benchtv
a benchmark production

Précis Paper

Voidable Unfair Preferences in Liquidation

Abstract – This paper critically analyses the objective and subjective elements of the 'Alsafe Security'; investing a specific focus into unfair preferences, defences, insolvency, the relation-back period and the notion of 'suspicion'.

Discussion Includes

- What is an unfair preference when a company is in liquidation?
- What are the elements of an unfair preference under Section 588FA?
- What defences are available?
- What circumstances will lead to finding that a creditor suspects the debtor may be insolvent?
- What should a supplier dealing with a company that may be in financial difficulties do?
- What is the relation back period?
- What should a creditor who has been paid by a company that has gone into liquidation do if it receives a letter of demand from a liquidator?
- What is the running account defence?

Précis Paper

Voidable Unfair Preferences in Liquidation

1. In this edition of BenchTV, Ingrid King (Barrister at 10th Floor St James Hall) and Andrew Behman (Lawyer at CLH Lawyers) discuss the 'Alsafe Security' case and its impact on the rights and obligations of creditors and debtors. Discussion topics include unfair preferences, unsecured debt, the relation back period and the running account defence.

What is an unfair preference when a company is in liquidation?

2. This presentation is based on the 'Alsafe Security' case, which concerns a preference claim. It was heard at the Supreme Court of NSW.
3. Andrew liaised with the liquidator to draft the statement of claim, originating process and the affidavits.
4. Ingrid came in shortly after the commencement of proceedings. The matter went to hearing as the mediation was unsuccessful.
5. It is important to look over all of the relevant financial records. The Supreme Court typically assesses the transactions between the debtor and creditor companies, which often reveals the truth without even oral evidence.
6. An unfair preference arises in situations when a company goes into liquidation. The creditor notices that some companies have been paid ahead of others. It is a common principle for all creditors in the same class have an equal share within liquidation contexts. The creditor will look into the relation-back period, which shows how much funds each creditor has received. Fundamentally, this results in one creditor having an unfair preference over another.
7. In this case, payments were made towards Darley during the relation-back period. It accumulated to $100 000.

What are the elements of an unfair preference under Section 588FA?

8. Section 588FA of the *Corporations Act 2011* (Cth) covers preferences. There are certain provisions within that division (e.g. Sections 588FE and 588FF) which provide for the transaction. The creditor received the preference to pay that amount back as part of the liquidation process. This becomes the dividends for creditors.

9. The Court can set aside the transaction on the application of the liquidator. All of this depends on whether the liquidator decides to approach the Court or not.
10. Prior to the commencement of proceedings, the liquidator did write to the creditor to demand payments. Background needs to be given in relation to why there is a preference.
11. The liquidator will first assess the company records and its relationship with the creditors. In this case, the liquidator looked at the trading history between the creditor and the company.
12. In light of numerous factors like the account moving from a 30 days term to cash before delivery, the liquidator deemed the situation as a preference.
13. The next step is to determine whether the company is insolvent.
14. Andrew recommends that the first step in helping a client comes down to looking at whether a payments was made or not. Legal advice from an insolvency lawyer should only be sought when there is a payment.

<u>What defences are available?</u>

15. This case did not require any technical defences apart from the defence under Section 588FG 2. There are other technical defences available to creditors.
16. For example, if the payment was not made by a third party, that in itself can be utilized as a defence.
17. An unfair preference claim has multiple elements under Section 588FA; the company and the creditor must be parties to the transaction and the transaction must result in the creditor receiving from the company in respect of an unsecured debt.
18. Essentially, this is a comparison between the amount of money that the creditor received from the now insolvent company (during the relation back period) and what the creditor company will receive in the insolvency as a member of the class of creditors to which it belongs.
19. A creditor company must determine whether or not the payments made to the now insolvent company were in relation to an unsecured debt.
20. An unsecured debt is absolutely crucial because it is the only class of debt which are used for determining the existence of an unfair preference.
21. Currently, there is growing discussion about how the term, unsecured debt, is to be interpreted in light of the *Personal Properties and Securities Act (2009)* (Cth).
22. All the elements need to be proven by the liquidator (possesses the onus of proof); there needs to be a transaction and there needs to be proof that more money has been received in relation to an unsecure debt compared to liquidation.
23. There is an important defence under Section 588FG (2) known as he 'good faith' defence. This is one of the most difficult defences to prove. It is a combined defence which possess both subjective and objective elements.

