UNFAIR PREFERENCE PAYMENTS

EXPERIENCE AND EXPERTISE

As experts in bankruptcy and personal insolvency, we specialise in turnaround and restructuring services. Our partners and staff have worked on more than 1000 insolvency administrations.

We have a highly talented team of in-house professionals which include

- Official liquidators
- Bankruptcy trustees
- Lawyers
- ARITA members
- CPAs
- Chartered Accountants

If you are in financial difficulty, we can help you.

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1. INTRODUCTION

The *Corporations Act 2001* provides a framework that enables a liquidator to set aside and recover payments that discriminate in favour of one creditor at the expense of other creditors.

Transactions that have the effect of giving one creditor a "preference, priority or advantage" can be invalidated by a liquidator with the court's assistance.

This process of setting aside a payment or a transaction is variously known as an unfair preference, a voidable transaction or a preference payment. A common example of an unfair preference payment is a director of an insolvent company repaying family loans in full and not paying the ATO anything.

An unfair preference payment becomes void only when the court makes an appropriate order.

The purpose of invaliding unfair preference payments is to enforce equal treatment amongst creditors. This enables a liquidator to distribute the proceeds of the company's assets not from what is left at the date of liquidation, but instead from the resources of the company at date the company became insolvent.

A liquidator's power to recover an unfair preference payment is limited to payments and transactions that were made to creditors during the 6 months that precede the company's liquidation.

It is important to note the 6 month period available for a liquidator to recover preference payments is extended to 4 years if the payment or transaction involves a related entity. (ie related companies, director's spouse, brother, sister, children).

Payments and transactions with creditors that fall outside of this 6 month window, may still be pursued by a liquidator if they constitute an uncommercial transactions (2 years) or obstruct creditors' rights (10 years). Each of these recovery actions are generally more difficult to establish than an unfair preference action.

2. THE LAW

The relevant extract of Section 588FA of the *Corporations Act 2001* provides that a transaction is an unfair preference if:

a) The company and the creditor are parties to the transaction (even if someone else is also a party) and

b) The transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company.

THE ESSENTIAL ELEMENTS OF A UNFAIR PREFERENCE PAYMENT

Section 588FE of the *Corporations Act 2001* may be paraphrased as follows:

1. The company was insolvent,
2. There was a payment or transaction between the company and a creditor,
3. During the relevant time period, and
4. The creditor benefited from the transaction by receiving more than if the transaction was set aside and the creditor proved in the liquidation.

3. INSOLVENCY

WHEN IS A COMPANY INSOLVENT?

The date of insolvency is always a subjective and complex issue. Lawyers love this issue because there's always something to argue about. Boring textbooks have been written on this single concept (we keep those books and read them on our holidays!).

The problem with determining a date of insolvency is that companies have good and bad months. A temporary lack of liquidity is not the same as insolvency. Some companies are asset rich and cash flow poor. Some have access to credit. These are just a few of the issues that must be considered when considering a company's solvency.

The concept of insolvency is very simple. If you can't pay your creditors you are insolvent.

Section 95A of the *Corporations Act 2001* states:

> “ *A company is solvent if, and only if, it is able to pay all its debts as and when they become due and payable*

But the application of this concept to the specific circumstances of a corporate failure is difficult and contentious. Establishing solvency is often spoken of as an art rather than a science.

There is no specific requirement that debts must be paid from the companies own money (this was removed in 2001). The statutory focus is on solvency, not liquidity. Thus it is appropriate to consider the terms of credit and financial support available to the company to pay its creditors.

A company will be presumed to be insolvent in certain circumstances, which includes failure to keep adequate books and records for the 12 months preceding a liquidation. Where those presumptions do not apply, or they are rebutted, the liquidator will be required to demonstrate insolvency.

THE SIGNS OF INSOLVENCY

The following are indicators of insolvency:

- Cash flow shortage
- Overdraft limit reached
- Trading losses
- Creditors unpaid outside usual terms
- Increasing debt
- Problems selling stock or collecting debts
- Unrecoverable related party loans
- COD terms with suppliers
- Post-dated cheques or dishonoured cheques
- Payment arrangements with creditors
- Defaults on loans
- Incomplete financial records
- Inability to obtain finance
- Change of bank
- Financier scrutiny
- Solicitors' letters
- Statutory demands
- Litigation and debt recovery
- An expectation that the 'next' big job/sale/contract will save the company

In practice, the date of insolvency is typically fixed to be the date a company fails to pay its taxation obligations on time and starts accruing these debts without the consent of the ATO.

The deadline for the payment of the ATO obligations are fixed and variations are difficult to organise so it's relatively easy to argue, these debts were due and payable and not paid and thus the company is insolvent.

The money collected for GST and PAYG tax withheld on wages belongs to the ATO, when this is used to pay trade creditors, a company will generally be in trouble, this may be a temporary liquidity problem or a more serious sign of insolvency.

4. THE TRANSACTION

The definition of a transaction in the *Corporations Act 2001* is very broad. It includes normal payments of money, i.e. paying company invoices and trade creditors, but it also includes a conveyance of land, a transfer of property, granting a security interest, an agreement that a third party satisfy the debt, a release, a waiver or a loan, a novation of an asset.

