Chapter 11. Funding Company Operations

Table of Contents

Introduction

[11.10] A company can raise the funds necessary to carry on its business in two primary ways:

- by borrowing funds from investors (known as "loan capital" or "debt capital"); or
- by issuing equity interests (such as shares) to investors.

The first method is called "debt financing" and the second is "equity financing". Different laws apply to each type of financing. Companies are specifically empowered by s 124 of the *Corporations Act 2001* (Cth) to borrow money, to grant security for such loans, and to issue shares.

To facilitate effective operations of the company, company managers need to make and implement decisions about the capital needs of the company. Such decisions include the amount of capital required by the company, and the most effective source of that capital. Companies who wish to expand their future trading opportunities will inevitably have to finance those operations by raising sufficient funds through either a process of issuing shares, or borrowing money directly through the agency of a financial institution or by issuing debentures.

Most companies will choose to finance their operations with a mix of debt and equity financing. Practical difficulties (eg difficulty in finding a willing financier) may impact the type of funding chosen. Contractual obligations may require the company to maintain its capital around a certain gearing ratio (the balance between the two types of funding).

If the company elects to issue shares, the investor becomes a shareholder and, as such, a member of the company under s 231 of the *Corporations Act 2001* (Cth). If funds are raised through borrowing money or issuing debentures, the provider of such funds is classified as an external creditor.

Key points

[11.20] This chapter will provide a greater understanding of:

- how a company can raise money for its operations;
- the differences between debt financing and equity financing;
- the nature of, and legal requirements for, equity fundraising; and

- the nature of, and legal requirements for, secured and unsecured debt fundraising.

Key terms

[11.30] The key terms in this chapter are:

- Debt financing
- Equity financing
- Disclosure
- Prospectus
- Offer information statement
- Short form prospectus
- Disclosure document
- Fundraising
- Due diligence
- Share capital
- Gearing ratio
- Debenture
- Unsecured note
- Charge
- Personal property
- Security interest
- Personal property security interest
- Personal property security register
- Transitional security interest

- Attachment
- Perfection
- Purchase money security interest
- Priority
- Collateral

Capital structure

Balance between equity and debt

[11.50] Directors and controllers of companies need to decide which amount, type and balance of capital structure best suits the company's operations, both current and into the future. As mentioned above, a company can finance its operations through equity, debt (although finding and financing a wholly debt-financed operation may be problematic) or, most commonly, a mixture of both equity and debt.

Other circumstances may constrain these decisions. For example, a company which has little prospect of profits in the short term may find it difficult to adequately service debt or, indeed, to find a financier willing to finance such operations. Likewise, the financing of high-risk operations may be difficult to obtain or may be only obtainable on very expensive terms, thus leaving managers of such operations with little choice but to resort to equity financing. A company with few assets may find debt financing wholly unobtainable, at least without the financier negotiating the benefit of personal guarantees of that debt from the company's directors. It is quite usual for a financier to require a proprietary company's directors to personally guarantee the company's loan. A company which urgently needs short-term funds may have little alternative but to raise a loan through debt financing from external sources.

The prospective investor (whether investing by way of debt or equity) may also impact this decision. For example, an investor may prefer the relative certainty of a return on their investment by way of regular, calculable interest on a loan to the company, instead of the rather less certain prospect of sharing in the company's profits (if there are any) by way of an unknown dividend in the indefinite future. On the other hand, if an investor considers that the company is likely to be the next Google, they may wish to invest in equity, thus benefiting from what the investor hopes will be astronomical returns on their investment in a very profitable company.

Alternatively, an investor in a strong bargaining position may negotiate that their investment will be in the form of a convertible debenture. This form of investment allows the investor to profit from the less risky, more certain debt investment initially, and to have the option of converting the debenture into equity at some defined point in the future, when the company's profits may be more visible. A convertible debenture can also be to the advantage of the company, which benefits from tax deductions for the interest paid to the investor in the initial stages of the investment (compared to equity investments, where no tax deductions are available for dividends paid to the investor). Further, convertible debentures are less risky for the investor than solely debt financing or solely equity financing, and give the investor the potential to share in profit, which may enable the company to negotiate lower financing costs than would be the case in either solely debt or solely equity financing.

Existing shareholders may have concerns which can also impact a company's decision in regard to capital structure. An additional issue of shares may be seen by existing investors as resulting in a dilution of their investment and may adversely affect the expected return on their investment – particularly if the new share issue is of preference shares rather than ordinary shares.

Thus, when deciding the ideal capital structure for the company, managers will need to consider not only the ideal gearing ratio for the company, but also the company's ability to negotiate and obtain finance from sources that are available, affordable, and acceptable to its existing shareholders.

Gearing ratio

[11.60] If a company has borrowed a large amount of money relative to its issued share capital, it is described in corporate finance theory as being *highly geared*. Conversely, companies which borrow little and consequently carry a small amount of debt finance relative to their share capital, are said to be *lowly geared*.

The gearing ratio will potentially influence the return available for distribution to the investors. Provided a *lowly geared* company can satisfactorily service repayments of its debts, it is able to offer a relatively higher dividend to its investors than a *highly geared* company.

However, if a *highly geared* company's income declines, its investors face the prospect of the repayment of debt eroding the company's profit, reducing not only their return on their investment, but also eating into the company's capital, potentially bringing about the ultimate liquidation of the company. For this reason, lenders will usually insist that the amount borrowed is well within the company's ability to repay. For instance, the company may only be permitted to borrow up to a certain percentage of the company's assets in order to ensure that repayment of the principal is feasible. The financier may negotiate the right to cause the loan to become payable on demand, if the company's gearing ratio falls outside a permitted range. This would, if the loan is secured (eg by a mortgage or company charge), allow the financier to seize and sell company assets and to use the sale proceeds for repayment of the loan.

Distinction between share capital and loan or debt capital

[11.70] Each of these forms of capital investment in a company has distinct differences. It should be noted, however, that frequently companies may issue shares or equities which possess (on face value) many of the attributes of debt finance. These are generally referred to as *hybrid equities*.

Share capital

[11.80] An investor becomes an equity investor on subscribing for and receiving shares in a company. Alternatively, an investor may acquire shares in a company from an existing shareholder, although such transactions do not represent any change to the company's capital structure (and accordingly, the company's assets do not increase by virtue of such a sale of shares). Thus, the difference between the "issue" and the "sale" of shares is important.

