A Guide to Defending Unfair Preferences

In collaboration with:

1) Introduction

At the invitation of the AICM, the Partners at Turks have prepared this guide as a resource for credit managers assessing whether they have reasonable grounds to challenge unfair preference claims made by liquidators of customers who have entered liquidation. It also outlines the key defences available to creditors responding to such claims, helping them navigate these complex legal issues with confidence.

What is an unfair preference?

Under the ***Corporations Act 2001 (Cth)*** ("**the Act**"), liquidators of insolvent companies can seek to recover payments made to creditors if they believe those payments have given a particular creditor an unfair preference over others. An unfair preference occurs when a creditor receives payment from an insolvent company that places them in a more advantageous position compared to other creditors.

An example of an unfair preference could be a customer unable to pay all its creditors and choosing to pay the invoices of only one of its creditors just prior to the customer's liquidation and leaving the others unpaid. The purpose of this provision is to ensure fairness by returning such payments to the general pool of funds, allowing for equitable distribution among all unsecured creditors.

Why is this problematic for Credit Managers?

This legislation proves problematic for credit managers, especially when dealing with customers experiencing cash flow difficulties and falling behind on trading terms. Credit managers, whilst wanting to maintain cash flow for the business will be concerned that payments received could later be clawed back by a liquidator if the customer enters liquidation. There is also the headache of having to respond to unfair preference claims of liquidators and convince the liquidator a statutory defence is available to the creditor.

When does this apply?

- Unfair preference claims arise exclusively in company liquidations.
- These do not apply in deeds of company arrangement ("**DOCA**"), receiverships or small business restructuring arrangements.

2) Key defences for unfair preference claims

Didn't know the company was insolvent when receiving payments? You may have a defence.

a. No suspicion of insolvency defence

You may have a defence under **section 588FG** of the Act if you can prove all of the following:

- **Subjective Test**: At the time of the payment, you had no reasonable grounds for suspecting the company was insolvent. This test takes into account the training, skills, and experience of the creditor at the time of the transaction (usually at payment);
- **Objective Test**: A hypothetical reasonable person, with the knowledge and experience of an average business person in the creditor's circumstances, would not have suspected the company was insolvent; and
- **Good Faith**: The transaction was entered into in good faith.

While a liquidator has the onus of proving insolvency, the creditor has the onus of establishing this defence on the balance of probabilities.

Factors that may indicate grounds to suspect insolvency:

- repeated history of late payments and age of debts;
- default on payment arrangements;
- dishonoured payments;
- stopping providing credit and only accepting cash on delivery terms; or
- letters of demand or creditor's statutory demand issued.

Note: Courts distinguish between suspecting cash flow difficulties and insolvency. Late payments alone are not conclusive evidence. The suspicion must arise at the time of the transaction, typically when receiving payment.

IMPORTANT CONSIDERATIONS FOR CREDIT MANAGERS...

Ways to minimise a creditor's risk:

- obtain security (unfair preference claims only apply to unsecured debt);
- ask for payment from a third party (for example guarantors or related parties); and
- ask for payment in advance or cash on delivery (if payment received before or at the time of delivery, the creditor is unlikely to suspect insolvency).

b. *Running account defence*

If there is a continuing business relationship between the creditor and the insolvent company, you may rely on the 'running account' defence under **section 588FA(3)** of the Act. Where there is a continuing business relationship, the liquidator must treat a series of debits and credits as a single transaction, with the 'preference' being the amount by which payments exceeded the value of goods or services supplied during the relevant period.

Note: This defence applies even if the creditor suspects the debtor was insolvent, provided there was an express or implied mutual expectation between the creditor and debtor that payments secured future supply while settling past debts.

The relevant timeframe for assessing transactions runs from the date of insolvency or relation-back date to the liquidator's appointment. A continuing business relationship may end if a creditor imposes stop supply, cash on delivery terms, terminates a supply agreement, or enters a new supply arrangement. Payments received after these steps are standalone transactions and may no longer qualify under the defence.

