Setoff Defence – A very useful tool to defend an unfair preference claim

Daniel Turk and Melissa Jarvin | August 2019 | Commercial

Summary

What is one of a creditors' biggest nightmares? The unfair preference claim brought by a liquidator under section 588FA of the *Corporations Act 2001* (Cth) (Act).

The bad news for creditors is that the unfair preference claim is not going anywhere (and perhaps may become even more prevalent in the future). The good news is, however, that there are defences available to creditors and one, in particular, that has made some headway in recent years; the setoff defence.

The setoff defence

If the setoff defence is available to a creditor, it could significantly reduce the amount of a liquidator's claim against the creditor (or nullify it entirely) because it may allow the creditor to off-set any debt owing to it by the company, prior to the company being placed in liquidation, against the amount of the alleged unfair preference payments.

For example, if Creditor A was owed $100,000.00 by Company X and Creditor A receives $30,000.00 in preference payments, Creditor A can potentially claim a setoff of $70,000.00 (the amount still outstanding), which results in the preference claim being reduced to zero. On the other hand, if Creditor A is owed $40,000.00 by Company X but receives $30,000.00 in preference payments, Creditor A can potentially claim a setoff of the amount outstanding of $10,000.00, reducing the unfair preference claim to $20,000.00 (meaning Creditor A would still be liable for this amount).

Stone v Melrose Cranes case

The leading (and most recent case) on the setoff defence is the Federal Court case of *Stone v Melrose Cranes & Rigging Pty Ltd, in the matter of Cardinal Project Services Pty Ltd (in liq) (No 2)* [2018] FCA 530 ('Stone v Melrose Cranes'). In that case, the Court confirmed that setoff, (under section 553C of the Act), is an available defence to a creditor in the context of an unfair preference claim but only if, at the time of giving credit to the company in liquidation, the creditor did not have notice of the fact that the company was insolvent. This is a higher standard than only having a suspicion of insolvency.

Notice of the fact of insolvency

But what does "notice of the fact that the company was insolvent" really mean?

The relevant question is whether the creditor, at the time of giving credit to the company, had actual notice of the facts that would have indicated to a reasonable creditor, in that particular creditor's position, that the company was unable to pay all of its debts as and when they became due and payable.[1]

The time of giving credit

The relevant time to assess notice of insolvency is not the time the alleged preferred payments were received, but the time the creditor gives credit to the company (which ultimately results in the unpaid debt the creditor seeks to setoff). The "time of giving credit" is the time in which the creditor allows the company buying goods or services to make payment at some future date (which is, for example, when the outstanding invoices were rendered or the goods were supplied).

Facts indicating actual notice of insolvency

In *Stone v Melrose Cranes* the Court found that Melrose Cranes was not entitled to a setoff as it had notice of the fact that the company was insolvent at the time of giving credit to the company. The following were, in summary, the relevant facts which led the Court to its conclusion:

1. The company's numerous promises of payment that were not met despite persistent follow up by Melrose Cranes,
2. The company's credit account had been suspended in the past due to a large debt being owed outside of the 30 day payment terms and during the period relevant to Melrose Cranes' setoff, the account was eventually frozen (and was never unfrozen before the company was placed into liquidation),
3. The company made payments to Melrose Cranes irregularly and in rounded amounts not referrable to any tax invoices,
4. Melrose Cranes entered into a payment arrangement with the company and, in doing so, required director guarantees as security (indicating Melrose Cranes was protecting itself in the event that the company went into liquidation), and
5. Further services were only provided by Melrose Cranes to the company on the basis that payment was guaranteed by third parties.

The creditor's circumstances

Nonetheless, the existence of similar facts to the above (or at least, some of them) is not necessarily determinative of "notice of insolvency". All of the circumstances present at the time, as known to the creditor, are relevant to the "notice of insolvency" assessment, which might include the character of the debt and the nature of the company's business (and, perhaps, its cyclical nature).[3] Similarly, the trading relationship and history of the creditor and the company must be considered alongside any potential insolvency indicators (at the relevant time) because the conclusion of insolvency must be "warranted" by the facts known to the creditor.[4] For example, frequent delays in payment by the company, during the relevant time, may not mean the creditor had "notice of insolvency" if the company, throughout its trading relationship with the creditor (and before it was deemed insolvent), frequently paid late. Yet, if the company habitually paid on time and then, in the lead up to the company's liquidation, it stopped paying on time; that would likely be an indication, to a reasonable creditor in the position of that creditor, that the company was insolvent.

The lesson

The lesson is therefore that the "notice of the fact that the company was insolvent" test is to be determined on a case by case basis because each trading relationship between a creditor and debtor company is different.

Conclusion

While there haven't been any superior court cases since *Stone v Melrose Cranes*, it is important that creditors are reminded, particularly in circumstances where the outstanding debt owing by the company in liquidation is quite significant, that the setoff defence can be, if understood and applied correctly, a very useful tool to defend an unfair preference claim.

[1] Test set out in *Jetaway Logistics Pty Ltd v Deputy Commissioner of Taxation* (2009) 26 VR 657, approved by *Stone v Melrose Cranes & Rigging Pty Ltd, in the matter of Cardinal Project Services Pty Ltd (in liq) (No 2)* [2018] FCA 530 at [285] – [287].
[2] *Morton & Anor v Rexel Electrical Supplies Pty Ltd* [2015] QDC 49 at [81].
[3] *Jetaway Logistics Pty Ltd v Deputy Commissioner of Taxation* (2009) 26 VR 657 at [15] (approved by *Stone v Melrose Cranes & Rigging Pty Ltd, in the matter of Cardinal Project Services Pty Ltd (in liq) (No 2)* [2018] FCA 530.
[4] See *Jetaway Logistics Pty Ltd v Deputy Commissioner of Taxation (2009) 26 VR 657 at [22] (approved by Stone v Melrose Cranes & Rigging Pty Ltd, in the matter of Cardinal Project Services Pty Ltd (in liq) (No 2)* [2018] FCA 530, where Robinson J said:

> "…What is required is proof of facts known to the creditor which warranted the conclusion of insolvency…."

For more information, please contact:

Daniel Turk
Partner
T: 02 8257 5727
M: 0408 667 220
daniel.turk@turkslegal.com.au

Melissa Jarvin
Senior Associate
T: 07 3212 6705
M: 0424 990 088
melissa.jarvin@turkslegal.com.au