



Unfair preference payments

Decision tree

SEPTEMBER 2023

Table of contents

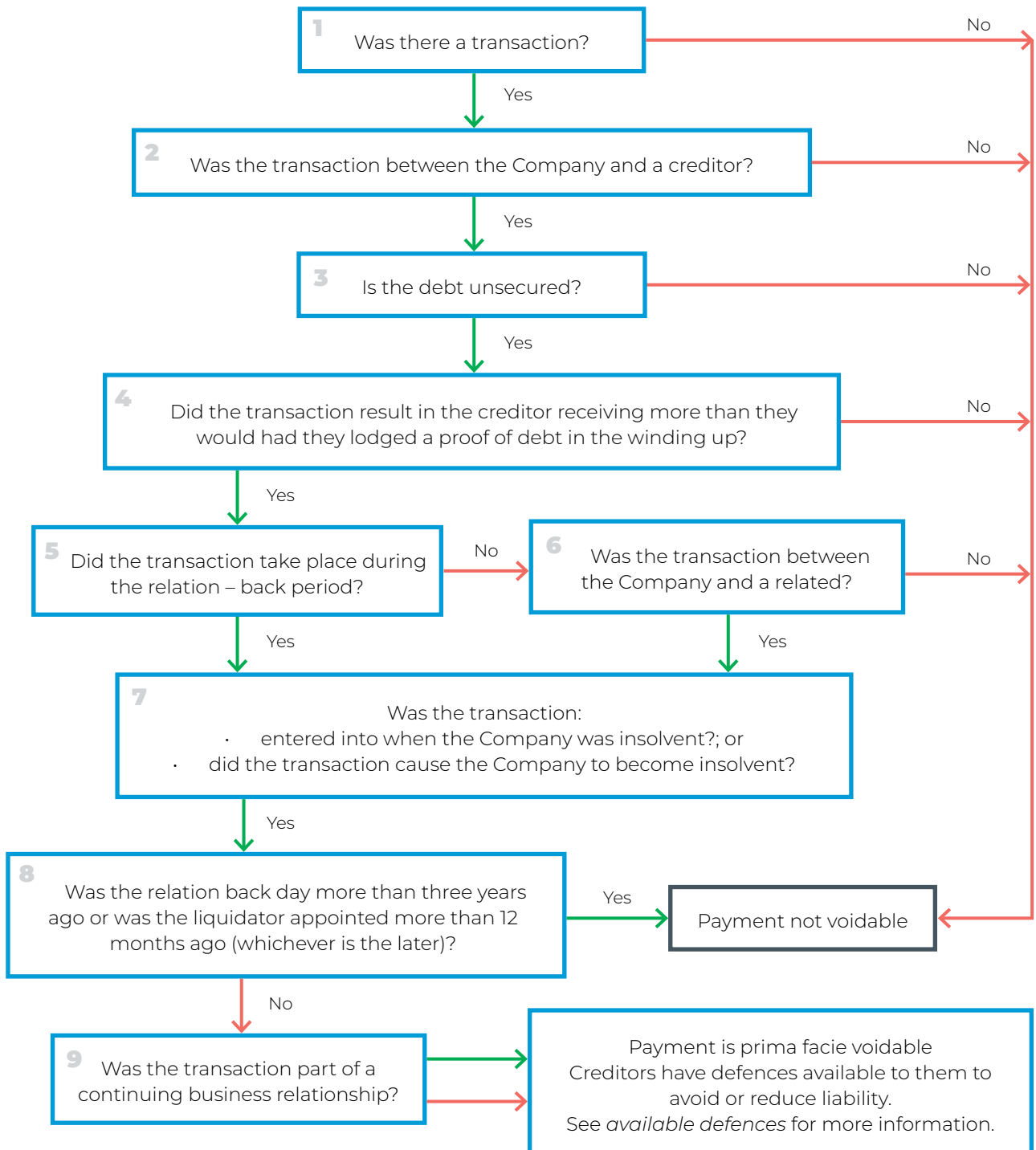


UNFAIR PREFERENCE PAYMENTS: DECISION TREE	3
NOTES ON DECISION TREE	4
AVAILABLE DEFENCES	8
HOLDING REDLICH KEY CONTACTS	9
REFERENCES	10

Unfair preference payments: Decision tree



Click on each box for more information.



Notes on decision tree

NOTE 1

Was there a transaction?

'Transaction' is broadly defined in section 9 of the Corporations Act. For example, a transaction includes, but is not limited to:

- a payment
- a loan
- a guarantee
- a conveyance
- a release or waiver
- a set off
- a security interest granted
- an obligation incurred.

