



I'll see your unfair preference and (now I can) raise you a set off

Key Summary

The Queensland District Court in *Morton & Anor v Rexel Electrical Supplies Pty Limited* [2015] QDC 49 has detonated the time bomb of the NSW Court of Appeal's approval of *Re Parker* [1997] FCA 1264 regarding the application of set off claims under s553C of the *Corporations Act* (Cth) 2001 in the context of voidable transactions.

In the Morton decision, the Court has for the first time determined that a creditor is entitled to set off the amount of a debt owed to it against the amount of any unfair preference which it is found to have received. This is a potentially wide-reaching decision of significance to creditors and insolvency practitioners alike.

Morton Judgment - Summary

The creditor, Inaco, supplied goods to the debtor, Management. Payments of approximately \$197,000 were made by Management to Inaco between 14 February 2012 and 14 August 2012, being the relation back period. Management's liquidator asserted that these payments were unfair preference payments pursuant to s588FA of the *Corporations Act* (Cth) 2001 (**Act**).

In response, Inaco asserted that it was entitled to the benefit of the 'good faith' defence under s588FG of the Act or that there was running account, which triggered the operation of s588FA(3) of the Act. Alternatively, in the event that there were any unfair preference amounts received by Inaco, approximately \$90,000 (being monies still owed to Inaco by Management) should be set off against those amounts pursuant to s553C of the Act.

The Court rejected Inaco's first two grounds of defence, but found that the amount of the unfair preference received by Inaco was able to be set off against the balance of the debt Management still owed Inaco.

Factual background

On 31 January 2012, Inaco issued an invoice to Management for \$215,000. A fortnight later, Inaco's credit manager chased payment of the invoice and was informed by Management's internal accountant that Management did not have the money to pay the invoice straight away, so Inaco would have to wait until Management was able to pay. Importantly, there was no explanation given which indicated that Management was suffering from a temporary cash shortage.

Throughout the balance of February and into March, further payment demands were sent by Inaco and, ultimately, a payment plan was entered into in early April to pay out the debt.

The payment plan was not complied with, and in June Inaco issued a Creditors Statutory Demand on Management for the balance, being approximately \$90,000.

Unfair preferences identified

The Court was satisfied that Management was insolvent from 14 February 2012, and that the payments, totalling \$197,000, received by Inaco from Management during the relation back period were unfair preferences (**Preferences**).

The Court found that both Inaco, and any reasonable person in Inaco's position, had reasonable grounds to suspect that Management was insolvent from mid-February 2012, as a consequence of being informed that Management did not have the money to pay its January invoice. In making this finding, the Court placed emphasis on the lack of any qualification accompanying that statement which may have given rise to a conclusion that the cash shortage was temporary in nature.

Further, the Court was not satisfied that the Preferences were part of a running account and an integral part of a continuing business relationship. Instead, the Court found that those amounts were a series of payments designed to reduce Management's pre-existing indebtedness.

Set-off accepted

Section 553C of the Act provides that, in the event of mutual dealings between a creditor and a company which is being wound up, only the net position is relevant for the purposes of calculating any proof of debt lodged against the company, or claim for monies payable to the company. Critically, the benefit of such a set off is not available to a person if, at the time of giving credit to, or the time of receiving credit from, the company, the person had notice of the fact that the company was insolvent.

Inaco asserted that, in view of *Buzzle Operations Pty Limited (In Liq) v Apple Computers Australia* [2011] NSWCA 109 and *Re Parker*, it was entitled to set-off the \$93,000 debt still owed to it by Management against the Preferences.

In response, the liquidator asserted that if such a right of set-off existed it would frustrate the purposes of the unfair preference provisions in the Act as there would arise one of two unsatisfactory outcomes, namely:

- The Preferences become a debt in the liquidation, to which Inaco could have regard when calculating its set-off amount. This results in a set off amount of \$287,000 (being \$197,000 plus \$90,000) and entirely frustrated the unfair preference provisions.
- The Preferences should be ignored, so that Inaco could only rely upon any amount outstanding beyond the Preferences – resulting in a set off amount of \$90,000. Such an outcome means a creditor who has received only part-payment of their debts (and therefore still has some amount to be used as a set-off) is better off than a creditor who has been paid the whole of their debt (in which case it would have no set-off).

Irrespective of the 'potential unsatisfactory outcomes' arising from the reasoning in *Re Parker*, the Court in *Morton* found that it was bound by the superior Court's unanimous approval of that reasoning and the plain language of s553C in concluding that Inaco was entitled to a set off in respect of the Preferences.

It wasn't all good news for Inaco though. While the Court found that it was entitled to the benefit of the set off provisions in respect of the \$90,000 that was still outstanding, this amount was then limited to approximately \$64,000, being the amount which related to invoices issued by Inaco to Management prior to the mid-February discussion with Management's internal accountant.

In doing so, the Court found that the mid-February discussion constituted actual notice to Inaco of facts that indicated to a reasonable person in Inaco's position that Management was insolvent.

Conclusion

At least until any new decision by a superior Court on this issue, insolvency practitioners should not be surprised to now find in response to unfair preference claims that they are confronted with assertions of a set off wherever a creditor has not received full payment of their debts, in addition to the 'traditional' good faith defence.

A creditor seeking to assert a set off will need to show that it has unpaid debts which arose prior to the time when the creditor received notice of the fact that the company was insolvent. This is a higher bar than the good faith defence, which only requires that a creditor have reasonable grounds for suspecting insolvency. Further, while the good faith defence requires consideration of the creditor's knowledge (and that of a reasonable person in their position) *at the time of receipt of the payment from the company*, assessment of a set off involves consideration of the creditor's knowledge *at the time of giving credit to, or receiving credit from, the company* – in Inaco's case, the date of each of its invoices.

For creditors, this has the potential to allow them to reduce or even completely set off any asserted preference claim made against them.

Perhaps of most significance for insolvency practitioners will be whether the ATO now seeks to raise a set off in response to preference claims made against it, given that there is often tax debts of some significant age existing in a large proportion of liquidations which may act to prevent recovery by insolvency practitioners of a traditional source of preference recoveries.

This article was prepared by Colin Brown, a partner in our insolvency and reconstruction team. We invite you to contact Colin or Michael O'Neill, should you have any questions or require any further information about the matters discussed in this article.

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