Scheme: see generally Helen Anderson, *The Protection of Employee Entitlements in Insolvency: An Australian Perspective* (Melbourne University Press, 2014) 68–78.

the insolvent company for their business and people who were in an employee-like relationship (such as contractors) with the company.[120]

Another issue is that secured creditors may be encouraged to lend moneys to companies without employees (or companies that choose to engage contractors instead of employees) in order to avoid the application of ss 433 or 561.[121] Companies may endeavour to avoid entering into employee–employer relationships in order to secure funding with lenders, creating a 'casualisation' of the workforce.[122] Admittedly, attempts to avoid particular relationships being deemed to be employer–employee relationships may not always be successful.

Further, knowing that the proceeds of unfair preference recoveries may be available to the secured creditors in priority to unsecured creditors, liquidators may be discouraged from pursuing unfair preference claims.[123] While secured creditors may choose to fund a preference recovery, they do not have standing to bring a claim themselves given that the right to bring the action vests in the liquidator of the company.

Notably, it is possible for a secured creditor to obtain the benefit of subrogation under s 560 of the *Corporations Act*, without the law recognising any equitable right to subrogation such as the remedy in *Cook v Italiano*. Section 560 is generally relied upon by the Australian Department of Employment when it provides financial assistance under the FEG.[124] By s 560, a person is entitled to subrogation where he or she has paid moneys directly to the company for distribution to the employee creditors. If a secured creditor wishes to retain his or her right to the company's circulating assets or their proceeds, it is reasonable that he or she contribute directly to the payment of employee debts upfront.

120 Law Reform Commission, above n 28, 294 [723]. The Law Reform Commission discusses the creation of a wage earner protection fund to protect such unsecured creditors: at 294–7 [723]–[727]. See also Whelan and Zwier, above n 29, 4.

121 Parliamentary Joint Committee on Corporations and Financial Services, Commonwealth of Australia, *Corporate Insolvency Laws: A Stocktake* (2004) 175 [10.38], 181 [10.54].

122 Ibid 177–8 [10.42].

123 Poulton, above n 7, 195–6.

124 Thomson Reuters, *McPherson's Law of Company Liquidation*, above n 27, [13.1300], in relation to the General Employee Entitlements and Redundancy Scheme.

C *Does Subrogation Require a Breach of Trust?*

If a secured creditor is entitled to a right of subrogation, should the right of subrogation depend on a breach of trust? Limiting a right of subrogation to circumstances where there is a breach of trust is problematic because there are clearly circumstances where the secured creditor should be entitled to subrogation and no breach of trust has occurred. It seems unduly harsh and artificial to force parties to prove that a trust relationship exists and some breach of trust has occurred. For this reason, commentators greeted the decision in *ExDVD*, which recognised a right of subrogation unrelated to breach of trust, with a 'welcome sigh of relief'.[125]

Requiring proof of a breach of trust may also force secured creditors to prove that employee debts have been paid under statutory compulsion. There may be difficulties in proving that the payments are not voluntary given that s 561 applies whether or not a secured creditor consents.[126]

A further issue is whether it is appropriate to interpret s 561 as creating a trust relationship without further clarification from Parliament. In *Saker*, McKerracher J pointed out that the mere existence of a statutory obligation does not create a trust relationship. There is no universal rule that an obligation to hold money or property for another person creates a trust relationship. Generally, a trust is created where a person (the trustee) receives money on the basis that it is to be kept separate from his or her own money and is available only to satisfy an obligation to another person (the beneficiary).[127] On the other hand, if a person receives money on the basis that he or she must, at some specified time, pay an equivalent amount to another person, then the recipient of the money appears to be a debtor and it appears that no trust relationship is created.[128] Further, the fact that s 561 does not require a liquidator to place the relevant property in a separate bank account from

[125] Lewis Gentry, 'Clarification of Employee Entitlements in Insolvency — *Re Divitkos; ExDVD Pty Ltd (in liq)*' (2014) 15 *Insolvency Law Bulletin* 74, 76.

[126] Thomson Reuters, *Company Receivers and Administrators*, above n 30, [11.4770].

[127] See, eg, *Walsh Bay Developments Pty Ltd v Federal Commissioner of Taxation* (1994) 29 ATR 311, 319 (Foster J); *Jessup v Queensland Housing Commission* [2002] 2 Qd R 270, 274–5 [10]–[12] (McPherson JA).