Equity investors will only be entitled to a return on their investment if the company makes a profit, since companies are prohibited from paying dividends except to the extent to which their assets exceed their liabilities, and dividends can only be paid if fair and reasonable to shareholders and will not materially prejudice the company's ability to pay its creditors: s 254T. However, even if such profits exist, shareholders cannot force a dividend to be paid; the decision to declare a dividend will rest with the board of directors: s 254U. See also *Burland v Earle*.[1]

If a company becomes "insolvent" (which is defined as being unable to pay debts when they fall due: s 95A) and goes into liquidation, equity investors rank after all creditors under s 556 and are most unlikely to have their investment returned, since by virtue of the definition of "insolvency", an insolvent company is unable to repay all of its creditors, let alone have funds left over for its equity investors.

Loan or debt capital

[11.90] The money lent to the company (the principal) will have to be repaid at the expiration of an agreed period. Ordinarily, the lender is also contractually entitled to be paid a return, in the form of interest. The amount of interest is negotiated between the company and the lender, and is specified in the loan contract. It can be a fixed rate, or a variable rate of interest, or can be calculated by means of a formula specified in the contract. The dates for payment will be a matter of negotiation between the lender and the company. The interest rate for any given loan generally reflects the market rate, plus the perceived risk of lending the money to the particular company. The date(s) that interest must be paid, is a matter for negotiation between the company and the lender.

---

1 *Burland v Earle* [1902] AC 83.

2 See also *Ampol Petroluem Ltd v RW Miller (Holdings) Ltd* [1972] 2 NSWLR 850 & *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

The payment of interest is a tax deduction for the company, unlike the return on a shareholder's investment in the company. Dividends paid to shareholders are not tax deductible. Additionally, unlike shareholders, the lender receives this interest regardless of how well the company performs. Interest is a debt that becomes due and owing to the lender, and is thus also enforceable in a court if necessary. This contrasts starkly with the entitlements conferred on shareholders who only receive a return if the company makes a profit, and they cannot force the company to pay this return on their investment.

Because a lender is a creditor of the company, in a liquidation the lender will have a right to priority repayment of their funds ahead of investors in shares. However, as discussed above, an insolvent company in liquidation is unlikely to be able to repay all of its creditors in full. Secured creditors will be repaid ahead of unsecured creditors – hence, the lower cost of borrowing money under a loan which is secured by a mortgage, company charge, or other security.

Equity fundraising

Power to issue shares

[11.110] Section 124 of the *Corporations Act 2001* (Cth) empowers companies to issue shares (and options over shares). Any company has the power to issue shares to any person at any time, but only a public company can offer to issue shares to the public. A proprietary company can only issue shares to individual persons known to the company.

If a company wishes to issue new shares, it is generally regarded as a matter within the competence of the board of directors. This is based on the assumption that an injection of capital is necessary for the financial operations of a company from time to time.

Restrictions on the ability to issue shares

[11.120] Certain restrictions do apply to the right to issue shares.

Restrictions in the internal rules of the company

[11.130] Restrictions can be self-imposed by the company's internal rules. For instance, the company may have placed restrictions in its constitution on its future ability to issue certain types of shares. The Replaceable Rules (which apply by default to a multi-shareholder company without a constitution) include s 254D of the *Corporations Act 2001*, which requires a proprietary company wishing to issue shares to first offer those shares to existing shareholders in the proportions in which they currently hold shares. This pre-emptive rights provision protects shareholders against dilution of their interest in the company through future share issues.

Restrictions in the Corporations Act

[11.140] Other restrictions are contained in the *Corporations Act 2001*. For example, a company cannot issue shares where the issue would be oppressive towards existing shareholders: s 232. Directors must not issue shares for an improper purpose such as to assist or frustrate a takeover: s 181(1)(b).[2] The case of *Ampol Petroleum Ltd v RW Miller (Holdings) Ltd*[3] emerged out of a takeover battle for control of RW Miller (Holdings) Ltd. Ampol and Bulkships Ltd controlled 55% of Miller's issued capital. Between them, they wished to acquire all other shares in Miller (Holdings). Miller's response was to cause the directors to issue to Howard Smith, who had made its own takeover bid, 4.5 million shares, which reduced the Ampol and Bulkship shareholding to 36%. The directors contended that they had acted for proper purposes in that the Howard Smith takeover bid was more favourable to the company. However, this argument was rejected by the court and the share issue was invalidated on the basis that the directors had breached their duty to act for proper purposes.

A company can only issue preference shares if its constitution sets out the particular rights of those preference shares. Further, a company cannot, by an issue of shares, vary the rights of an existing class of shareholder without following procedures set out in the company's constitution (or in s 246B(2), if there is no constitution or if the constitution is silent on this matter). Certain issues of shares are deemed to vary the rights of existing shareholders under s 246C – eg an issue of preference shares ranking equally with existing preference shares will be deemed to vary the rights of existing shareholders unless the constitution provides otherwise: s 246C(6).

As discussed above, a proprietary company must not offer to issue shares to the public: s 113(3). Only a public company can offer to issue shares to the public, and only if the issue complies with Ch 6D of the *Corporations Act 2001*.

Restrictions in the Listing Rules

[11.150] A publicly listed company wishing to increase the company's issued capital by more than 15% in a year will require a vote of the members under ASX Listing Rule 7.1.

Chapter 6D – disclosure documents

2 See also *Ampol Petroluem Ltd v RW Miller (Holdings) Ltd* [1972] 2 NSWLR 850 & *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

3 [3]*Ampol Petroleum Ltd v RW Miller (Holdings) Ltd* [1972] 2 NSWLR 850.

[11.160] Chapter 6D of the *Corporations Act 2001* provides protection for investors wishing to purchase new shares in a company by requiring that all relevant information is disclosed to the investor (through a *disclosure document*) before the investor can acquire shares in the company. This is to enable potential investors to ascertain whether they wish to pursue the investment. The most common form of disclosure document is known as a *prospectus*, but the disclosure document can take other forms as follow:

(a) *Short Form Prospectus*. Section 712(1) enables a prospectus to refer to material already lodged with the Australian Securities and Investments Commission (ASIC) – eg financial reports. These documents are taken to be part of the prospectus and copies must be made available.

(b) *Profile Statements*. This applies to certain industries, but a prospectus still has to be lodged: s 709(2). An example would be a managed investment scheme (MIS). The profile statement and not the full prospectus may be supplied to investors.

(c) *Offer Information Statement*. This deals with situations involving small fundraising scenarios: s 709(4). The company is able to raise the first $5 million making minimal disclosure. However, s 715 requires that the document, amongst other things, directs investors to obtain their own professional advice prior to deciding whether to invest or not.

