



CONSTRUCTION LAW UPDATE No. 808A

It may sound unfair but it's the law

Introduction

In *Woodgate v Fawcett* the NSW Supreme Court was asked to determine whether money repaying a loan from a widowed mother to her son should be handed over to the liquidator of the son's company.

Unfair preferences

The law as to unfair preferences is set out in Update 808, attached with this update. We have put out the two associated updates, one to explain the law and how to try to avoid its consequences, the other to give a practical illustration of how the law works.

The background facts

Mark Fawcett was the director of two companies; "MGB" and "Herd". MGB owned the business factory and another property. Herd manufactured bull bars and armoured vehicles from the factory.

MGB borrowed funds from a financier against the properties with the borrowings secured by a mortgage. At 17 March 2006, MGB had borrowed over \$3.3 million.

Mark's parents ("the Fawcetts") also owned properties and borrowed monies to lend to Mark's company, MGB. Mark's father died on 10 October 2005 leaving his mother as the sole lender to MGB. By 17 March 2006, Mark's mother had borrowed a total of \$2.593 million for MGB from the same financier, secured by mortgages against two properties that she owned.

The problems emerge

In March 2006, Mark decided to close down his business. He called his mother and informed her that he needed some support, that he was closing his business. Mark assured her that he would be able to repay to her all of the borrowed monies.

Mark's mother travelled down to the factory and worked there as a receptionist for a week as the business closed.

On 15 March 2006, Mark's mother lodged a caveat on another property Mark owned. On 17 March 2006, MGB sold the factory and the other property for a total of \$6 million. On the same day, Herd closed its doors and the business ceased trading. The funds received from the sale were sufficient to repay all of the mortgages, but not sufficient to pay all of the debts of Herd and MGB. Some of the council rates outstanding on the properties were paid by the purchaser.

The mortgages on Mark's mother's properties were fully paid out. Mark's mother gained a clear title to her properties. The loan was fully repaid.

The employees

Herd had eight employees, and all were made redundant when the business closed. All received payments towards their wages, annual leave and long service leave. On the day they left Herd's employ, the employees were given a form to complete to apply for Commonwealth Employee Entitlements and Redundancy Rights. At the end of the form, there was a question; "What reason was given for termination?" They all answered "unable to pay wages".

The liquidator appointed

On 28 March 2006, a liquidator was appointed to MGB and on 2 May 2006, it was placed under a creditor's voluntary winding up. On 18 May 2006, Mark was made bankrupt. Mark's trustee in bankruptcy filed a claim against the liquidator of MGB for \$596,000 for monies lent by Mark to MGB and not repaid.

The liquidator examined the records of Herd and MGB and questioned the transaction of 17 March 2006.

He said that the payment in full of the loan monies to Mark's mother was a voidable transaction on the basis that it was either an unfair preference or an unreasonable director related transaction. In this update, we focus on the first of these.

The mother's defences

Mark's mother raised two defences. She said that she did not consider that MGB was insolvent when it repaid the loan. Secondly, she raised the statutory defence saying that she had no reasonable grounds for suspecting that MGB was insolvent when it repaid the loan and that a reasonable person in her position would have had no grounds for suspecting insolvency.

Insolvency

The liquidator brought detailed evidence of the insolvency of MGB. Liquidators generally retain accountancy experts to deal with these issues, at significant cost. There is a strategic decision to be made by parties in the position of Mark's mother – whether to concede immediately in the hope that the funds will not be wasted in the battle, or whether to battle on and try to keep the money. Mark's mother chose to fight. The Court found that evidence of insolvency was overwhelming.

The outcome

As to the statutory defences, Mark's mother faced a difficult task for several reasons:-

1. The business was being closed down rather than sold;
2. The staff, including family members, were let go in circumstances where the business was unable to keep paying them;
3. She had lodged the caveat on Mark's property only two days prior to the sale to protect her position.

The Court held that the repayment of the loan by MGB gave unfair preference to Mark's mother in comparison to other creditors who received nothing.

The Court also found in this case that the repayment of the loan was an unreasonable, director related transaction and breached another provision of the Corporations Law. The repayment of the loan to Mark's mother was not beneficial to MGB and detrimental to other creditors who received nothing. Where parties are related, as in this case where the director was the son of the recipient of the money, the Court will look more closely at such a transaction and be less inclined to excuse it.

For these two separate reasons, Mark's mother was ordered to pay the liquidator the sum of \$2.593 million plus interest.

In these cases, the liquidator's costs are deducted from the funds recovered. Ultimately, Mark's mother might participate in a distribution to creditors when the liquidator's work is complete. When that occurs, the total remaining asset pool will be divided between all of the creditors of MGB.

Ironically, Mark's trustee in bankruptcy will no doubt receive some of the money that Mark previously paid to his mother to repay the loans.

Conclusion

Our accompanying update sets out some of the ways in which parties can endeavour to minimise the risk of being exposed to successful claims for unfair preferences.

The law is clear, where companies are in their sunset period, it is not acceptable to apply pressure to jump the payment queue. The law seeks to distribute the remaining assets fairly to all creditors.

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