Practical example:

	Supply	Payments	Running balance
1 July 2024			$100,000
15 July 2024	$10,000		$110,000
29 July 2024		($5,000)	$105,000
5 August 2024	$40,000		$145,000
19 August 2024		($20,000)	$125,000
2 September 2024		($10,000)	$115,000
6 September 2024	**COD terms applied**		
9 September 2024	$30,000		$145,000
9 September 2024		($30,000)	$115,000
Sub-total	**$80,000**	**$65,000**	

Applying the running account defence, the supplier has not received a preference because the total value of supplied goods ($80,000) exceeds payments received ($65,000).

If the running account ceased on 6 September 2024, the payment of $30,000 made after that date could become a standalone preference rather than part of the continuing business relationship.

IMPORTANT CONSIDERATIONS FOR CREDIT MANAGERS...

- Supplier communications will be scrutinised by the liquidator and the Court when determining whether a continuing business relationship existed.
- Clear evidence of express or implied mutual expectations regarding future supply is crucial.
- To strengthen reliance on the 'running account' defence, suppliers should ensure payment and supply arrangements reflect an intent to continue trading.

3) Can unpaid debts offset an unfair preference claim?

The answer is **no**, you cannot set off unpaid debt to defeat an unfair preference claim.

It used to be unclear whether a creditor could rely on **section 553** of the Act to set off unpaid debt owed to it by an insolvent company against a valid unfair preference claim.

Under **section 553C**, where there have been mutual credits and debits between an insolvent company and a party, the party can seek to have any debt owed to the insolvent company set off against any debt owed to the party. To claim a set-off, an account must first be prepared to document the sums owed by each party to the other. Only the balance of the account (if any) will be payable to the insolvent company in the winding up. A party is not entitled to claim the benefit of a set-off where, at the time they offered a credit to the insolvent company, they had notice of the fact that the company was insolvent.

However, the recent High Court case of *Metal Manufactures v Morton* (HCA 2023) ("***Morton***") clarified that creditors cannot use set-off provisions under **section 553C** of the Act as a defence to an unfair preference claim or to reduce any outstanding claim that it may have against a company in liquidation. This is because a preference claim is a claim that is personal to a liquidator, and it is not a claim by the company itself.

Summary of key facts in *Morton*:

- A creditor received $190,000 in payments within six months of liquidation.
- The liquidator claimed these as unfair preferences.
- The creditor attempted to offset the $190,000 payment against a $194,000 debt owed by the insolvent company. However, the court ruled that there were no 'mutual dealings' at the time of liquidation because, while the insolvent company still owed the creditor money, the creditor did not owe any debt in return. The liability that later arose due to the liquidator's unfair preference claim was a consequence of the liquidation itself and was therefore insufficient to satisfy the set-off requirements under **section 553C**.

IMPORTANT CONSIDERATIONS FOR CREDIT MANAGERS...

- The decision of *Morton* provides much needed guidance to creditors with respect to unfair preference claims.
- With set-off no longer available to creditors as a defence, creditors will need to focus their attention on other defences that may be available to any unfair preference claim.

4) Becoming a Secured Creditor

Secured creditors are not subject to unfair preference claims, but only to the extent of the value of their own security. This can often be a difficult issue for liquidators and creditors to properly prove.

For this reason, one of the most effective steps to avoid unfair preference claims is by registering security interests (such as retention of title rights found in standard terms of trade) on the Personal Property Securities Register ("**PPSR**").

Importantly, PPSR registration formally establishes a creditor's secured status in liquidation. If a liquidator is appointed, the registered security interest serves as proof of a secured claim, possibly preventing liquidators from clawing back payments made during the relation-back period as unfair preferences. This is the case, even if the creditor in question knows full well that the Company is insolvent when it received its payment. When it comes to the PPSR, registration is key.

Pursuant to **section 588FA** of the Act an unfair preference claim may be brought by a liquidator against a creditor only 'in respect of an unsecured debt that the company owes to the creditor'.

In the 2016 case of *Hussain v CSR Building Products Ltd* (FCA 2016) ("***Hussain***"), Edelman J ordered that the liquidator's claim to recover $153,554.00 from FPJ Group be dismissed as, not only did the liquidators fail to prove that FPJ Group was insolvent, but the money also received by CSR Building Products Ltd ("**CSR**") was a repayment made towards a debt that was secured.