Requirements

[11.170] Since proprietary companies cannot solicit money from the public for the subscription of shares in the company (s 113(3)), this discussion relates only to public companies.

If a company is offering to issue new securities, it must prepare a disclosure document (s 706) and lodge it with ASIC (s 718) unless the offer is exempted under s 708 or s 708A. Some important exemptions are:

- small-scale offers where fewer than 20 persons subscribe for less than $2 million worth of shares in any rolling 12-month period;

- where the subscribers are regarded as sophisticated investors – ie those who subscribe $500,000 or have net assets of $2.5 million and gross income of over $250,000 and this has been certified by an accountant;

- where the subscribers are regarded as professional investors – ie listed companies, superannuation funds, banks etc;

- where the offer is made through a licensed dealer;

- where the offer is made to persons associated with the company, such as existing shareholders, executive officers of the company (and their relatives and associated companies);

- where the offer is a rights issue to existing holders of listed securities which are currently traded on a securities market, such as the Australian Securities Exchange (ASX), and from a company which is subject to the continuous disclosure obligations applicable to most listed companies.

Contents

[11.180] Section 710 is a general disclosure requirement, which obliges the entity to disclose all information investors and their advisers would reasonably expect the prospectus to contain, to aid their decision in relation to whether or not to acquire the securities. In *Fraser v NRMA Holdings Ltd*,[4] it was held that by not including in the prospectus the case against restructuring, the company had failed to provide the information required by s 710.

Section 711 sets out a long list of specific matters that must also be included in the prospectus. This list includes, eg disclosure of any interests in the company which any person associated with the prospectus has, has had, or has agreed to receive.

The application form must be attached to the prospectus: s 721. If circumstances change during the life of the prospectus, or if a mistake is discovered, there is provision for the issuing of a supplementary prospectus: s 719. Under s 739, ASIC can issue a "Stop Order" if the prospectus is inaccurate or does not comply with Ch 6D.

By the very nature of a prospectus, it will include forecasts, where the outcome of such information is uncertain. If this is so, it is very important that the persons making such forecasts have reasonable grounds for making them, otherwise the statement will be deemed to be misleading and deceptive under s 728(2) and those persons will be liable for any loss suffered by investors as a result.

Reforms

[11.185] On 12 April 2011, ASIC announced that it proposed a "major overhaul of prospectuses that would make them much easier for retail investors to use and would improve the quality of information on the proposed business model and the associated risks". These proposals are contained in two documents released on 12 April 2011, just as the current (fourth) edition of this book was being finalised.

The proposals were contained in Consultation Paper 155[5] (on which submissions were accepted until 7 June 2011) and an annexed draft Regulatory Guide. The major proposed changes to prospectus disclosure were:

- Companies would need to provide a balanced investment overview that highlights key

[4] *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452; 13 ACLC 132.

[5] *Available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/CP155-Published-12-April-2011.pdf/$file/CP155-Published-12-April-2011.pdf (accessed 21 July 2013)*

information in a separate section;

- There would be no photos in the overview other than on the front cover;

- Companies would need to "use practical communication tools" to help make prospectuses "clear, concise and effective" and reduce their length where possible;

- Companies would need to highlight all principal risks, rather than list every conceivable risk, and also explain the consequences if the risk occurs;

- Companies would need to explain their plans to generate income or capital growth, and explain the strategic risks to this strategy;

Under the proposals, Companies would need to fully disclose the expertise and skill of directors and key managers, including any criminal convictions, declarations under s 1317E of the *Corporations Act 2001*, personal bankruptcies, disqualifications or disciplinary action within Australia or other jurisdictions that are less than 10 years old, as well as whether the person has been an officer of a company when (or within 12 months of when) that company entered external administration.

In November 2011, following the consultative process and after publication of the fourth edition of this book, ASIC issued Regulatory Guide 228.[6] In the main, Regulatory Guide 228 implemented the proposals from Consultation Paper 155. In particular, Regulatory Guide 228 emphasises:

- The overriding principle that prospectuses be 'clear, concise and effective' and as short as possible. The guide outlines methods by which this can be achieved;

- The need for an investment overview, summarizing the most important information for investors, including business model and assumptions underpinning the model, key risks, financial information, leadership, benefits and related party interests, directors. Companies need to highlight all principal risks, rather than list every conceivable risk, and also explain the consequences if the risk occurs. Companies need to explain their plans to generate income or capital growth, and explain the strategic risks to this strategy. This disclosure needs to be logically organised;

- There must be no photos in the investment overview other than on the front cover. Photographs should carry meaningful labels and be used only where they are relevant to the company's offer or business; and

- Companies need to provide information about the their financial position, performance and prospects, as well as balanced information about management (and this may require disclosure of any disciplinary proceedings or management of insolvent companies, if relevant to the investor's investment in this company). Disciplinary proceedings

[6] *Available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg228-published-10-November-2011-1.pdf/$file/rg228-published-10-November-2011-1.pdf (accessed 21 July 2013)*

unrelated to the company (such as driving offences) would not need to be disclosed.

The Regulatory Guide 228 also made a few changes from Consultation Paper 155. In particular:

- There is no need to automatically disclose commercially sensitive information or trade secrets. In all cases, the company should weigh the benefit of the information to investors compared to the potential harm to the company's undertaking;

- Companies need to disclose not only their dividend policy but also capital management policy, including how surplus funds will be dealt with and whether the company will likely require additional capital in the future;

- A company with operating history should include an audited consolidated statement of financial position for the most recent year, plus an audited consolidated income statement for at least the three most recent financial years, and if a restructure has occurred, historical information should include proforma financial information for the effect of that restructure. Where financial information is not prepared in accordance with the International Financial Reporting Standards (such as proforma historical financial information following a restructure), Regulatory Guide 230 (released 9 December 2011) provides guidelines to ensure that information is meaningfully communicated to investors, and is not misleading.

- Each individual company can decide whether to include financial ratios in their prospectus, but if included, companies should how the ratio was calculated.

This regulatory guide actually represents one of the biggest regulatory changes to prospectuses in twenty years. The company issuing a disclosure document can no longer satisfy its disclosure obligations by including every detail that is in any way possibly material, making the document full but unwieldy (which was the case previously). Instead, after Regulatory Guide 228, the need for a 'clear, concise and effective' prospectus means that companies will need to justify why information is included in the prospectus, including only the most relevant information, focusing on information important to the investor (such as risks, business model, etc) rather than 'hiding' these amongst all the other detail in a large unwieldy prospectus.