A series of transactions, events or acts can also comprise a single transaction.

NOTE 2

Was the transaction between the company and a creditor?

The transaction must be a transaction 'from the company'.¹ The company and creditor do not have to be the only parties to the transaction. Keeping in mind, also, that a series of transactions can also comprise a single transaction, whether the company is a party to the transaction can become complicated in real life scenarios.

Take, for example, a building arrangement. The Head Contractor (**H**) is due a progress payment under its head contract from the Principal (**P**). At the same time, H needs to pay its subcontractors (**S**) under various subcontract agreements for various works. H directs P to pay the progress payment directly to S. In this scenario, the liquidator of H may be able to claw the payment back from S as an unfair preference as the transactions between the three parties, H, P and S, are characterised as a single transaction which effectively results in a payment by H to S.²

Holding Redlich has acted for liquidators in which it has successfully recovered payments in similar (but significantly more complicated) circumstances.

The question as to whether a debtor/creditor relationship exists can also raise some questions in real life examples and has been the subject of some court decisions. At a high level, a creditor is defined as a person who, at the time of the transaction, would have a claim against the company that could form the subject of a proof of debt in a winding up.³ The term has been given a liberal interpretation and is more easily defined by examples of what does not constitute a debtor/creditor relationship.

Firstly, a pre-payment will generally not give rise to a debtor/creditor relationship.⁴

Secondly, and related to the first point, payment for goods on a "cash on delivery" basis does not give rise to a debtor/creditor relationship.

Thirdly, payments are sometimes made by parties despite there being no legal or contractual liability for that payment, in which case there may be no debtor/creditor relationship. For example, consider a long-running construction project where the principal engages a head contractor who subcontracts works to various subcontractors. Over time, the head contractor is replaced by a new entity but the legal documentation is not updated. The new entity continues to make payments to the subcontractors before going under. If the head contractor had no legal obligation to pay the subcontractors, the subcontractors may be able to argue that no debtor/creditor relationship existed and the payments cannot be considered preference payments.⁵

In Holding Redlich's experience, each of the three examples above regularly arise in preference payment claims, Holding Redlich has acted both for and against liquidators in such scenarios, as well as advising companies around managing debtors to ensure a debtor/creditor relationship does not arise to protect them from potential preference claims.



NOTE 3**Is the debt unsecured?**

A secured debt is immune from a preference claim.

This covers standard mortgages and securities granted under financing arrangements.

With the introduction of the Personal Property Securities Register (**PPSR**), suppliers of goods who have a valid PPSR registration (for example, in relation to a Retention of Title clause), are also secured creditors and immune from preferences.

However, the payments must equate to the value of the security.⁶

For example, a distributor of fast moving consumer goods. The distributor ensures that it has retention of title clauses in each of its agreements with its customers and that security (retention of title) is validly registered on the PPSR. One of its customers is placed into liquidation and the liquidator is considering whether payments received by the distributor could potentially be preference payments. In order to consider this claim, the liquidator will need to assess the value of the unsold stock held by the customer at the time that each payment was made. If the payment is equal to or less than the value of the stock, the payment is secured and there can be no preference. If the payment is greater than the value of the stock, the difference between the payment and the stock value may be a preference. One question which arises and is unresolved by the Courts is the relevant timing of this "stocktake" valuation – is it the time the security was granted, the time of the payment or on the date of the winding up? There is one District Court of South Australia decision on the question which determined it was the date of the winding up, however that has been called into question by many insolvency practitioner and lawyers.⁷

Holding Redlich has advised many clients on establishing security arrangements, including through PPSR registrations, to protect both recovery from the debtor as well as protecting against preference claims. Holding Redlich has also worked with liquidator clients in assessing security values for the purpose of considering whether any payments could amount to preferences.

NOTE 4**Did the transaction result in the creditor receiving more than they would had they lodged a proof of debt in the winding up?**

For example, if an unsecured creditor received \$100,000 from the Company prior to the winding up of the Company but would have only received \$5,000 in the winding up of the Company, it can be said that the unsecured creditor has received an unfair benefit of \$95,000.

In order to undertake this calculation, you need to take into account the whole transaction with the creditor. For example, if the insolvent company was a retail tenant and that, in exchange for paying the landlord \$100,000 in rent, it was able to continue to occupy the leased shop and earn revenue, such revenue needs to be taken into account in the above calculation. This is called the doctrine of ultimate effect.

The precise legal formulation of the doctrine of ultimate effect is not settled by the Courts and the application of the doctrine remains complex and uncertain. Holding Redlich has both relied on the doctrine in acting for creditors and responded to defences by creditors relying on the doctrine when acting for liquidators.

