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What is an unfair preference claim and how do I respond?

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An unfair preference claim often arises in situations where a director of company, anticipating the company's liquidation, prefers some creditors over others by prioritising the payment of their debts. When the company is eventually wound up, there are then fewer assets available to unsatisfied creditors as a result of those earlier payments. In those circumstances, the liquidator can then commence a preference action claim against the preferred creditors to reclaim such payments. The rationale behind this action is to prevent the situation where preferred creditors receive more than what they should receive had they applied in the liquidation process along with the other creditors of the subject company.

This article details which payments liquidators can recover as unfair preferences, the defences available and what creditors should look out for in their trading relationships.

What payments can a liquidator recover?

In order to successfully recover a payment as unfair preference, a liquidator will generally need to establish the following:

- the payment was made to an unsecured creditor of the insolvent company;
- the company and the creditor were party to the transaction. A transaction is widely defined under the *Corporations Act 2001* (**Act**) and can include transactions such as a transfer of property of the insolvent company, payment made by the insolvent company or charged created on property of the insolvent company;
- the payment was made in the 6 months before the date an application was commenced in Court to wind up the company or the date a liquidator is appointed to the company. This time is extended to 4 years for creditors which are a related entity of the insolvent company;
- the company was insolvent when the transaction was made, or became insolvent as a result of the transaction; and
- the creditor received more than they would have as an unsecured creditor in the liquidation process.

How to respond to an unfair preference claim

If you have received a demand from a liquidator to repay any allegedly unfair preference payment, there may be some defences available to you in order to resist the claim. These defences include:

- **good faith** – a creditor can receive a preference payment if they did not know or did not have any reasonable grounds to suspect that the company was insolvent or would become insolvent, and the creditor provided to the company something in return for the payment. This defence will not apply where a reasonable person in the creditor's circumstances would have had grounds to suspect the company's insolvency.
- **running account –** this is a technical defence that applies where there is a continuing business relationship between the company and its creditor and the amount of net indebtedness increases and decreases over time as part of that relationship. This is most apparent where a company buys goods and services on credit from a creditor. For these 'running account' relationships, the relevant transactions must have occurred between the parties within the 6 month period of the 'relation back day' (usually the date of liquidation) and are treated as a single transaction for the purposes of assessing whether it is an unfair preference.
- **secured creditor** – a creditor can defend a preference claim on the basis that it is a secured, rather than an unsecured, creditor. A creditor does not have to register their interest on the Personal Property Security Register to become secured. A common example of this is 'retention of title' clauses. These state that ownership of goods does not pass until payment is received in full, and are common in supply agreements.

Previously, there had been controversy over whether a set-off of a debt owed by the insolvent company to the creditor could be relied on as defence to an unfair preference claim. However, the Full Court of the Federal Court of Australia has since clarified that such a defence is no longer available. In *Morton as Liquidator of MJ Woodman Electrical Contractors Pty Ltd v Metal Manufacturers Pty Limited [2021] FCAFC 228*, the Court confirmed that a creditor of an insolvent company is unable rely on the right of set-off under section 553C of the Act when responding to an unfair preference claim.

What if I received payment from a third party?

In some circumstances, there may be a situation where a payment was made by a third party to a creditor at the direction of the insolvent company. Where this situation leads to a reduction in the insolvent company's own money or assets, then there is a significant risk of such payments being clawed back by liquidators as an alleged preference, notwithstanding that the payment was not received from the insolvent company directly.

Given the above, creditors still need to be wary of the entities or persons they are receiving payments from, particularly if such payments are related to a company which may be, or is close to being, insolvent.

What should creditors look out for?

To mitigate the risk of unfair preference claims, trade creditors should be mindful and aware of the following:

1. companies not paying invoices on time or at all;
2. communications in commercial dealings where there is mention of an inability to make payments or struggles with cashflow;
3. any defaults by the company lodged with credit reporting agencies such as Equifax or Dun & Bradstreet; and
4. lump sum payments in place of payment of specific invoices and instalment arrangements outside of trading terms.

The above factors will be important in being able to establish whether any defences, such as a good faith defence, are available in response to a demand for payment by a liquidator of an alleged unfair preference claim.

If you would like more information on unfair preference claims or require assistance in responding to a liquidator's unfair preference claim, please Lesly Ann Cho on 02 8235 1251 or your usual CK contact.

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