Regulatory Guide 228 also makes it clear that its requirements to not only apply to prospectuses, but also to bidders' statements and scheme booklets.

In response to submissions received on Consultation Paper 155, ASIC issued Report 261,[7] a response to those submissions, which (in part) noted the need for revision of the provisions relating to electronic disclosure documents. This issue then resurfaced for public consultation in Consultation Paper 211,[8] which was issued on 17 June 2013, and requests comments to be submitted by 12 August 2013.

---

7 *http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep261-published-10-November-2011.pdf/$file/rep261-published-10-November-2011.pdf (accessed 21 July 2013)*

8 *http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp211-published-17-June-2013.pdf/$file/cp211-published-17-June-2013.pdf (accessed 21 July 2013)*

In Consultation Paper 211, ASIC notes that:

- It considers that electronic disclosure documents are permitted by the current legislation and that there are benefits to the use (most noticeably ease and convenience for investors), although paper documents are still required for lodgment at ASIC and should remain available free of charge for investors who may have limited internet access;

- Electronic documents should be published in pdf or tiff format, or some other widespread format that provides reasonable access and reasonable protection against fraud or tampering. They can be distributed either by download or by hypertext link to the document or a website containing it, but there may be other acceptable methods that allow investors access to it (including the ability to download, save or print it);

- ASIC's good practice guide in relation to the issuance and distribution of electronic disclosure documents. Hyperlinks within the document are acceptable, but to avoid confusion, should not be used to direct investors outside the document;

- Electronic documents need not be exactly identical to the paper copy, provided the differences are immaterial and facilitate investor understanding and engagement with the document (eg by adding interactivity in the electronic version, or increasing functionality (eg by search functions, pop up definitions instead of standard glossaries, zoom facility, or pure formatting changes due to the electronic nature of the document). ASIC emphasizes that differences must not undermine the integrity of the paper document lodged with ASIC or cause investors to confuse it with any other document.

As noted above, submissions on these proposals close 12 August 2013, so additional reform is likely on this issue, either late 2013 or early 2014.

Liability – claims by investors

[11.190] Section 729 entitles a person who has suffered loss or damage as a result of relying on information contained in disclosure documentation to claim compensation against the company, the directors and underwriters.

A claim can also be made against any person who is named with their consent in the prospectus as making a statement in the prospectus (typically, this would be experts acting in a professional capacity) or any person involved in the preparation of the prospectus, but only in respect of statements included with their consent.

Of course, practical concerns remain for an investor. For instance, an investor may have an entitlement to recover his or her loss from persons associated with the company, but effective recovery also requires that the person liable has the necessary funds to pay a compensation order.

This can also be affected in the event of a company's insolvency. The 2007 High Court case of

Sons of Gwalia Ltd v Margaretic[6] held that claims by shareholders for the recovery of losses due to a company's misleading prospectus can rank equally with the claims of unsecured creditors. This decision was contentious because it characterised shareholders (who normally rank last in a liquidation) as creditors where the shareholders have a claim against the company. This benefited shareholders, and potentially disadvantaged creditors, who can be exposed to greater risk of reduced funds available for repayment of their debt. The issues raised by this case were referred to the Corporations and Markets Advisory Committee (CAMAC) for analysis, and eventually led to the passage of new legislation to reverse this court decision in late 2010.

The *Corporations Amendment (Sons of Gwalia) Act 2010* (Cth) was passed in late 2010 and came into effect on 18 December 2010. The Act introduced a new s 247E which specifically states that a person is not prevented from obtaining damages or compensation from a company merely because the person is or was a shareholder or member. The *Corporations Amendment (Sons of Gwalia) Act 2010* (Cth) also repealed the existing s 563A (as interpreted in the *Gwalia* decision), replacing it with a new s 563A which said that any claims for any debts owed by the company that related to a person's capacity as a member of the company (whether by way of dividends, profits or otherwise), or any other claim arising from the purchase, sale or dealing of company shares, would be postponed until all other claims against the company were fully satisfied. In effect, in an insolvency, this makes shareholder claims subordinate to non-shareholder claims and reinstates the position that was understood to exist prior to the *Gwalia* decision.

Basis of liability

[11.200] The basis of liability for claims for financial loss by investors is contained in s 728. This provision prohibits a person from offering securities under a disclosure document if there is a misleading or deceptive statement in, or an omission from, such a document. In terms of predictions and forecasts, a statement is regarded as misleading if reasonable grounds did not exist for making the statement: s 728(2). If a person contravenes s 728(1), they can be ordered to pay compensation and are subject to criminal sanctions, including imprisonment.

The defences to claims for financial loss by investors are contained in ss 731 – 733, which provide uniform defences for all persons potentially liable.

Section 731 applies to prospectuses and provides a “due diligence defence” against s 729 liability where the party involved made all reasonable inquiries and reasonably believed the statement was not misleading or deceptive or that there was no omission of required information. Because of this defence, most companies who propose to issue securities under a prospectus will form a due diligence committee, which is responsible for the contents of the prospectus and which collates information supporting and evidencing the reasonableness of the committee's belief that the prospectus complies with Ch 6D.

Section 732 applies to Offer Information and Profile Statements and provides a defence if the party concerned did not know that the statement was misleading or deceptive. This reflects a

[6] *Sons of Gwalia Ltd v Margaretic* (2007) 81 ALJR 525; [2007] HCA 1.

reduced disclosure requirement.

Section 733 applies to all disclosure documents where it is demonstrated that there was reasonable reliance on another person supplying information. It is also a defence if it is proved a party was unaware of a new matter or they withdrew their consent.

Debt fundraising

Borrowing money

[11.220] A company can borrow money directly from a financier, similar to any other person. Such loans can be secured or unsecured. Alternatively, a company can borrow money from investors, by issuing debentures or notes.

What is a debenture?

[11.230] Section 124 of the *Corporations Act 2001* (Cth) empowers companies to issue debentures and to borrow money through the use of debentures.

A "debenture" is the right to enforce a company's undertaking to repay a debt: s 9. Previously, the *Corporations Act 2001* defined "debenture" as the evidence of a company's indebtedness – hence, the instruments or documents by which companies borrow funds are today still referred to as "debentures". Technically, however, a debenture is the right to enforce the debt; the instrument or document creates that right.[7]

Debentures are intangible personal property, and therefore are readily transferable. Debentures can be listed on the ASX. In order for them to be listed it is necessary that they (and the company) comply with the ASX's Listing Rules.