What circumstances will lead to finding that a creditor suspects the debtor may be insolvent?

24. The defendant credit company has to prove that at the time they entered into the transaction, they did so in 'good faith' and that there were no reasonable grounds to suspect that the insolvency of the company that subsequently went into liquidation.
25. Additionally, they have to prove that a reasonable person in the person's circumstances would have no such grounds for so suspecting insolvency.
26. In the case, Justice Black held that while there was subjective evidence from officers of the company, no one suspected insolvency. This never determines the issue.
27. Another factor to take into consideration, is the use of the word 'suspect' in objective contexts. There is a difference between observing and suspecting insolvency. This is why the defence is hard to prove.
28. Creditors usually do not have access to company books and records. This increases the difficulty of the defence. Subsequently, they are reliant on other factors of the company in order to come to that suspicion.
29. If creditors have to start chasing the payment of their invoices, that in itself can be argued as evidence leading to suspicion of probable insolvency.
30. The extent of the definition of the term, 'suspect' is as follows – there has to be some reasonable apprehension that you will not get paid. A mere possibility of not getting paid is insufficient. An entity has to definitely know that they are not going to be paid.
31. Usually, the officers of a company, accounts manager or Director are the providers of evidence.
32. When it gets to the objective side of the test, the term, 'reasonable business person' is imperative. This person must act business-like and would make commercial decisions that a reasonable business person would make.
33. For example, if a company knew that a company was going to be insolvent and had a huge debt with them, a commercial decision would be to try and recover as much money as possible.
34. In this case, Darley suggested that if they knew of Alsafe's insolvency, they would have ceased trading immediately. However, a reasonable business person would not do that because future financial losses will be incurred.
35. In looking at both the objective and subjective tests, it is clear that no party should be solely relying on representations from a company that is insolvent.
36. The use of the word 'suspect' dates backs to bankruptcy legislation and decisions in regards to bankruptucy.
37. In the 'Queensland Bacon' case, it was found that a reason to suspect that something exists is in itself, more than a reason to consider the possibility of existence.
38. When the Court is looking at whether the defence is being made out, they look at the situation of the creditor company and make a determination about whether a

reasonable person would have an actual apprehension that the debtor company was unable to pay their debts. This comes back to the concept of insolvency.

39. There are many examples of situations where suspicion is permitted; debtor's accounts are run in the excess of usual trading terms, dishonored cheques, continued non-payment of undisputed debts, attempts to re-negotiate trading terms or if there are any documents showing that there is financial difficulty.
40. At times companies enter into temporary cash flow problems, they make reach out to ask via email to ask for extended deadlines to repay debt. This could however, be a reason to suspect insolvency.
41. In this case, Alsafe had a history of not paying invoices on time, but that was not a legally accepted basis to suspect insolvency in the relation-back period.
42. His Honour found that Darley had placed Alsafe on credit hold for 2 years, prior to the insolvency. During that period of time, Alsafe paid rounded amounts of debt instead of paying amounts linked to specific invoices. The transactions were most cash before delivery in nature. The stamps revealed this.
43. Liquidators often compare the differences in how a creditor treats various debtors.

