

April 2020

Improving your security position: a guide for Creditors

In challenging times for businesses, it is imperative to be paid in full for goods or services provided on credit. It is important to know what types of security may be available to secure debts, whether it is possible to register any security, and how a creditor may be affected if it has an unsecured debt and its debtor enters into liquidation.

In light of the current and expected impact of COVID-19 on Australia's economy and the resulting financial hardship being experienced, you should be vigilant in ensuring that you are getting paid for the goods and services you provide. Against this background, it is important to consider:

- what types of security you could take to protect your interests;
- if you have an agreement that grants you security – ensuring that your interest is registered, if possible; and
- possible consequences of having an unsecured debt if a company that owes you money goes into liquidation.

Taking security

If you are entering into an agreement where another party will have an obligation to pay you money (for example in exchange for services or goods), you should consider whether the other party has assets that you could take security over in order to secure payment of the debts they will owe to you.

Types of security that you may consider include:

- director guarantees;
- real property (land) securities; and
- security interests in personal property (generally, assets other than land).

Director guarantees

It is common when transacting with a company for the director (or the directors) of that company to provide a **guarantee and indemnity** in which they guarantee the obligations of the company under an agreement and agree

to indemnify the other party (you) for loss suffered as a result of the company's default under the agreement.

This can provide a very useful recourse for creditors, particularly in circumstances where the company does not own any significant assets or the company's assets are already heavily encumbered in favour of other creditors.

Additionally, you will generally still be able to recover amounts owing to you from the director under a guarantee when the company is placed into liquidation and you are commonly only able to recover a portion of the debt owing to you as a distribution from the winding up.

Further, a guarantee could also include a provision for the director to give security over any real estate they own.

Real Property

If the company or individual owns real property (land), they can grant a security interest in such property in your favour. For example, this could be by way of a **mortgage** over the property or by a **charge** over the property, which may entitle you to register a mortgage or a caveat on the title of the property.

In order to ensure the priority of your interest in the real property, it is important to register mortgages and caveats in accordance with the relevant property law legislation.

Personal Property

Personal property is defined by the *Personal Property Securities Act 2009* (Cth) (**PPSA**) and it includes all property other than land or anything which is specifically excluded under the PPSA (for example, some statutory licences). It includes **tangible and intangible property** and **present and future property**.

An interest in personal property that in substance secures payment of a debt or other obligation, regardless of the

form of the transaction, can be registered as a 'security interest' on the register established by the PPSA, which is called the Personal Property Securities Register (PPSR).¹

Given the broad definition of '**security interest**' and '**personal property**', there could be many transactions which could give rise to a security interest under the PPSA.

The most common example of such a transaction is the sale of goods on a **retention of title** basis. In this case, the supplier has a security interest in the goods supplied, even though it still retains title to those goods until they are paid for.

Why is it important to register your PPSA security interest?

In order to protect against competing third parties asserting a claim to the same assets, the secured party must '**perfect**' the interest.

The most common third party claims are those of other creditors with security interests, such as financiers with security over all of the assets of the party granting the security, and those of an administrator or liquidator appointed to the party granting the security.

Perfection usually occurs through registration on the PPSR. It can also occur through possession or control. This Alert will focus on perfection through registration on the PPSR only.

Priority of registrations

Registration on the PPSR will ordinarily determine the order of priority between secured creditors. Generally, the first to register over the secured assets will have priority over the other:

- Perfected interest has priority over later perfected interest;
- Perfected interest has priority over later unperfected interest;
- Perfected interest has priority over earlier unperfected interest.

Note: These rules are subject to **exceptions**.

The most common exception to the rule is in the case of a **Purchase Money Security Interest (PMSI)**. This special type of security interest secures the repayment of debt in connection with the purchase price of the assets which are the subject of the security interest. A retention of title arrangement and sale of goods on credit, including specific asset finance, are examples of transactions which qualify for special PMSI status.

Subject to the strict registration requirements set out below, a PMSI registration in respect of specific goods will have **priority** over any earlier perfected security interest in the goods.

In the absence of registration or in the case of a defective registration of a security interest on the PPSR, and where the debtor enters into voluntary administration or liquidation, the creditor will be in the same position as an unsecured creditor. In this case, a retention of title clause will not afford any protection and the creditor will lose its goods to the administrator or liquidator.