Further, a company can be a party to the transaction where it instigates, authorises or ratifies the transaction and this has the effect of extinguishing a debt.

Transactions involving third party payments to creditors can also be the set-aside as an unfair preference.

5. THE TIME PERIOD

The exact start date of the 6 month and 4 year time periods that define an unfair preference payment are unnecessarily complex and difficult to determine.

The legislature really did a bad job when they took a simple concept and wrote it into law.

The *Corporations Act 2001* defines the start of the time period by reference to concept known as the Relation Back Date.

Section 9 of the *Corporations Act 2001* orporations Act 2001 defines the Relation Back Date as either:

- The date when a court petition to wind up a company was filed (not the date of a court Order but instead the date the petition was filed), or
- The date of appointment of a voluntary administrator, or
- The Commencement Date of the liquidation

There are 12 potential dates to determine the Commencement Date in the *Corporations Act 2001*.

6. CREDITOR BENEFIT FROM THE TRANSACTION

The *Corporations Act 2001*prescribes a comparison should be made between:

1. The quantum of the actual preference payment the creditor was paid pre liquidation, and
2. The amount the creditor would get if they returned this money and were instead paid a dividend as an ordinary unsecured creditor post liquidation. (i.e. when the preference creditors get paid pro-rata with all other creditors).

The difference between what the creditor did get paid pre-liquidation and what they should have been paid as a dividend post liquidation is the quantum of unfair preference payment.

DEFENCES

If you receive an unfair preference, the following defences are available:

- The payment was received in 'good faith' (i.e. you did not know that the company was insolvent, or likely to become insolvent, when you received the payment), or
- A reasonable person in your position would not have suspected that the company was insolvent, or
- A running account exists

RUNNING ACCOUNT DEFINITION

A running account is a fancy name lawyers invented to describe the normal terms of trade offered by a supplier when they deliver goods or services to a regular customer on credit.

To understand this defence it's important to momentarily think like an accountant. Consider a normal suppliers ledger (or account), it looks just like a bank statement. One side of the ledger will list all the deliveries of goods and services that need to be paid. The other side of the ledger will list all the payments that have been paid to the supplier.

The sum of both columns will equal the account balance. As the account balance changes, it is said to be active (or running).

THE RUNNING ACCOUNT DEFENCE

The key principle for recovery of a preference is the party who got the preference payment, the payee/creditor, is *in fact* preferred and received some benefit other creditors did not receive.

Liquidators must assess the net effect of the monetary value of delivered goods and services and compare this value to the sum of the payments made to the supplier to determine if there was in fact a net preference (I like to think of this as adding up the value of the ins & outs).

Section 588FA(3) of the *Corporations Act 2001* attempts to codify this common law concept by making the courts consider, the overall effect of the trading history and not just the preference payment in isolation. Lawyers have called this concept the doctrine of ultimate effect.

So far it all seems fairly sensible, now, here's the tricky part. The Law is unclear on when exactly liquidators should start counting the ins and outs.

There was a line of authority going back to the 1960's that suggested a liquidator could pick any time within the last 6 months and calculate the ultimate effect of the preference payment. So typically, liquidators would run claims that show the greatest preferential effect and make the claim for the preference payment as big as possible.

However, in 1996, the High Court delivered a complex and challenging decision which included one line in a very long judgement that suggested liquidators cannot pick any point within the 6 months, they must analyse the entire 6 months of transactions, deliveries and payments to determine the ultimate effect to the creditor.

Most lawyers were surprised by this decision because it was a one liner that had the effect of changing 30 years of established law.

Lower court decisions have been morphing back to the old line of authority that liquidator can pick the start date, but it's not settled law.

7. WHO MAY RECOVER PREFERENTIAL PAYMENTS?

The *Corporations Act 2001* provides that only a liquidator has the power to attempt to recover an unfair preference payment. Creditors, ASIC, director's, shareholders, provisional liquidators, voluntary administrators, deed administrators, receivers, receivers and managers do not have the power to recover a unfair preference payment.

Unfair preferences are recovered by the liquidator under a statutory right provided by the *Corporations Act 2001*. The proceeds from the liquidator's recovery actions become available to ordinary unsecured creditors of the company. They are not available to banks and other secured creditors who may hold security interest (formerly known as a mortgage or a fixed and floating charge).

8. PROTECT YOURSELF AGAINST UNFAIR PREFERENCE CLAIMS

You can protect yourself against a potential unfair preference claim by:

- Ensuring you get paid before you supply goods or services. Insist on COD terms (this avoids being in a debtor/ creditor position at the time of payment).
- Taking security from the company equal to the amount of payment received (an unfair preference can only be recovered from an unsecured creditor).
- Registering your security interests on the Personal Properties Security Register.

DO YOU NEED HELP?

We invite you to give us a call. All initial discussions are free of cost or obligation. Talk to our in-house liquidators, bankruptcy trustees, lawyers or accountants about your circumstances and options.

We have offices in Sydney, Melbourne and Byron Bay together with affiliated offices in each capital city. Our nationwide network lets us service our clients' needs throughout Australia.