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Unfair Preference Claims and the Conceivable Third-Party Shield from the Claws of Liquidators

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Receiving a letter of demand from a liquidator demanding repayment of monies received for an unsecured debt owed by a company in liquidation whereby it is alleged that the creditor has been preferred over other creditors can be rather daunting to receive. However, unsecured creditors may now, in certain circumstances, benefit from a successful defence highlighting a loophole which has materialised in the recent decision handed down by the Victorian Court of Appeal in *Cant v Mad Brothers Earthmoving Pty Ltd* [2020] VSCA 198 (“*Cant Case*”), whereby the issue of third party payments was put under the microscope.



What is an unfair preference claim?

One of the key duties of a liquidator is to examine the undertakings of the insolvent company he/she has been appointed to and to ascertain whether any voidable transactions that have taken place in the lead up to the appointment, so that the liquidator may recover monies for the benefit of creditors of the company. One such voidable transaction is an unfair preference payment. In most scenarios

involving an insolvent company, there are typically numerous unsecured creditors with outstanding debts owed, therefore, the law considers it unfair for one particular unsecured creditor to receive payment in priority to other unsecured creditors who do not receive payment within 6 months of the appointment of the liquidator. As such, section 588FA of the *Corporations Act 2001* (“the Act”) permits a liquidator to claw back unfair preference payments from unsecured creditors received from the insolvent company less than 6 months prior to the liquidator’s appointment.

Defence

Whilst a liquidator can seek to claw back preferential payments from unsecured creditors, in certain scenarios there are defences available to unsecured creditors to oppose that such payments have to be repaid.

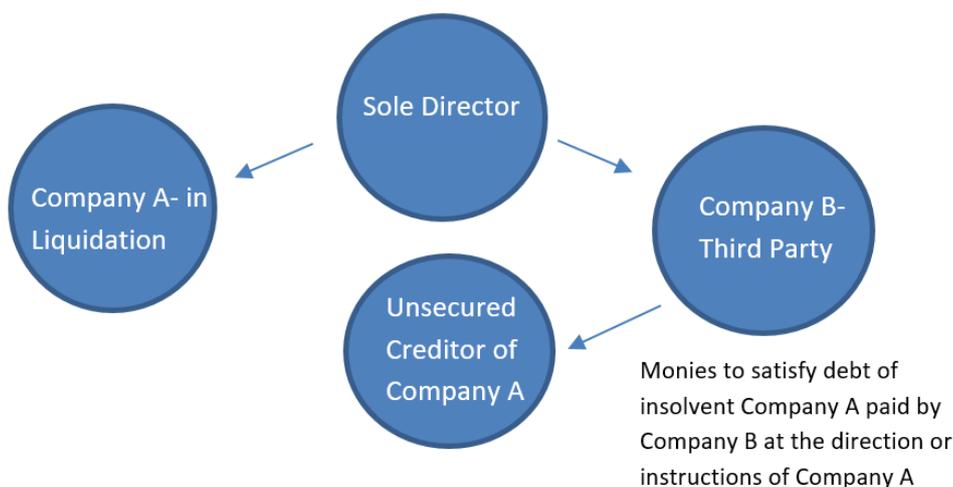
The main defences available are summarised as follows:

1. The Good faith defence under Section 588FG (2) of the Act, where the unsecured creditor can establish that it could not have reasonably suspected that the company was insolvent;
2. The Running Account defence, where payments are made as an integral part of a continuing business relationship between the insolvent company and the unsecured creditor.
3. The Set Off defence under Section 553C of the Act, where an unsecured creditor may set off a debt/credit owed to the insolvent company against a credit/debt owed by the insolvent company to the same party.
4. Some creditors argue that they had security in place at the time of the payment and as such they cannot be considered as an unsecured creditor.

One scenario which now gives rise to a defence is the situation where a third party makes payment to the unsecured creditor on behalf of the insolvent company. This defence was recently raised and determined in the *Cant Case*.

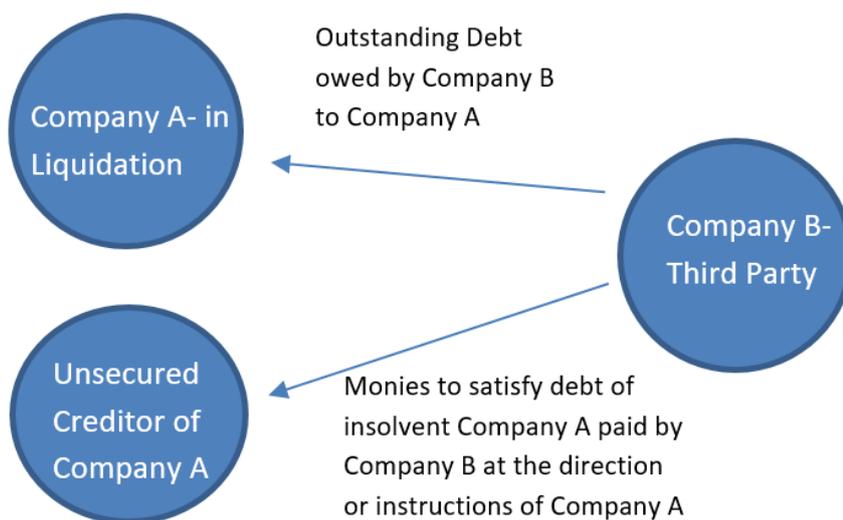
The Third-Party Veil

In the recent *Cant Case*, the Victorian Court of Appeal deliberated on whether monies paid from a third-party company to a creditor in satisfaction of an unsecured debt owed by the insolvent company could be deemed an unfair preference. It is worthwhile to note, that the sole director of the company in liquidation was also the sole director of the third-party company that made payment to the unsecured creditor.



The Court confirmed that in order for a payment to be considered an unfair preference it must come “from the company” as intended within the provisions of section 588FA or result in a diminution of the company’s assets that are available to creditors. In the *Cant Case*, the payment came from a third-party’s own money and not from the insolvent company. As the insolvent company’s assets were not diminished by the transaction the Court found there could be no unfair preference. This was held despite the fact that the company in liquidation endorsed, directed and authorised the payment by the third-party to the unsecured creditor, or the fact that both companies were controlled by the same director. In the alternative, the Court acknowledged that in circumstances where company B (the third-party) owes a debt to company A (company in liquidation), and company B is instructed to make payments to an unsecured creditor instead of company A for a debt owed by company A to the unsecured creditor, the transaction in such case would be deemed an unfair preference. This is because the debt owed by the third party to the insolvent company is considered an asset of the insolvent company and therefore as that debt is directed to paying an unsecured creditor of the insolvent company, the insolvent companies’ assets are diminished.

Potential Third-Party Unfair Preference Transaction:



Key Takeaways

The recent decision offers some clarity on the position concerning payments made by third-parties, that being, such payments will not necessarily amount to an unfair preference if there is no obligation or liabilities between the third party and the insolvent company. Although the case was handed down in Victoria, it is plausible to assume that other states will also follow the footsteps of the position laid down in the *Cant Case*. The complex provisions contained in the *Corporations Act* are intended to ensure that the assets of a company in liquidation are apportioned fairly. However, this decision invites a potential loophole for insolvent companies who may arrange payment to one or more unsecured creditors ahead of others, by ensuring payments are made from a third party rather than from the company.

How we can help you

JHK Legal has extensive experience in dealing with insolvency and debt recovery matters, and can advise companies, creditors and third-parties on unfair preference transactions and insolvency matters generally. Please do not hesitate to contact us today to discuss your situation.

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