Similarly, if the retention of title creditor does not register its security and a secured creditor with a validly registered security interest takes enforcement action, the retention of title creditor will lose priority to its goods.

PPSR timing requirements

There are also strict requirements to be met in relation to both the type and details of the registrations, and the timing of making the registration, on the PPSR. A failure to register in time will leave the registration vulnerable in the event that an administrator or liquidator is appointed subsequently.

In terms of such timing requirements:

1. PMSIs must be registered:
 - before the debtor obtains possession of the goods where the goods supplied become part of the debtor's inventory;² or
 - 15 business days from the time the debtor obtains possession of goods where the goods supplied will not form part of the debtor's inventory.³
2. Where the debtor is a company, a registration other than a PMSI must be made either:
 - within 20 business days after the security agreement giving rise to the security interest comes into force;⁴ or
 - earlier than 6 months before the debtor enters liquidation or administration.⁵

It is possible to extend these time limits, but the circumstances in which such extensions will be granted are limited.

Consequences of having an unsecured debt

Unpaid creditors

If your debt is properly secured and, if required, registered, you **will** be able to enforce that security in order to recover

¹ Section 12(1) of the PPSA.

² Section 62(2) of the PPSA.

³ Section 62(3) of the PPSA.

⁴ Section 588FL of the *Corporations Act 2001* (Cth) (**Corporations Act**).

⁵ Section 588FL of the *Corporations Act*.

the debt owed to you (subject to the rights of any other secured creditors that have priority over your interest). For example, this may include taking possession of property and selling it to realise funds to discharge the debt. This will also be the case where a company becomes insolvent and enters into liquidation.

If your debt is not secured (you are an unsecured creditor) and the company that owes you money becomes insolvent and enters into liquidation, you **will not** be able to recover your debt from any secured property and will instead only be paid out from the general assets of the company (excluding any secured assets which will be realised for the benefit of secured creditors first, with only surplus proceeds available to unsecured creditors), together with other unsecured creditors.

You would then be paid a distribution out of the available assets of the company in proportion to the debt owed to you. Generally, where a company is insolvent unsecured creditors will only receive a small portion of the debt they are owed (for example, 10 cents in the dollar).

Unsecured creditors that have received payment

A company's insolvency also poses a risk if you are an unsecured creditor and you **have** received payment from the company.

If a company is subsequently wound up, a liquidator appointed to that company will be able to claw back certain payments made by the company, including payments made legitimately to its unsecured creditors, within 6 months, as an '**unfair preference**'.⁶

Whilst you may be able to rely on a '**good faith**' defence⁷ to prevent the liquidator from recovering such payments, you must be able to show that you had no reasonable grounds for suspecting that the company was insolvent (or would become insolvent as a result of the payments) at the time of those payments, or that a reasonable person in your position would have had no such grounds for suspecting insolvency. If a liquidator can show that you [knew about factors that indicated the company was insolvent](#), you may not be able to take advantage of this defence.

If an unfair preference claim is made in respect of payments you received, you will need to pay back the amounts received by you to the company's liquidator (or reach a settlement in relation to the amount paid to you). You would then be entitled to lodge a proof of debt in respect of the amount owed to you by the company and receive a distribution in the ordinary course of a company's winding up, depending on the assets available for distribution.

⁶ See sections 588FA, 588FC, 588FE and 588FF of the Corporations Act.

The unfair preference provisions of the Corporations Act only apply to unsecured creditors. This is another reason to seek to take security if possible.

Conclusion

Given the uncertainty most Australian businesses are facing, whilst being sympathetic and working together to achieve the best possible recovery, it is obviously preferable to seek to improve your position as a creditor if possible.

As should be apparent from the above summary, it is important to ensure that any agreements which provide for security are drafted appropriately and registrations of securities are made if necessary. Compliance with the requirements under the PPSA should be given careful consideration, as the consequences of getting it wrong are significant.

Further information

For further information in relation to certain matters referred to in this Alert, please see:

[What are Directors' Duties during Uncertain Financial Times?](#)

["Safe Harbour" Laws – How can Directors' Steer the Ship During Uncertain Financial Times?](#)

[Coronavirus \(COVID-19\): Important Temporary Relief in Insolvency Law](#)

[What to look for: Signs that a company may be insolvent](#)

[COVID-19 Legal Issues & Considerations](#)

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⁷ Section 588FG of the Corporations Act.