



CONSTRUCTION LAW UPDATE No. 808

Summary of the law relating to Unfair Preferences

What is an Unfair Preference?

When a company makes a payment shortly before it is placed into liquidation, the liquidator may in certain circumstances claw back that payment for the benefit of creditors generally. Such a claim brought by a liquidator is called an “unfair preference” claim.

The liquidator may seek to recover (in certain circumstances) any payments made by the company during the six month period ending on a date known as the “relation-back” date. This date is usually either the date the company was placed into administration or the date on which an application to wind up the company in insolvency was filed at Court.

The liquidator has the power to apply for a Court order to compel such monies to be repaid to the company. The money claimed back is then applied to pay any fees and costs associated with the liquidation and the balance is distributed to creditors generally according to ranking provisions set out in the *Corporations Act* 2001.

The liquidator has the power to bring Court action to recover an unfair preference payment any time up to three years after the “relation-back” date, which can be up to three and a half years after the payment in question was made by the company. The liquidator may (and often does) delay bringing a claim until three years have passed from the initial insolvency event, which often comes as a very unwelcome surprise to the company or individual who receives a letter of demand from the liquidator.

Elements of an Unfair Preference Claim

A liquidator cannot simply claw back every payment made by an ailing company in its final six months. There are three necessary elements to be satisfied before a liquidator can bring an unfair preference claim. All must be present for a claim to be successfully brought by a liquidator.

1. The liquidator must prove that the company was insolvent (ie. unable to pay its debts as and when they fell due) at the time the payment was made by it, or alternatively that the company became insolvent as a result of making the payment.

2. The liquidator must establish that there was a debtor-creditor relationship at the time of the payment.
3. The liquidator must establish that the person receiving the payment was an *unsecured creditor* of the ailing company at the time the payment was made.

In other words, payments made whilst there is security in place, or payments made other than on a debtor-creditor basis (eg. cash on delivery) are not caught by the unfair preference legislation. This is crucial, as attacking either of these elements is a common (and very effective) way of minimising or eliminating the risk of an unfair preference claim.

Defences to Unfair Preference Claims

There are a number of defences which may be available to an unfair preference claim, depending on the individual circumstances of the payment(s).

From a commercial perspective, it is better to avoid an unfair preference claim being made in the first place than to defend a claim. However, if an unfair preference claim is brought by a liquidator the following defences may be able to be established. Whether any or all of the defences is available will depend on the circumstances of each case:

1. **No suspicion of insolvency – “good faith” defence.**

It will be a defence to an unfair preference claim if the recipient of the payment did not know or suspect that the company was insolvent (unable to pay its debts as and when they fell due) at the time the payment was made, and if a reasonable person in the recipient's position would not have known or suspected that the company was insolvent. A “suspicion” is more than a mere wondering. The High Court describes it as a “*positive feeling of actual apprehension or mistrust*”. (*Queensland Bacon Pty Ltd v Rees* (1996) 115 CLR 266). This is a very common defence to an unfair preference claim.

2. Doctrine of Ultimate Effect

The Court will consider the net (or ultimate) effect of a payment when considering whether it amounts to an unfair preference. The High Court has summarised this doctrine as follows: “*Resort must be had to the business purpose and context of the payment to determine whether it gives the creditor a preference, priority or advantage over other creditors, the payment must ultimately result in a decrease in the net value of the assets that are available to meet the competing demands of the other creditors.*” (*Airservices Australia Pty Ltd v Ferrier* (1996) 185 CLR 483).

3. Running Account

The running account ‘defence’ does not provide a complete defence to a claim. However, it will often have the effect of reducing (in some cases significantly) the amount of the liquidator’s claim. It is relevant where there are multiple transactions (an “active account”) between the debtor and creditor over the relevant six month period. In that case, the court will assess the amount of the preference not as the total amount of all payments made over the period, but rather as the difference between the “peak” (maximum) amount of the debt during the six month period, and the amount owed on the “relation-back” date.

Steps to Minimise Risk of Unfair Preference Claims

If you are dealing with a company on a credit basis which you know or suspect is struggling financially, there are certain steps you can take to minimise the risk that any payment you obtain from the company is not later able to be clawed back by a liquidator.

The best way to minimise the risk of a payment being clawed back is to avoid the debtor/unsecured creditor relationship. Some ways to effect this include:-

- Ensure all trading is carried out on COD (cash on delivery) terms, or require payment in advance of supply;
- Obtain security before credit (or further credit) is extended. Security can include fixed and floating charges over company property, or a mortgage over real estate. A secured creditor is not affected by the unfair preference legislation. A fixed or floating charge is usually created by a deed of charge which is then registered with ASIC. A mortgage over real estate should be registered with the Lands Titles Office;
- Insert a retention of title clause into your terms and conditions of supply which may assist in an argument that the debt is secured;
- Insist on payment by a third party (eg. a director of the company), or payment pursuant to a bank

guarantee/letter of credit rather than payment by the ailing company itself.

It is also prudent to seek legal advice before you issue letters of demand, final notices, threats of legal action and other steps that may prejudice the chances of arguing the “good faith” defence. Ironically the harder you push for payment from a struggling company, the more likely it is that a liquidator later appointed to the company will be able to claw back the payment as an unfair preference.

Conclusion

Unfair preference claims are expected to become more prevalent due to the current economic downturn, with more companies likely to become insolvent within the next 12-18 months. Many encounters with unfair preference laws come as an unpleasant surprise to those receiving letters of demand from a liquidator. It is important to be aware of the laws in respect to unfair preference claims, defences available to any claim and steps you can take now to minimise the chances of an unfair preference claim being made in the future. If you receive a letter of demand from a liquidator claiming back a payment as an unfair preference it is highly recommended that you seek prompt legal advice to maximise your prospects of successfully defending the claim.

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