NOTE 5**Did the transaction take place during the relation – back period?**

To be classified an unfair preference the transaction must have been entered into within six months of the relation-back day.

The relation-back day is one of the following:

- for a court-ordered winding up, where there was no prior insolvency administration, it is the day on which the winding up application was filed with the court⁸
- for a voluntary winding up where there was no prior insolvency administration, the day the members resolved by special resolution that the Company be wound up voluntarily⁹
- where the Company was placed into liquidation by resolution of creditors at the conclusion of a voluntary administration, the date of the creditors' resolution.¹⁰



**NOTE 6****Was the transaction between the Company and a related entity?**

If the transaction was entered into between the Company and a related entity it may be rendered an unfair preference payment if entered into within **four years** of the relation back day.¹¹

Section 9 of the Corporations Act defines a related entity in relation to a body corporate as any of the following:

- a promoter of the body
- a relative of such a promoter
- a relative of a spouse of such a promoter
- a director or member of the body or of a related body corporate
- a relative of such a director or member
- a relative of a spouse of such a director or member
- a body corporate that is related to the first-mentioned body
- a beneficiary under a trust of which the first-mentioned body is or has at any time been a trustee
- a relative of such a beneficiary
- a relative of a spouse of such a beneficiary
- a body corporate one of whose directors is also a director of the first-mentioned body
- a trustee of a trust under which a person is a beneficiary, where the person is a related entity of the first-mentioned body because of any other application or applications of this definition.

NOTE 7**Was the transaction entered into when the Company was insolvent or did the transaction cause the Company to become insolvent?**

The Corporations Act defines solvency as follows:

- a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable
- a person who is not solvent is insolvent.

Common indicators of insolvency include:

- ongoing losses
- poor cash flow
- liquidity ratios below 1 (calculated by dividing the value of current assets by the value of current liabilities)
- increasing debts
- creditors remaining unpaid outside of usual trading terms
- suppliers placing the Company on COD (cash on delivery) terms
- overdue taxes and superannuation liabilities.

There are also statutory presumptions that may be relied upon to prove insolvency including:

- where the Company has failed to keep adequate accounting records the Company is presumed to have been insolvent throughout the period to which the failure relates¹²
- if the Company has been proven insolvent in other recovery proceedings.¹³

NOTE 8**Was the relation back day more than three years ago or was the liquidator appointed more than 12 months ago (whichever is the later)?**

The Corporations Act imposes a time limit by which proceedings seeking orders to set aside voidable transactions must be initiated.¹⁴ A claim must be brought before the later of:

- 3 years after the relation-back day; or
- 12 months after the first appointment of a liquidator.

A liquidator may apply to the Court to extend this period but such an application must be made within the period during which the proceedings seeking to set aside the voidable preferences is to be initiated ie. 3 years following the relation back day or within 12 months of appointment of the liquidator (whichever is the later).



**NOTE 9****Was the transaction part of a continuing business relationship?**

Recent High Court authority confirms that courts are now bound to take a practical approach when determining whether or not there was a continuing business relationship between parties.¹⁵ The use of threats and pressure tactics, like letters of demand or a stop and 'hold' credit will not necessarily bring a continuing business relationship to an end. Nor will a knowledge, suspicion or reasonable grounds to suspect insolvency. The existence of such a relationship is question of substance rather than form. Matters that the courts will consider in implying a continuous business relationship are whether the particular payments were connected with the subsequent provision of goods or services; whether the purpose of the payment was to induce the creditor to provide further goods or services as well as to discharge an existing indebtedness, unless the payment exceeded the value of the goods or services acquired or whether there was an express agreement that one of the purposes of the payment was to permanently reduce the level of the prior debt.

Should a continuing business relationship be established, and consequently a running account, liquidators can no longer nominate a date within the relevant period that maximises their preference claim (known as the 'peak-indebtedness rule')¹⁵. The entire transaction during the relation-back period must be considered, rather than a shorter date range within that period which results in a higher return for the liquidator.



Available defences



The following are available as partial or complete defences to a preference claim.

GOOD FAITH

A creditor can resist a preference claim if at the time the payment or payments were received they were received in good faith without a reasonable belief or suspicion that the Company was insolvent or would likely become so.

