Set-off and Unfair Preference Claims

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The Queensland District Court has recently considered whether set-off is available in respect of unfair preference claims.

The decision of the Queensland District Court in *Morton & Anor v Rexel Electrical Supplies Pty Ltd* [2015] QDC 49 ("**Rexel**") has re-ignited debate about the scope of the set-off provisions in s.553C of the *Corporations Act 2001* ("the **Act**"). In Rexel a set-off was said to apply in respect of unfair preferences paid to a creditor. That is a major shift in application of the set-off provisions. We look at the history of judicial application of the set-off provisions to understand how that decision was arrived at.

Rexel concerned an unfair preference claim. Relevantly, the creditor was paid money by the company during the relation back period (during which the company was insolvent). There was ultimately no return to unsecured creditors in the winding up. The payments by the company to the creditor were unfair preferences but there remained a debt due from the company to the creditor. The question for the court was - is the creditor entitled to set-off that debt, under s553C, against the liability for the unfair preference?

The Court held the creditor was entitled to a set-off. That decision is a departure from understood practice in respect of unfair preference claims and has significant ramifications for liquidators and creditors.

STATUTORY PROVISIONS

Historically s553C has been applied by liquidators in adjudication of proofs of debt in a company's liquidation. Of course s553C does not form part of the regime in Part 5.7B of the Act (recovery of property or compensation for the benefit of creditors of insolvent companies). Relevantly, Part 5.7B also sets out the defences available to claims that might be made under that Part.

While the general principle is to give statutory provisions their widest meaning, it might be assumed that by excluding s.553C from the regime in Part 5.7B of the Act, Parliament intended that set-off was not to apply to proceedings under that Part of the Act.

The legislation also requires mutuality. A set-off will apply where there have been mutual credits, mutual debts or other mutual dealings between an insolvent company that is being wound up and a person who wants to have a debt or claim admitted against the company. At first glance there is a clear objection to finding mutuality between a liquidator's claim against a person or company under Part 5.7B and a debt due by the company to that person or company. They appear to involve different dealings, transactions or parties and thus lack mutuality.

SO HOW DID WE GET TO THE DECISION IN REXEL?

The starting point is the detailed analysis of set-off in respect of insolvent trading in *Re Parker* (1997) 80 FCR 1 ("**Re Parker**"). That case concerned a claim under s588W of the Act that a holding company was liable for the insolvent trading of a subsidiary company. The holding company sought to set-off any liability against debts it was owed by the subsidiary. Section 588W(1) of the Act (as with director insolvent trading under s588M(2) of the Act) provides that a recovery by a liquidator from the holding company (or director) is "as a debt due to the company". Weight was given to that phrase to establish the necessary mutuality between the liability for insolvent trading (as a debt due to the company) and the debts that remained outstanding (debts due from the company). Importantly, it was said that the events giving rise to the insolvent trading claim arose before the liquidation and the claim was the natural outcome of those events. It was held there were mutual credits and debts.

Those findings (and others in Re Parker) establish that set-off is available in respect of insolvent trading claims. Re Parker was considered, applied and upheld in respect of insolvent trading in *Smith v Boné* [2015] FCA 319. Detailed submissions about whether Re Parker was correct were preserved in the event there was an appeal. In fact there was an appeal, but it was resolved without hearing. Set-off and voidable transactions

The importance of Re Parker is that in *Buzzle Operations Pty Ltd (in Liq) v Apple Computer Australia Pty Ltd* [2011] NSWCA 109 ("**Buzzle**") the New South Wales Court of Appeal refused, for the purposes of set-off, to distinguish a claim for insolvent trading from a claim for an uncommercial transaction. The Court noted that Re Parker had been criticised[i] but held that it should be followed to allow a set-off in respect of an uncommercial transaction. In fact the point was not determinative in Buzzle because the Court had already found that a good faith defence applied to the uncommercial transaction claim and didn't need to decide the set-off point. The findings in Buzzle are therefore persuasive rather than binding but do nonetheless extend the application of set-off to uncommercial transaction claims.

Counsel for the creditor in Rexel relied upon Re Parker and Buzzle to persuade the Court to extend the application of set-off to liability for unfair preference claims. In one sense the extension to unfair preference claims is an inevitable consequence of the Buzzle decision. One can understand the reasoning - there is no reason in principle why uncommercial transactions should be treated differently to unfair preferences.

That does not mean to say that the decision sits comfortably. There are a number of objections to applying the set-off provisions to unfair preferences. The most important objection is based on mutuality. Without mutuality there is no set-off under s553C of the Act. The difficulty in characterising mutuality between a creditor's debt due from the company and the liquidator's right to recover an unfair preference is that the credits and debts arise out of different transactions and obligations. On the one hand the creditor gives credit to the company. On the other the liquidator has a right to apply to Court for an order directing repayment in circumstances where an unfair preference is found. There is no mutual credit, debt or dealing between the creditor and the liquidator.

There is another difficulty in characterising mutuality. Although, the Court might order in respect of an unfair preference claim that a person "pay to the company an amount" the amounts recovered are to be distributed by liquidators for the benefit of the company's creditors. The company is not free to do what it likes with the unfair preference recovery. There is no trust (in the legal sense) formed or administered by the liquidator but the recoveries are not for the benefit of the company in the same sense that the company benefited from the credit it was given. The entities involved in the credits, debts and dealings when a Court order is made on an unfair preference claim include the liquidator as well as the company and creditor. The company is altered by the liquidation as compared to the time when credit was given to the company. If the debts, credits and dealings are between or involve different entities there can be no mutuality.

Applying set-off to voidable transactions has the potential to lead to outcomes that do not benefit creditors. Liquidator's recoveries are to the benefit of all creditors.

Set-off offends that principle because it enables a single unsecured creditor found liable in respect of a voidable transaction to benefit at the expense of the other creditors by reducing the amount of its liability. Creditors as a whole will be worse off in the liquidation by virtue of the set-off reducing the amount of the liquidator's recovery.

A further concern arising from the decision is that set-off is not available where the person seeking the set-off has "notice of the fact of insolvency" under s553C(2) of the Act. Clearly, after the making of a Court order following a claim by a liquidator, the person seeking to benefit from the set-off has notice of the fact insolvency.

CONCLUSION

There are obvious legal and practical difficulties in applying set-off to liquidator's recoveries under the Act. At present though the authorities establish that set-off is available. The debate remains open as to whether that position is correct because of the nature and circumstances of those authorities. Re Parker and *Smith v Bone* were decisions of single judges of the Federal Court; the point was not determinative in Buzzle; and Rexel is a lower Court decision. It remains to be seen whether a superior Court, after hearing full argument and with detailed consideration, will uphold the application of set-off in similar circumstances. Certainly detailed consideration of the position at that level would be welcome.

There was an appeal by the creditor in Rexel. The appeal related only to the Court's findings in respect of insolvency and the running account defence. The judgment in the appeal (*Rexel Electrical Supplies Pty Ltd v Morton (as liquidator of South East Queensland Machinery Manufacturing and Distribution (Mining No.1) (in liq)* [2015] QCA 235) upheld the District Court's findings. There was no cross-appeal by the liquidator in respect of the set-off points discussed in this article.

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[i] The criticism was originally in Rory Derham's book *The Law of Set-off*, 3rd ed (Oxford University Press, 2003) and has been extended by him: Rory Derham, 2015, 'Set-off against statutory avoidance and insolvent trading claims in company liquidation', *Australian Law Journal*, Volume 89, Page 459-490