The following enforceable rights are excluded from the s 9 definition and thus are not "debentures":

- an undertaking to repay money deposited with or lent to the company by a person who ordinarily carries on business which involves the depositing or lending of money, and the company does not borrow the money for the purpose of a business of borrowing money and providing finance;
- an undertaking by an Australian authorised deposit-taking institution (ADI) to repay money deposited with it;
- an undertaking to pay money under a cheque, bill of exchange, or money order;

[7] There are some exclusions from the definition, discussed below.

- an undertaking to pay money under a promissory note of at least $50,000; and
- an undertaking to pay money to a related body corporate.

The debt is usually secured by a security interest (formerly known as charge) over company assets in order to ensure that the debt is repaid. A company cannot offer to issue debentures to the public (ie invite the public to loan the company money by way of debenture) unless the debentures will be secured by the security interest, otherwise the company commits an offence under s 283BH. The purpose of this principle is to provide the investing public with additional protection.

Section 283BH recognises that a debenture may be described as either:

- a "mortgage debenture" if it is secured by a first mortgage over land and the amount borrowed is no greater that 60% of the land's value;
- a "debenture" if it satisfies the requirements for a "mortgage debenture", or is secured by a charge over the whole or part of the company's assets that is likely to be sufficient for repayment of the debentures; or
- an unsecured note or unsecured deposit note, in any other case.

What is an unsecured note?

[11.240] If a debt is not protected by a security such as a charge or mortgage, it is known as an "unsecured note". An unsecured note is still enforceable, but the holder merely possesses a contractual right to enforce payment of the debt, and will have no recourse against the company's assets. To that extent, the noteholder is in the position of an unsecured creditor.

Technically, an unsecured note is still a debenture for the purposes of the *Corporations Act 2001*. This has the important result that *the laws relating to debentures still apply to unsecured notes*, but the company cannot describe an unsecured note as a debenture when talking to, or issuing documents for, the public.

The differences in description reflect the risk the investor or holder of the debenture takes, with the mortgage debenture affording the highest degree of protection and the unsecured note offering no level of protection in the event of default by the company.

Convertible debentures

[11.250] Debentures can be issued as convertible securities, whereby the holder is entitled to convert them into shares. In such a case, the convertible note would take the form of a hybrid investment, in that it is a loan and equity investment. The decision to convert by the investor would depend on the financial performance of the company and whether the value of the listed shares has increased; also whether the investor expects the company to be profitable in the future.

Issuing debentures and notes

Requirements: Ch 6D

[11.270] As a debenture falls within the definition of "securities" contained in s 92, any offer to issue debentures to the public is governed by the fundraising provisions in Ch 6D of the *Corporations Act 2001*. For example, s 727 prohibits an individual or entity from making offers for the issue of securities (including debentures) or distributing application forms for such offers, unless a disclosure document for the offer has been lodged with ASIC in accordance with Ch 6D, or the offer is exempted under s 708. There are strict content requirements for the issue of a disclosure document (discussed above) and harsh penalties if these requirements are contravened.

For clarification, this also applies to notes, as the section 9 definition of debenture includes notes.

Requirements: Ch 2L

[11.280] In addition to the Ch 6D requirements, which apply equally to all types of securities that are offered to the public, Ch 2L applies expressly to offers of debentures to which Ch 6D applies. Chapter 2L applies even where no disclosure document is required under Ch 6D, due to an exemption in s 708 applying.[8]

Before a company can issue debentures, Ch 2L obliges the company to make arrangements for the appointment of a trustee and subsequently enter into a trust deed with the trustee: s 283AA. Section 283AC limits the type of entity that can act as a trustee. A trustee can only be the Public Trustee, a trustee company, probate corporation, bank or life assurance company.

Section 283BB obliges the company to carry on its business in an appropriate and efficient manner, and to make its financial records available for inspection by the trustee. Additionally, the company must notify the trustee in respect of any charges over company property it creates (under s 283BE) and to provide the trustee and ASIC with quarterly reports about certain specific information relevant to the company's affairs, including quarterly financial reports: s 283BF.

The trustee is obliged, under s 283AB, to protect the interests of debenture-holders and, to this end, the trustee has the right under the trust deed to enforce the company's duty to repay the debt. The trustee is the trustee for the debenture-holders in respect of the holding of any charge or security for repayment of the debentures. Under s 283DA, the trustee must also exercise reasonable diligence to monitor the company's behaviour to ensure that the company complies with the terms of the debenture, the trust deed and the *Corporations Act 2001*. The trustee has to

[8] However, due to *Corporations Act 2001* (Cth) s 283AA(1)(a), Ch 2L does not apply to an offer of debentures that is exempted under s 708(14), which is the provision relating to the roll-over of existing debentures.

determine whether any breaches have occurred and, if so, to notify the company and ASIC. To aid this process, ss 318 and 313 confer on the trustee the right to receive a copy of the company's financial report and auditor's report.

It would be usual for the trust deed to specify that the company will be in breach of the trust deed if it enters into arrangements to borrow funds from another source, or fails to keep the value of charged property above a minimum amount. The trust deed may also include a "negative pledge", which is a promise by the company pursuant to which the company restricts its ability to enter into subsequent borrowing or security arrangements.

ASIC Requirements

[11.285] In February 2012, ASIC issued Regulatory Guide 156[9] in relation to the advertising of 'debentures', 'mortgage debentures', 'secured notes', 'unsecured notes' and 'unsecured deposit notes'. The guide sets minimum standards for advertising. In particular, it sets out the following table of requirements at page 5:

Table 1: Advertising standards for issuers of notes to retail investors

Area	Summary of standard
Repayment of principal investment	To avoid common misconceptions about the risk profile of notes, all advertisements for notes that are offered to retail investors should include a prominent statement to investors that there is a risk that investors could lose some or all of their money.
Comparisons with bank deposits and 'risk free' suggestions	Advertisements for notes should state that the note is not a bank deposit. They should also *not* suggest that: • the note is, or compares favourably to, a bank deposit; or • there is little or no risk of the investor losing their principal or not being repaid.
Warning statements generally	Warning statements in advertisements should be prominent to help ensure investors have a balanced impression of the note offering.
Suitability statements	Advertisements for notes should not state or imply that the investment is suitable for a particular class of investor.
Consistency with prospectus disclosure	Statements in advertisements for notes should be consistent with the corresponding disclosures on that subject matter in the prospectus.
Telephone inquiries	Statements made in response to inquiries are subject to the same regulation regarding misleading and deceptive conduct as the advertisements.