Courts have said that a creditor acts in good faith if they act with propriety and honesty.¹⁶ The value of the consideration paid is one factor in whether the transaction was entered into in good faith. Another factor is whether the recipient made any inquiries before entering into the transaction.¹⁷

A reasonable suspicion of insolvency is determined by reference to the commercial circumstances at the time of the transaction.¹⁸ A 'suspicion' means 'more than idle wondering'. It is a positive feeling of actual apprehension or mistrust without sufficient evidence of insolvency. The suspicion must be in relation to 'actual or existing insolvency, as distinct from impending or potential insolvency'.¹⁹

The following factors may give rise to reasonable suspicion of insolvency:

- the creditor serves a statutory demand on the Company²⁰
- the Company's account with the creditor exceeds usual trading terms
- the Company admits to the creditor that they are in financial difficulties²¹
- public announcements about the Company's finances confirm the company is in distress
- acknowledgment by the creditor that the Company is experiencing financial difficulties and requires creditor support.²²

SET OFF

The High Court recently confirmed that a creditor cannot rely on statutory set-off in section 553C of the Corporations Act as a defence to an unfair preference claim by setting off another debt owed by the company to the creditor.²³

Statutory set-off allows for mutual debts, mutual creditors or mutual dealings to be set off against each other. In respect to an unfair preference claim, the High Court found that there was no "mutuality" because the creditor's outstanding debt was due by the company whereas the creditor's liability for an unfair preference was due to the liquidator to be distributed to the company creditor's pursuant to the liquidation rules. In addition, the High Court said there was no mutuality as at the date of winding up given the unfair preference claim is only a mere possibility, subject to the liquidator's decision to sue and the Court's satisfaction that the elements of the unfair preference provision were satisfied.



Holding Redlich **key contacts**



Chris Brodrick
Partner *Melbourne*
T +61 3 9321 9804
christopher.brodrick@
holdingredlich.com



Toby Boys
Partner *Brisbane*
T +61 7 3135 0649
toby.boys@
holdingredlich.com



Marguerite Xavier
Partner *Brisbane*
T +61 7 3135 0672
marguerite.xavier@
holdingredlich.com



References

¹ *Cant (as liquidator of Eliana) & Anor. v Mad Brothers Earthmoving Pty Ltd* [2020] VSCA 198.

² See *Re Emanuel* (1997) 24 ACSR 292.

³ *Capital Finance Australia Ltd v Tolcher* (2007) 164 FCR 83 [122] per Gordon J.

⁴ *VR Dye & Co. v Peninsula Hotels Pty Ltd (In Liq)* [1999] 3 VR 201 [25] – [26] per *Ormiston J cf Mann v Sangria Pty Ltd* (2001) 38 ACSR 307 [37] per Bryson J.

⁵ Such a defence was successful in *Williamson (as liq of Merlino Construction Services Pty Ltd (in liq)) v Hawkwood Holdings Pty Ltd*, unreported, Supreme Court of Western Australia, 31 May 2002, Sanderson M.

⁶ Corporations Act 2001 (Cth), s. 588FA(2).

⁷ *Matthews v The Tap Inn Pty Ltd* [2015] SADC 108.

⁸ Corporations Act 2001 (Cth), s. 91(14).

⁹ Corporations Act 2001 (Cth), s. 91(15); s. 513B(e).

¹⁰ Corporations Act 2001 (Cth), s. 91(15); ss. 446A(2), 513B(b), 513C(b).

¹¹ Corporations Act 2001 (Cth), s. 588FE(4).

¹² Corporations Act 2001 (Cth), s. 588E(4).

¹³ Corporations Act 2001 (Cth), s. 588E(8).

¹⁴ Corporations Act 2001 (Cth), s. 588FF(3).

¹⁵ *Bryant v Badenoch Integrated Logging Pty Ltd* [2023] HCA 2 [76].

¹⁶ *Olifent v Australian Wine Industries Pty Ltd* (1996) 130 FLR 195.

¹⁷ *Cussen v Federal Commissioner of Taxation* [2004] NSWCA 383.

¹⁸ *Sydney Appliances Pty Ltd v Eurolinx Pty Ltd* [2001] NSWSC 230 at [43]-[47].

²⁰ *Dean-Willcocks v Commissioner of Taxation* [2008] NSWSC 1113 at [12]-[13].

