Liquidators beware: creditors may rely on set-off in unfair preference claims

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Summary

The use of the set off defence has drawn plenty of heated criticism from the legal and insolvency community for a number of reasons.

It is argued by critics that the necessary element of mutuality, that is an essential requirement for the application of section 553C *Corporations Act 2001* (Cth) (the Act), is lacking.[1]

In Turkalerts dated 10 June 2015 and 1 February 2016 we reported on the decision of *Morton & Anor v Rexel Electrical Supplies* [2015] QDC 49 where the set off defence was applied. As it was a lower court decision, it left room for debate about whether the set off defence would be applied in higher courts.

Now, in yet a further blow to liquidators, and a potential boon for creditors, the Federal Court of Australia (FCA) *In the matter of Stone v Melrose Cranes & Rigging Pty Ltd, in the matter of Cardinal Project Services Pty Ltd (in liq) (No 2)* [2018] FCA 530 has confirmed its position that a set off under section 553C of the Act can be utilised by creditors in unfair preference claims.

The FCA decision provides substantial support to creditors who are in a position to rely on the set off defence and seek to dissuade the critics who say it has no application, and will fail if the argument is tested in the Courts.

Background

On 1 February 2012, the plaintiffs, Richard Andrew Stone and Peter William Marsen, were appointed as liquidators of Cardinal Project Services Pty Ltd (In Liquidation) (CPS), a wholly owned subsidiary providing environmental services in waste management and recycling.[2]

In 2016, the Liquidators initiated proceedings against Melrose Cranes & Rigging Pty Ltd (Melrose) seeking orders under section 588FF of the Act that 18 payments from CPS to Melrose totalling $308,544.58 were voidable transactions and unfair preferences.[3]

Melrose disputed the Liquidators' position and asserted, inter alia, that:

- they were unaware of the fact that CPS was insolvent at the time that each payment was made;
- they had acted in good faith;
- any payments made were not unfair preferences but were instead an integral part of the continuing business relationship (referred to as a running account defence); and [4]
- they were entitled to a set off in the amount of $80,774.23 which was the amount in which CPS was indebted to it at the date of the appointment of the administrators.[5]

At trial, the Liquidators invited the Court not to follow a long line of cases that favoured Melrose's view that a set off may be available in the context of a preference claim, on the basis that the cases are "plainly wrong", however they did not provide detailed submissions on the issue.[6]

The Decision

On 19 April 2018 after a seven day hearing, the FCA ultimately found that payments made to Melrose were voidable transactions pursuant to section 588FE(2) of the Act, and that they were unfair preferences.

Accordingly the Liquidator's claim was successful and Melrose lost, but what is important for creditors is that the Court rejected the Liquidators' submission that a set off under section 553C is not available to creditors in the context of a preference claim.

Her Honour Justice Markovic stated that the Court was not prepared to depart from the leading judgment in *Re Parker* (1997) 80 FCR 1 or any of the other authorities permitting a set off to be utilised by creditors in voidable transaction claims.[7]

However, Melrose could not avail the defence, because it was found that it had the requisite notice and knowledge of insolvency at the time of the payments.[8]

Referring to the matter of *Jetaway Logistics Pty Ltd v Deputy Commissioner of Taxation* (2009) 26 VR 657 (Jetaway), her Honour found that Melrose had 'actual notice' of facts which disclosed that CPS lacked the ability to pay its debts when they fell due within the meaning of section 95A of the Act.

The relevant evidence included Melrose being aware of multiple promises of payment that were not met despite persistent follow up and knowing the CPS had no prospect of having any funds to pay the debts. These circumstances, amongst others, should have indicated to the director that CPS was insolvent, and therefore her Honour accepted that Melrose was not entitled to a set off.

Given the finding of actual notice, it was unsurprising that her Honour also found that Melrose could not make out its good faith defence.

The Court also held there was no running account, as there was no evidence of a 'mutual assumption' of payment, instead the agreements between the parties were on a project by project basis.[9]

Important Take Away Points

Despite a loss for Melrose, this decision represents a significant win for creditors, who can rely on the decision as further authority at the Federal Court level for the proposition that the set off defence is available in an unfair preference claim.

It is important to note that in order to be entitled to a set off, creditors must have no notice of a company's insolvency.

The onus of establishing such notice will be on the liquidator. The test is whether the creditor had actual knowledge that the company lacked the ability to pay its debts when they fell due. This is juxtaposed to the test for a good faith defence which is easier to overcome because the liquidators need only show that there were reasonable grounds for suspecting insolvency.[10] Accordingly, even a creditor who is unable to rely on the good faith defence may yet succeed with its set-off defence.

As a result of this decision, liquidators may find an increased amount of creditors using the set off defence to avoid repayment of pre-liquidation debts, which in turn could reduce the amount recoverable to be redistributed equally amongst all creditors.

Until this issue is considered by a higher court, we expect the controversy around its application to continue, but perhaps the tide is turning more sharply in the creditor's favour.

[1] An unfair preference claim is brought by a liquidator personally and arises post-liquidation. The opposing debt, arises pre-liquidation, and is owed to the creditor by the company.

[2] *Morton v Rexel Electrical Supplies Pty Ltd* [2015] QDC 49.

[3] Richard Andrew Stone and Peter William Marsen were previously appointed as joint and several administrators of Cardinal Project Services Pty Ltd pursuant to section 436A of the *Corporations Act* (Cth).

[4] See section 588FE(2) and 588FA of the Corporations Act 2001 (Cth).

[5] See *Airservices Australia v Ferrier* (1996) 185 CLR 483 where a majority High Court of Australia stated with regards to the running account defence that: "if the purpose of the payment is to induce the creditor to provide further goods or services as well as to discharge an existing indebtedness, the payment will not be a preference unless the payment exceeds the value of the goods and services acquired".

[6] See In the matter of *Stone v Melrose Cranes & Rigging Pty Ltd, in the*

matter of Cardinal Project Services Pty Ltd (in liq) (No 2) [2018] FCA 530 at [280].

[7] Ibid, [281]. See generally *Re ACN 007 537 000 Pty Ltd (in liq); Ex Parte Parker* (1997) 80 FCR 1, *Morton v Rexel Electrical Supplies Pty Ltd* [2015] QDC 49 and *Buzzle Operations Pty Ltd v Apple Computer Australia Pty Ltd* [2011] NSWCA 109.

[8] Ibid.

[9] See section 553C (2) of the Act.

[10] See *Sutherland v Eurolinx Pty Ltd* (2001) 37 ACSR 477.

[11] See section 588FG of the *Corporations Act 2001* (Cth).

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