The Regulatory Guide 156 also makes it clear that ASIC will hold publishers and other media conduits accountable for breaches of these advertising rules, stating that publishers should have systems in place to detect and refuse advertisements that breach these rules. Publishers who actively contribute to content (eg by writing advertorials), will bear primary responsibility for misleading and deceptive conduct offences, summarized in the following table on page 11:

9 http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg156-published-8-February-2012.pdf/$file/rg156-published-8-February-2012.pdf (accessed21 July 2013)

Table 2: Examples of misleading or deceptive conduct

Description of conduct	Legislation reference
Making statements that are materially false or materially misleading and are likely to induce persons to apply for financial products. Contravention of this provision is an offence.	s1041E, Corporations Act
Engaging in conduct, in relation to a financial product or a financial service, which is misleading or deceptive or is likely to mislead or deceive.	s1041H, Corporations Act
In trade and commerce, engaging in conduct, in relation to financial services, which is misleading or deceptive or is likely to mislead or deceive.	s12DA, ASIC Act
Engaging in conduct that is liable to mislead the public as to the nature, characteristics, suitability for their purpose or quantity of any financial services. This provision is a strict liability offence.	s12DF, ASIC Act

Note: Section 734 of the Corporations Act also contains restrictions on advertising of notes.

Table 3 (in Regulatory Guide 156, at page 12) outlines ASIC's regulatory options:

Table 3: Examples of regulatory options available to ASIC

Option	Legislation reference
Issue a stop order on any misleading or deceptive statements in an advertisement for notes.	s739(6), Corporations Act
Seek an injunction against a note issuer for note advertising that constitutes misleading or deceptive conduct.	For example, s739(6), Corporations Act, and s1324, Corporations Act
Issue a public warning notice containing a warning about the conduct of an issuer relating to consumer protection provisions in the ASIC Act.	s12GLC, ASIC Act
Investigate potential criminal and civil action for contraventions of certain provisions in Div 2 of Pt 7.10 of the Corporations Act or in Div 2 of Pt 2 of the ASIC Act.	For example, s1041E, Corporations Act; and s12DF, ASIC Act

Additional requirements

[11.290] Under s 171, each company issuing debentures is required to establish a register of debenture-holders.

Security Interests

[11.300] A company charge is a type of security interest over the company's personal property, which secures the company's repayment of a debt. A charge or other security interest often secures the repayment of debentures.

Personal property is property other than real property (which is an interest in or over land). It is important to note that a *charge* grants rights over *personal property* only; if real property is used as security for a loan, the rights over that property need to be in the form of a mortgage, not a charge. Mortgages are discussed in Chapter 7.

The term ‘charge’ is now outdated, due to legislation which came into effect in January 2012 and totally overhauled this area of the law, replacing ‘charges’ with ‘security interests’ and replacing registration of some charges at ASIC under the Corporations Act with the need to register all security interests on the personal property securities register under the Personal Properties Securities Act 2011. Because the change is so recent, there are many documents called ‘charges’ still in existence that have not been altered since the legislation. Also, the transitional phase of the legislation only ends on 1.1.14, so it is important to understand both regimes.

The historical position: fixed charges & floating charges

[11.310] The law used to distinguish between fixed and floating charges.

A **fixed charge** attaches to specific property owned by the company and was particularised or specified in the charge. Typically, such property would include plant and equipment belonging to the company. The significance of a fixed charge being granted over a company asset was that the company could not dispose of the charged property without first obtaining the consent of the lender. Because of this very important aspect of fixed charges, it was be extremely unlikely for stock in trade to be covered by a fixed charge.

If, after granting the charge, the company subsequently acquired more property that fits the charge's description of the charged property, then the charge would cover that after-acquired property and the lender would also have rights over that property.

[11.320] **Floating charges,** on the other hand, “hovered” over a category of assets specified in the charge, eg assets such as trading stock or debtors. Unlike a fixed charge, the assets covered by a floating charge, could be disposed of in the ordinary course of the company's business without the company needing to obtain the lender's prior written consent. Accordingly, the floating charge hovered over company assets, which flowed in and out of the company's possession. Sensibly, this arrangement enabled the company to carry on with its normal business operations without seeking the permission of the lender to dispose of the assets subject to the charge.

The charge was described as "ambulatory and shifting in nature, hovering over and … floating with the property … until some event occurs which causes it to settle on the … [charged] property": *Illingworth v Houldsworth*.[10] The event referred to is an event that is specified in the charge as triggering the process of crystallisation. "Crystallisation" was the process whereby a floating charge became a fixed charge. Typical crystallisation events (named in a charge) occurred when:

- interest owing was not paid;
- another party appointed a receiver to the company for the purpose of realising its assets to pay another party;
- the company created a subsequent charge in breach of a negative pledge; or
- the company was threatened with a winding up order.

Crystallisation was often automatic, but some charges required a notice to be given before crystallisation occurs. Once a floating charge had crystallised, the interests of the investor or holder were protected – ie the company is prevented from disposing of the relevant assets.

[11.330] Historical need for registration: The *Corporations Act 2001* used to require that certain charges be registered with ASIC. The purpose of registration was twofold:

1. it enables parties proposing to enter into lending arrangements with the company to be alerted to the fact that the company property, which is proposed to be the subject of a charge, is already the subject of a charge with other parties; and
2. in the event that a number of parties have lent money to the company, the timing of registration establishes the order of priorities amongst the various holders. Registration also eases the process of winding up a company; it establishes whether certain charges are valid and enforceable.

Section 262[11] used to set out a list of all charges that need to be registered to be enforceable. Under section 262, if the following charges were not registered, they were not enforceable:

- floating charges;
- charges over uncalled share capital, and charges over calls made but not paid;
- charges over personal chattels (other than registered ships);
- charges on goodwill, patent, trademarks, copyright, design or a licence to use any of these;

[10] *Illingworth v Houldsworth* [1904] AC 355 at 358.

[11] Section 262 has now been deleted from the Corporations Act 2001 (Cth).

- charges on book debts;
- charges on marketable securities;
- charges on negotiable instruments; and
- charges on crops, wool mortgages and stock mortgages.

Notification of the creation of a charge needed to be lodged for registration with ASIC within 45 days, under the former section 264[12]. Failure to lodge the charge did not render the charge invalid (s 262(11)) but failure to register it within 45 days of its creation (or within any extension of this time) meant that the chargee would be categorised as an unsecured creditor if the company was placed in liquidation within six months of the charge being registered, under the former s 266.[13]

The company granting the charge bore the primary responsibility for registration, but typically the chargee, who had the benefit of the charge, would register it to ensure its interests were protected. It is therefore important to lodge notification of the existence of the charge to ASIC if the holder is to be in a position to execute the charge against the company's assets.