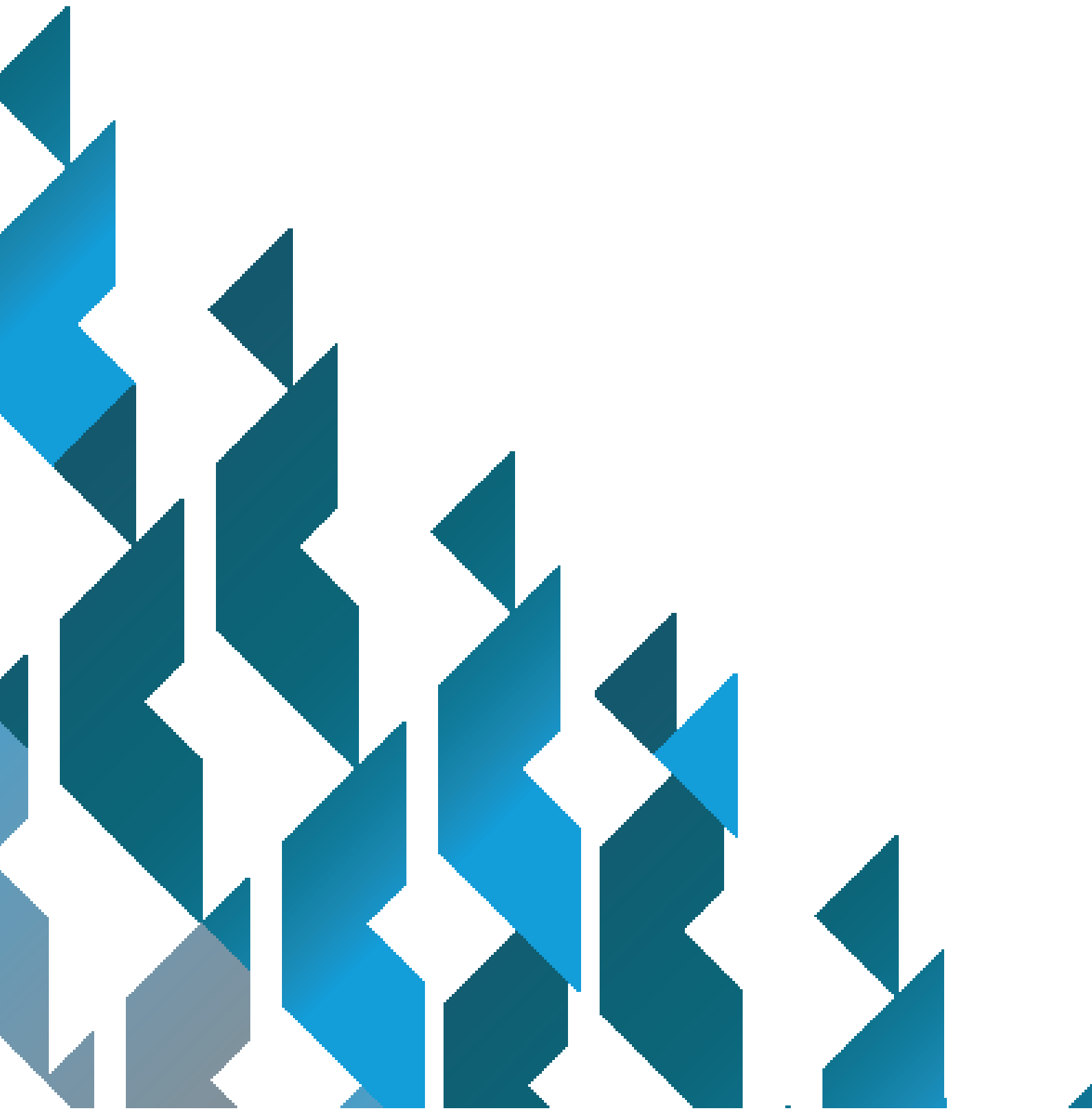
²⁰ *Chicago Boot Co Pty Ltd v Davies* [2011] SASCFC 92.

²¹ *Mann v Sangria Pty Ltd* [2001] NSWSC 172.

²² *Sydney Appliances Pty Ltd v Eurolinx Pty Ltd* [2001] NSWSC 230 at [135]-[136].

²³ *Metal Manufacturers Pty Ltd v Morton* [2023] HCA 1 [53].





MELBOURNE

Level 8
555 Bourke St
Melbourne
VIC 3000
GPO Box 2154
Melbourne
VIC 3001
T +61 3 9321 9999

CANBERRA

Level 7
Canberra House
40 Marcus Clarke St
Canberra ACT 2601
PO Box 1568
Canberra
ACT 2601
T +61 2 5115 1600

SYDNEY

Level 65
25 Martin Place
Sydney
NSW 2000
GPO Box 4118
Sydney
NSW 2001
T +61 2 8083 0388

BRISBANE

Level 1
300 Queen St
Brisbane
QLD 4000
GPO Box 490
Brisbane
QLD 4001
T +61 7 3135 0500

CAIRNS

Level 1
Cairns Corporate
Tower 15 Lake St
Cairns QLD 4870
PO Box 4766
Cairns
QLD 4870
T +61 7 4230 0400