Hussain, acting as liquidator of FPJ Group, submitted that the company was insolvent as of 21 November 2013 and that therefore payments made to CSR by FPJ Group between January 2014 and June 2014 constituted unfair preferences. CSR provided ongoing supply services to FPJ pursuant to a contractual agreement that contained a retention of title clause. What was particularly interesting about the Court's finding in *Hussain* was that even though the security interest was not registered on the PPSR, the Court held that a retention of title clause was sufficient to secure the debt owed by FPJ Group to CSR and, as such, prevented the liquidators from clawing back the payments.

In the more recent Victorian case of *Quin (in his capacity as liquidator of Roderick Group Pty Ltd (In Liquidation)) v Vlahos* (VSCA 2021), the Court noted that there are diverging authorities as to whether a retention of title clause in a contract is sufficient to demonstrate that a debt is secured either wholly or partly, but that if the security is registered on the PPSR then it is clear that the debt in question would be regarded as 'secured'.

It is apparent that the 'secured creditor defence' is available even if a creditor has not lodged its security interest on the PPSR. However, it is also clear that a creditor is certainly in a far better position to defend such a claim and will probably avoid having to deal with one altogether, if it has lodged its interest on the PPSR.

IMPORTANT CONSIDERATIONS FOR CREDIT MANAGERS...

- Always register your security interests on the PPSR. It provides indisputable protection against unfair preference claims and strengthens your legal standing.
- While helpful, relying solely on retention of title clauses without PPSR registration can leave room for dispute. Registration removes ambiguity.

5) Recoveries

a. *Recoveries post-administration*

When a company enters administration, are payments you receive during that period potentially recoverable by a subsequent liquidator?

The answer is **yes**, but it depends on the circumstances.

Once a company enters administration, three possible outcomes can follow:

1. a DOCA is proposed and approved;
2. the company enters into liquidation; or
3. the company is returned to the directors (rarely happens).

The outcome is dependant on a vote of creditors. During the normally short administration period (subject to extension), voluntary administrators may be personally liable for debts incurred after five business days, including ongoing trade supplies.

If a DOCA is approved, payments made outside its terms or not through the deed administrator during the DOCA period, may still be recoverable if the deed fails or the company enters liquidation.

This issue was considered in the case of *Yeo, in the matter of Ready Kit Cabinets Pty Ltd (in liq) v Deputy Commissioner of Taxation* (FCA 2020). The Court ruled that payments made directly to the Deputy Commissioner of Taxation during administration were not protected under the DOCA, as they were not made through the Deed Administrator or under its authority. These payments were treated as unfair preferences and recoverable by the liquidator.

This case highlights the importance of carefully drafting a DOCA, including the terms of payment. It also underscores the need to be aware of any ongoing supply arrangements during the deed period, as poorly structured payments or agreements could still be subject to recovery in liquidation.

b. Recoveries from third parties (including guarantors)

If a company enters liquidation, are earlier payments made by third parties that reduce the company's debts recoverable by the liquidator?

The answer is also **yes**, if the payment also diminishes the assets of the debtor company. For example the payor may be a debtor of the company and have its debt reduced by the payment.

Payments received from genuine third parties that have no effect on the debtor companies assets should avoid being clawed back as an unfair preference.

For example, in the case of *Pacific Plumbing Group Pty Ltd (in Liquidation)* (NSWSC 2024), Justice Black determined that a payment made by a third party was not an unfair preference where that payment did not diminish the assets of the company that would be available to creditors.

Conclusion: In both of the above scenarios, the one thing to identify is that it is important to put a liquidator to proof on these issues. A specific request for information on these issues may result in a reduced claim, an offer of settlement or the claim not being pursued altogether.

IMPORTANT CONSIDERATIONS FOR CREDIT MANAGERS...

- When dealing with a business under administration, ensure payments align with DOCA terms. Payments made outside these terms are at risk of recovery in case of liquidation.
- Carefully assess the context of third-party payments to understand their exposure to potential claims.

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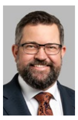

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