[11.340] Historical position relating to competing priorities:

The *Corporations Act 2001* used to prescribe default priority rules which applied to charges that were competing with each other to enforce rights over the same assets. These default rules were able to be overridden by a deed (known as a “deed of priority”) executed by each of the competing charges, under the former s 279(2).[14]

The former section 280 provided for the following general rules to apply to two competing charges of the same type:

- registered charges took priority over unregistered charges;
- the first registered charge prevailed over later registered charges;
- a registered charge was postponed to a charge created prior to it if the chargee can prove there was notice of the earlier created charge; and
- with unregistered charges, the first created will prevail.

In relation to the priority between fixed and floating charges, s 279(3) stipulated that for a prior created floating charge to take priority over a subsequently created fixed charge, it must have been registered with ASIC before the fixed charge, it must contain a restriction on the company's

[12] This section has now been deleted from the Corporations Act 2001 (Cth).
[13] This section has now been deleted from the Corporations Act 2001 (Cth).
[14] This section has now been deleted from the Corporations Act 2001 (Cth).

ability to create subsequent charges (a negative pledge clause), and notice of the negative pledge must have appeared on ASIC's register of charges.

Pursuant to s 433 (which still exists, but now refers to security interests instead of charges), the receiver appointed by the holder of a floating charge was required to first satisfy the claims of company employees to whom certain types of debts are owed. In liquidation, the liquidator owes similar duties under s 561. Thus, even the holder of the sole charge over the company assets could not be sure that those assets would be entirely available to meet the debt underlying the charge.

The current position: security interests under Personal Property Security Act 2009 (Cth)

Overview

[11.350] As discussed above, major reform to this area of law occurred in January 2012, when the Personal Property Securities Act 2009 (PPSA) extended its reach to cover charges (which had previously been covered by the Corporations Act), as well as liens and pledges, and indeed other interests outlined below. It is thus much broader than the Corporations Act's prior regulation of company charges. Indeed, the PPSA regime applies to all security interests, whether granted by a company or not. (There are a few exceptions, such as interests in land including fixtures and an interest taken by a pawnbroker, where the value of the interest is under $5000: ss 8(1)(f), (j) and (ja) respectively).

A charge created before or after the PPSA is still a valid security interest. It may be enforced under the PPSA similar to any other security interest under PPSA. Once the transitional arrangements end, distinctions between floating charges and fixed charges will become irrelevant for priority purposes. The PPSA provides that a reference to a 'floating charge' is deemed to be a security interest in a 'circulating asset'.

Personal Property

[11.360] The PPSA regulates security interests in 'personal property', and therefore does not regulate land or interests in real property. Section 10 of the PPSA defines personal property as all property other than real estate and fixtures to that real estate. This definition includes financial instruments, investments and intangible property such as copyright and other intellectual property rights. Intangible property also includes accounts receivable or book debts, and credit card receivables. The definition of 'personal property' specifically includes 'financial property', which is defined by section 10 to include mean 'chattel paper, currency, documents of title, investment instruments and negotiable interests'. 'Chattel paper' is defined as a document or documents that evidence a monetary obligation and a security interest in or lease of specific goods (for example, a hire purchase agreement).

Security Interest

[11.370] Under s 12, a security interest is an interest in personal property that in substance requires payment of a debt or other obligation, regardless of the form of the transaction. It includes company charges (both fixed and floating), mortgages over personal property, retention of title clauses, finance leases allowing for ownership acquisition, factoring agreements, consignment arrangements, lease of a car, boat or aircraft for less than three months, or lease of other property for more than a year, a pledge, a trust receipt, a lease of goods, a transfer of title, and a conditional sale agreement.

Furthermore, certain commercial interests are deemed to be security interests under section 12(3). These include the interest of a transferee under a transfer of an account or chattel paper, the interest of a consignor who delivers goods to a consignee under a commercial consignment; and the interest of a lessor or bailor of goods under a personal property security lease (which is defined as a lease of more than a year (or 90 days if the goods are described by serial number), provided for value, as part of the business of a person regularly engaged in the business of leasing goods: s 13 PPSA).

Secured Party and Grantor

[11.380] Under the PPSA, a 'secured party' is a person benefiting from the security. It includes persons known as chargee, lender, lessor and mortgagee. The 'grantor' is a person granting a security interest to the secured party. The grantor includes persons previously known as a chargor, mortgagor, or borrower.

Collateral

[11.390] 'Collateral' is secured property, for example property covered by the security interest.

Security Agreement

[11.400] 'Security agreement' is an agreement creating the security interest, for example the charge, mortgage, financing agreement, lease agreement, and the like. To be enforceable against persons other than the grantor (for example creditors), the security agreement must be in writing and signed by the grantor: PPSA s 20.

Attachment

[11.410] The PPSA applies where a 'security interest' has 'attached' to 'collateral'. 'Attach' means where the grantor has rights in the collateral (or the power to transfer rights in the collateral to the secured party) and by conduct (for example, accepting money or other value) creates the security interest. The rights of the grantor do not need to be ownership rights, but there needs to be some form of rights, else the security interest cannot be created.[15]

If the security interest does not attach to collateral, it is unenforceable between the debtor and the secured party: s 19(1) PPSA. However, the security interest can cover future property, so

[15] *Chrysler Credit Canada Ltd v MVL Leasing Ltd* (1993) 5 PPSAC (2d) 92.

attachment does not need to occur before 'perfection' (discussed below). If the security interest is registered before attachment occurs, perfection starts at the time of registration, not at the time of attachment: s 55(5) PPSA.

'Attachment' is governed by the terms and conditions of the security interest and thus relates to the relationship between the secured party and the grantor.

Perfection

[11.420] The 'perfection' of a security interest is the last requirement to preserve the priority of a security interest. Because it relates to priority, it relates to the position of the secured party compared to the position of other creditors of the grantor. Compared to 'attachment', perfection is paramount because it ensures the security interest survives the bankruptcy or insolvency of the grantor.