<u>What should a supplier dealing with a company that may be in financial difficulties do?</u>

44. In this case, Darley gave evidence that all the debtors had 30 days to pay. Under certain situations, extensions may be granted for up to 45 days without incurring any adverse consequences.
45. The oral evidence indicated to the Court that cash before delivery payments are actually unusual. In similar cases, it is common for a pool of debt to be identified as high-risk. The Courts as of now, do agree that the unusual nature of cash before delivery transactions could be the basis for suspicion.
46. The creditor's change of mind, is an indicator of being worried that they are not going to be paid. This could form the basis of suspicion.
47. There was a lot of evidence from Darley's company offices which suggested the following – AlSafe's sponsorships suggested financial strength and viability.
48. His Honour focused on the financial evidence and looked at the actual financial history. This revealed that Alsafe was financially struggling.
49. At the start of the relation-back period, debt had peaked. Over the next 6 months, the debt owed to Darley had decreased but the trading terms for the invoices were increasing.
50. A graph prepared by the liquidator found that Alsafe paid Darley's invoices, but the payment of invoices became slower during the relation back period, but the trend had already started even before this.

<u>What is the relation back period?</u>

51. The relation back period is statutory provided for in the Act. It is a specified timeframe that provides for a liquidator to clawback transactions. It usually goes for 6 months. If there is a related party, it can be extended to 4 years. If the purpose is to defeat creditors, it can be extended to 10 years.
52. In this case, Darley was an ordinary supplier within a 6 month period, as a non-related party.
53. The 6-month period begins from the date of administration or date of winding up (if the Court ordered it).
54. The final result of the case has been that Darley has been ordered to pay the liquidator $97 628.58. There will also be a claim for interests and costs.
55. Businesses must carefully consider their relationship at all times when deciding whether or not to suspect insolvency. This is the commercial reality.

What should a creditor who has been paid by a company that has gone into liquidation do if it receives a letter of demand from a liquidator?

56. Liquidators often operate in confined circumstances. If a person has received a letter from a liquidator, negotiation and compromise becomes possible. Liquidators are open to providing mutually beneficial solutions, as the earlier a matter is settled, the less costs there are. Liquidators are experienced litigators and are usually keen to take part in mediation/dispute resolution.
57. It is not uncommon for liquidators to be in situations where there are not readily available books or records.
58. The liquidator must be aware of time limits.
59. There are 2 issues, which are triggering conversation in the insolvency community; creditor company entitlements to a set off under Section 553C and the criteria for what constitutes unsecured debt for the purposes of the unfair preferences claim.
60. When a liquidator is looking the books/records of an insolvent company, they are often inadequate.
61. The liquidator can issues notices to produce if litigation has commenced. Assembling these records usually strengthens the liquidator's case. In such situations, better deals can be made.
62. When a liquidator deals with the Director or company officers after the winding up process, there must be a degree of scrutiny exercised towards payment arrangements.

What is the running account defence?

63. In this case, the liquidator conceded the running account defence; looks at the nature of the business relationship between the debtor company and creditor company. It compares the peak level of indebtedness with the supplier's goods/services.
64. It can be viewed as the flip side to the whole nature of unfair preferences. Allowing a debtor company to continue with their business activities, will make sure that a certain creditor will not get an advantage over other creditors.
65. The trend graph showed that Darley achieved a significant wind back. This is an useful litigation tool.
66. This case sends the message that it is highly unlikely for unsecured creditors to receive a distribution.

BIOGRAPHY

Ingrid King

Barrister, 10th Floor St James Hall, Sydney

Ingrid practices in general commercial and public law. She regularly appears for private companies, insolvency practitioners, directors and government entities in State and Federal courts, commercial arbitrations and tribunals.

Andrew Behman

Lawyer, CLH Lawyers, Sydney

Andrew is an experienced lawyer. In the past he has worked as a lawyer at Smith Leonard Fahey Lawyers.

BIBLIOGRAPHY

Focus Case

Alsafe Security Products Pty Ltd atf the Alsafe Trust (in liquidation) [2016] NSWSC 428.

Benchmark Link

xxxx

Judgment Link

xxxx

Cases

Queensland Bacon Pty Ltd v Rees [1966] HCA 21; 115 CLR 266 at 303 per Kitto J.

Legislation

Corporations Act 2011 (Cth), s 553, 588.

Personal Properties and Securities Act (2009) (Cth).