[128] See, eg, *Walker v Corboy* (1990) 19 NSWLR 382 (Priestley, Clarke and Meagher JJA); *Compass Resources Ltd v Sherman* (2010) 42 WAR 1 (Beech J).

other property held by the liquidator indicates that no trust relationship is created.[129]

Finally, further problems may arise if s 561 does create a trust relationship because the liquidator would owe fiduciary duties to the secured creditor. These duties may conflict with a liquidator's fiduciary duties to the company, and in particular, the duty to pay the company's debts from the available assets.[130]

D *Whether Subrogation Should Be Statutory or Equitable*

The advantage of looking to equity rather than a statutory right of subrogation is that equity is inherently flexible. There is a long history of courts looking to equity to solve problems where there are competing interests and it is necessary to distribute assets between parties.

Nonetheless, the secured creditors' right to subrogation certainly warrants consideration by Parliament. These issues are not 'one-off' problems but problems that arise frequently — as demonstrated by the spate of cases since *Cook v Italiano*.

A statutory right of subrogation would be useful because of the certainty it creates. Insolvency practitioners do not need to speculate as to how the court may exercise its discretion. Without a statutory right, it is difficult to predict how the court will address a problem and whether the court will award equitable subrogation or another equitable remedy, such as a constructive trust or an equitable lien or charge. For example, in *Leon Plant Hire*, the right to subrogation appeared to be made out, however, Black J found that subrogation was not appropriate because an equitable charge was sufficient to avoid an unconscionable result in the circumstances.[131]

A level of certainty is particularly desirable given the recent decisions in *Cook v Italiano*, *Damilock*, *Dalma No 1*, *ExDVD* and *Saker*, which are difficult

[129] See *Peter Cox Investments Pty Ltd (in liq) v International Air Transport Association* (1999) 161 ALR 105, 118 [49] (O'Loughlin J); *Gliderol International Pty Ltd v Hall* (2001) 80 SASR 541, 549 [39] (Nyland J).

[130] See, eg, *Pulsford v Devenish* [1903] 2 Ch 625 where the liquidator failed to inform the creditors of the liquidation and distributed the company's assets without notice to them. For the general duties of a liquidator, see LexisNexis Australia, *Australian Corporation Practice* (at Service 116) [26.100].

[131] [2015] NSWSC 397 (10 April 2015) [72].

to reconcile. Insolvency practitioners are less likely to require directions from the court. Applications under s 511 of the *Corporations Act* can be extremely costly and the certainty provided by a statutory right of subrogation might result in greater funds being available to creditors.

Conventionally, it was thought that statutory remedies may be less flexible and inappropriate when novel fact scenarios arise. However, this view has been challenged by commentators such as Joachim Dietrich and Thomas Middleton who explained that:

> statutory remedies (inspired by similar equitable forms of relief) are widely available, on an even broader, less restricted and more flexible basis than in equity itself … As the High Court has pointed out in *Cardile v LED Builders Pty Ltd*, statutory injunctions 'empower courts to give a remedy in many cases where none would have been available in a court of equity in exercise of its jurisdiction'.[132]

A statutory remedy based on s 560 of the *Corporations Act* may be appropriate. Accordingly, the insertion of a new s 560A is proposed:

560A Secured creditor subrogation

If:

(a) a payment has been made in accordance with section 433(3); or

(b) a payment has been made in accordance with section 561;

then:

(c) the person whose secured property has been diminished by the payment made in accordance with section 433(3) or section 561 has, in the winding up of the company, the same right of priority of payment in respect of the money so paid as the person who received the payment would have had if the payment had not been made; and

(d) the right of priority conferred by paragraph (c) is not to exceed the amount by which the sum in respect of which the person who received the payment would have been entitled to priority in the winding up has been diminished by reason of the payment.

[132] Joachim Dietrich and Thomas Middleton, 'Statutory Remedies and Equitable Remedies' (2006) 28 *Australian Bar Review* 136, 167–8, quoting *Cardile v LED Builders Pty Ltd* (1999) 198 CLR 380, 394 [28] (Gaudron, McHugh, Gummow and Callinan JJ).

V Conclusion

This article considered the application of ss 433 and 561 of the *Corporations Act* and the effect of recent case law which has left the law in a confused and unsatisfactory position. It is presently unclear whether a secured creditor has an equitable right of subrogation in the context of ss 433 and 561 and whether such a right of subrogation exists independently of a breach of a trust obligation. While the decision in *ExDVD* has brought some level of certainty, it is unclear when it may be unconscionable for a company to retain the benefit of funds paid in accordance with ss 433 or 561.

A related issue examined in this article is the longstanding principle in insolvency law that the proceeds from preference recoveries are available only for distribution to the unsecured creditors. This article has argued that it is desirable that all preference recoveries, whether they comprise moneys or specific property, be available for the unsecured creditors of the company. To that end, this article submits that the amendment to the *Corporations Act* proposed by Poulton should be adopted.

Finally, it is submitted that a statutory entitlement to subrogation should be enshrined in legislation allowing secured creditors to share in the proceeds of preference recoveries where their security has been diminished as a result of the application of ss 433 or 561.