Perfection cannot occur unless there is a valid security interest, which attaches to the underlying collateral (which must be personal property). Section 21 provides that:

> (1) A security interest in particular collateral is perfected if:
> (a) the security interest is temporarily perfected, or otherwise perfected, by force of this Act; or
> (b) all of the following apply:
> (i) the security interest is attached to the collateral;
> (ii) the security interest is enforceable against a third party;
> (iii) subsection (2) applies.
> (2) This subsection applies if:
> (a) for any collateral, a registration is effective with respect to the collateral; or
> (b) for any collateral, the secured party has possession of the collateral (other than possession as a result of seizure or repossession); or
> (c) for the following kinds of collateral, the secured party has control of the collateral:
> (i) an ADI account;
> (ii) an intermediated security;
> (iii) an investment instrument;
> (iv) a negotiable instrument that is not evidenced by a certificate;
> (v) a right evidenced by a letter of credit that states that the letter of credit must be presented on claiming payment or requiring the performance of an obligation;
> (vi) satellites and other space objects.
> (3) A security interest may be perfected regardless of the order in which attachment and any step mentioned in subsection (2) occur.
> (4) A single registration may perfect one or more security interests.

Essentially, thus, perfection occurs when the security interest has attached to the collateral, it is enforceable against third parties, and:

(a) the security interest is registered on the personal property security register ('perfection by registration'); or

(b) the collateral is in the actual or apparent possession of the secured party ('perfection by possession'); or

(c) the collateral is in the control of the secured party and is one of the following types: ADI account, intermediated security, investment instrument, negotiable instrument without a certificate, right under a letter of credit, satellite, space object. This is known as 'perfection by control' but this method of perfection only works for these types of collateral.

Perfection can occur by more than method – for example, by both registration and possession.

Transitional Security Interests

[11.430] The PPSA provides for a two year transition period, with the aim of ensuring that security interests that existed elsewhere (for example, company charges) prior to the commencement of the PPSR regime on 30 January 2013, are protected and do not lose priority to interests created after the PPSR regime commenced.

All charges registered at ASIC on or before 30 January 2012 had their registration automatically transferred across from ASIC's register of charges to the personal property securities register. This occurred from October 2011 until 30 January 2012.

This is achieved by defining a 'transitional security interests' ('TSI') as an interest which existed on 30 January 2012 (or which was created by an agreement dated before 30 January 2012, although the security interest arose after 30 January 2012).

Each TSI is deemed to have 'attached' to the collateral immediately before 1 February 2012, satisfying the attachment requirement. The PPSA also provides for temporary perfection. Each TSI is deemed to be perfected until the earlier of (a) when it is perfected under the PPSA or (b) 30 January 2014: s322 PPSA. This allows for a period of 2 years where TSIs have priority over all security interests created under the PPSA. If the holder of a TSI does not perfect their security interest before 30 January 2014, the security interest will become 'unperfected' on that date and will loses priority to any security interest which has attached to the same collateral and which has been perfected under the PPSA. Priority rules are discussed in more detail below.

General Priority Rules under the PPSA

[11.440] Obviously, two security interests only compete for priority if they both cover the same (or some of the same) property as collateral. The PPSA sets out both general priority rules and specific priority rules. The general rules apply only if no more specific rule applies. Under section 55 PPSA, the default rules are:

- a perfected security interest has priority over an unperfected security interest;
- For two competing perfected security interests – the interest that was perfected earlier in time takes priority over the one that was perfected later in time;
- For two competing but unperfected security interests – the one that was attached earlier takes priority over the one that was attached later.

As discussed above, in the period from 30 January 2012 to 30 January 2014, a TSI will be deemed to be perfected prior to any interest that is not a TSI and thus a TSI will always take priority over a security interest that is not a TSI.

Continuous perfection is required: s 56. This is not difficult with perfection by registration, but needs to be attended to if one of the other methods of perfection is used.

Specific Priority Rules – Purchase Money Security Interests

[11.450] One of the more specific rules relating to priority, relates to purchase money security interests ('PMSI'). Under section 14, these are security interests which secure all or part of the purchase price of the collateral. The interest will not be a PMSI if the grantor intends to use the collateral for personal, household or domestic purposes, or if it is part of a sale and lease back arrangement, or the collateral is an investment instrument.

A PMSI that is perfected after an earlier security interest which is not a PMSI, will take priority over the earlier interest: s 62 PPSA. This is an exception to the general rule that earlier perfected interests take priority over later ones: s 55 PPSA.

Specific Priority Rules – Perfection by control

[11.460] Another exception to the general rules is where the perfection occurs by control (which only applies to particular types of collateral, as discussed above). A security interest which is perfected by control takes priority over a security interest which is perfected by other means, regardless of the timing of perfection: s 57 PPSA.

Extinguishment Rules

[11.470] A buyer or lessee of property which is collateral to an unperfected security interest to which the buyer or lessee is not a party, takes that property free from the security interest: s43 PPSA.

There are various other specific provisions for extinguishment of particular types of collateral in particular circumstances under Part 2-5 of the PPSA.

Where the property is taken free from that security interest, the holder of the security interest does not lose the interest outright, and instead is merely subrogated to the interests of the buyer or lessee: s53 PPSA.

Security Interests in an Insolvency

[11.480] Certain provisions in the *Corporations Act 2001* can cause security interests to become "void as against the liquidator" when a company enters into an insolvent liquidation. This effectively renders the security interest unenforceable, as the liquidator controls the company in the liquidation. This does not apply to the underlying debt; it only applies to the security interest which secures the debt. Thus, the underlying debt does not become void; only the charge which secures the debt becomes void, with the effect that the holder of such a security interest will be regarded as an unsecured creditor, who as such is unlikely to have the debt repaid in full (as by definition, an insolvent company has insufficient assets to repay all of its liabilities when they fall due).

Any security interest in favour of a director which is registered less than six months before the company enters liquidation, will be unenforceable against the liquidator unless the court specifically allows enforcement: s 267 of the *Corporations Act* 2001 (Cth).

In addition, under s 588FE of the *Corporations Act*, the following security interests can be void against the liquidator if the liquidator chooses to render them void:

- any security interest which is granted in the six months before the company enters liquidation, if the company was insolvent at the time or the security interest causes the company to become insolvent;

- any security interest granted in the two years before the company enters liquidation, if the company was insolvent at the time or the security interest causes the company to become insolvent, and the security interest was entered into on uncommercial terms;

- any security interest granted to a related party in the four years before the company enters liquidation;

- any security interest which is granted in the four years before the company enters liquidation, to a director or an entity related to a director, which is on unreasonable terms given the benefits and disadvantages to the company; and

- any security interest granted in the ten years before the company enters liquidation, if the charge was granted for the purpose of defeating, delaying or interfering with the rights of any or all of its creditors.