Can creditors apply both a running account and set-off defence together?

Allan Kawalsky & Alison Malek | December 2018 | Commercial Disputes & Transactions

Summary

When served with an unfair preference claim, creditors can potentially defend themselves with a number of statutory defences.

A running account defence is well known and is generally accepted as a starting point by most liquidators to reduce the preference, usually by reference to the peak indebtedness rule.

More recently creditors have relied on a "new" defence, the set-off defence, in efforts to reduce or diminish a preference claim by a liquidator. This defence is a controversial one because many commentators think it should not be applied to unfair preferences.

Even more controversial is the possibility that the running account and the set-off defence can be applied by a creditor at the same time. The possibility exists, but we have yet to see a decision in which the two regimes have been applied together.

Defences

The primary defences available to a creditor in response to an unfair preference claim are:

1. Secured creditor defence;
2. Good faith or "no knowledge of insolvency" defence under section 588FG of the Corporations Act (the Act);
3. Running account "defence" under section 588FA(3) of the Act (*not strictly a defence*); and
4. Set-off "defence" under section 553C of the Act.

The first two defences are complete defences. This means that if they are argued successfully, the preference claim falls away and no money is required to be disgorged.

The second two defences are partial defences. This means that if they are accepted by a liquidator or a Court, they generally serve to reduce the amount being claimed, and the balance becomes the preference amount.

Criticism of the set-off defence

The use of the set-off defence has been heavily criticised in an unfair preference context, and it has not traditionally been a defence upon which creditors have placed substantial reliance in defending a preference claim. The principal reasons for the criticism are:

1. The use of a set-off defence by an unsecured creditor gives that creditor favourable treatment compared to other unsecured creditors who are in all respects in the same situation but for the ability to set-off. How so? If creditor A was owed $100,000 and it received the entire amount by preference payments, it would have to disgorge those payments in full and has no set-off claim available to it. By comparison, if creditor B is also owed $100,000 but only receives $30,000 in preference payments, it can claim a set-off of $70,000 (the amount still outstanding) which results in the preference claim being reduced to zero. Creditor B keeps the $30,000 preference, but Creditor A gives up the full $100,000, a peculiar and unsatisfactory result.
2. For two debts to be set-off, they must be mutual. This means that the debts are between the same parties, in the same capacity, and they are both monetary claims. In an unfair preference context, it is arguable that the claim of the creditor and the claim of the liquidator are not mutual. An unfair preference claim is brought by a liquidator and arises post liquidation. The opposing debt, by comparison, arises pre-liquidation and is owed to the creditor by the company, not by the liquidator.

These arguments were raised (and dismissed) in cases such as *Morton v Rexel Electrical Supplies Pty Ltd* [2015] QDC 49 (*Morton v Rexel*) and *Hussain v CSR Building Products Limited, in the matter of FPJ Group (in liq)* [2016] FCA 392 (*Hussain*).

Further, it is important to note that under section 553C(2) a creditor cannot claim a set-off if it had notice (i.e. knowledge) of the company's insolvency. This means a liquidator must show that the creditor had a higher level of awareness of the Company's insolvency than if it was simply challenging an ordinary good faith defence.

There have been several decisions approving the application of section 553C in an unfair preference context (for example *Buzzle Operations Pty Ltd (in liq) v Apple Computers Australia* (2001) 81 NSWLR 47; *Morton v Rexel; Stone v Melrose Cranes & Rigging Pty Ltd, in the matter of Cardinal Project Services Pty Ltd (in liq) (No 2)* [2018] FCA 530 and others), thereby providing support for creditors who wish to rely on the set-off defence in response to a preference claim, despite the arguments set out above. Various reasons have been examined; including that bringing a preference claim is *"merely a procedural device for enforcing what is clearly a claim of the company"* and therefore the requirement of mutuality is still met.

Applying defences together?

In light of this, trade creditors in particular may find that they are able to rely on both partial defences being the running account defence and set-off defence, and this begs the question: can the two partial defences be applied together?

If so, a creditor is arguably subtracting its debt twice from the preference claim (i.e. firstly, because it is the set-off, and secondly as the final balance subtracted from the peak indebtedness under the running account).

Consider an example:

Peak indebtedness during relation-back period	$300,000
Less amount of debt at date of appointment which for argument's sake is $150,000	$150,000
Less amount of set-off (being $150,000 amount due to creditor at date of appointment set-off against the $150,000 preference claim after applying the running account)	$0

It is evident in the above example that the $150,000 debt due to the creditor is being counted once for the running account reduction and a second time for the set-off, reducing the preference to zero.

There is little guidance in the case law regarding whether creditors are permitted to argue that both defences should be applied together. It is not expressly prohibited.

In the reported cases dealing with these defences in an unfair preference context, either only one of the defences was raised, or both were raised but one was unsuccessful. There was no express rejection of the application of the defences together.

In *Hussain v CSR Building Products Limited, in the matter of FPJ Group (in liq)* [2016] FCA 392, his Honour Justice Edelman of the Federal Court refers to this issue in obiter remarks, but leaves open the possibility that the two regimes can be applied together. He says at 237-239:

> *"The first additional matter which was not addressed is the question of whether a set-off claim can be used to outflank the statutory running account… the doctrine of set-off remains conceptually distinct from the running account so that the codification of the running account would not be outflanked by permitting a concurrent claim for set-off. But before I were to determine whether s 553C applied to a claim under s 588FF based upon an unfair preference under s 588FA, it would have been necessary for me to hear submissions about the history of s 588FA(3) and its relationship with s 553C of the Corporations Act".*

Some academics such as Rory Derham have described the use of set-off defences in an unfair preference context as operating almost like a security interest. Although not a security in the strict sense of the word, nevertheless the set-off performs a similar function because it acts as a shield against the preference claim. Further, if the creditor is able to apply both running account and set-off defences together, the creditor effectively takes advantage of that shield for a second time.

It will be interesting to see whether this issue is clarified by the Courts.

Takeaway Points

- The use of the set-off defence has been permitted, notwithstanding its use is criticised in an unfair preference context.

- There is no determinative position on whether a running account defence and set-off defence can be applied together. It is an issue yet to be decided.
- If it is permitted, a creditor who is able to rely on both defences effectively takes advantage of a double counting of the debt on appointment to set off a preference claim.

For more information, please contact:

Allan Kawalsky
Partner
T: 03 8600 5022
M: 0434 305 902
allan.kawalsky@turkslegal.com.au

Alison Malek
Senior Associate
T: 03 8600 5029
M: 0411 482 219
alison.malek@turkslegal.com.au