

TECHNICAL INSIGHTS

Issue 4 - 2016

Defending an unfair preference claim - the hybrid and objective nature of the statutory defence

In this issue

- ▲ The elements of the statutory defence to an unfair preference claim contained in section 588FG (2), Corporations Act reviewed.
- ▲ The most common elements of the defence arising for consideration are to be found in section 588FG (2)(b)(i) and (ii).
- ▲ With respect to para's (2)(b)(i) and(ii) the onus will be on a defendant to satisfy the hybrid and largely objective nature of the defence.
- ▲ The recent decision in *In the matter of Alsafe Security Products Pty Ltd atf the Alsafe Trust (in liquidation)* [2016] NSWSC 428, 14/4/2016 discussed as it relates to the operation of para's (2)(b)(i) and (ii).

Introduction

In general terms section 588FF, Corporations Act provides that where, on the application of a company's liquidator, a court is satisfied that a transaction of the company is voidable as an unfair preference, the court may, inter alia, make an order directing a person to pay to the company an amount equal to that paid by the company to that person under the transaction.

Significantly, for the purposes of this article, section 588FG(2) directs that with respect to an unfair preference a court is not to make an order if it is proved by the party to the transaction that:

- a. the person became a party to the transaction in good faith; and
- b. at the time when the person became such a party:
 - i. the person had no reasonable grounds for suspecting that the company was insolvent at that time or would become insolvent as mentioned in paragraph 588FC(b); and
 - ii. a reasonable person in the person's circumstances would have had no such grounds for so suspecting; and
- c. the person has provided valuable consideration

under the transaction or has changed his, her or its position in reliance on the transaction.

In most cases the first of these matters will not be in contention, and the valuable consideration requirement will usually be satisfied by the supply of goods or services to the company. On the other hand para's (b)(i) and (ii) are most often in issue between the parties, and it is these provisions which form the focus of our discussion. Moreover we shall take the opportunity to review the recent decision in *Alsafe Security* (above) as it relates to these provisions.

The elements of the defence under section 588 FG (2)(b)(i) and (ii)

Section 588 FG (2)(b)(i)

The terms of para (b)(i) are directed at determining whether the defendant creditor with the information available to it, had "no reasonable grounds" for suspecting the company's insolvency at the relevant time. Usually the creditor will seek to demonstrate that on the basis of available information it could not reasonably have suspected that the company was insolvent.

Essentially, under para (b)(i):

"... the court will assess the conclusion which ought

Defending an unfair preference claim – the hybrid and objective nature of the statutory defence

reasonably to have been reached by a creditor who in fact has taken a particular step or steps formally or informally in the process of deductive reasoning.” See *Simms v Celcast Pty Ltd* (above)

In the event that the creditor on reasonable grounds has formed the view that the company was not insolvent at the relevant time, the creditor will gain protection under the provision. Alternatively, if the creditor’s conclusions as to the solvency of the company are flawed, and a reasonable person would not have arrived at that flawed position, then the creditor will not acquire the protection of para (b) (i). On that basis protection under para (b)(i) is principally concerned with evaluating the subjective belief of the creditor, and then determining whether such subjective belief would have been arrived at by a reasonable person.

Section 588 FG (2)(b)(ii)

By way of contrast with para (2)(b)(i), para (b)(ii) is largely concerned with conclusions as to the insolvency of the company that a reasonable person ought to have made at the relevant time, irrespective of any beliefs that the creditor may or may not have held.

Para (b)(ii) is particularly relevant where a creditor seeks to gain protection against the liquidator’s unfair preference claim by arguing that it was ignorant as to the company’s financial position, such that it was not aware that the company was insolvent at the relevant time. Here the question becomes whether, notwithstanding the absence of any opinion as to the insolvency of the company, a reasonable person in the creditor’s circumstances ought to reasonably have recognised that the company was insolvent at the relevant time. As observed by NSW Court of Appeal in *Cussen v Commissioner of Taxation* [2004] NSWCA 338:

“It has been said that sub-para (b)(ii) denotes an objective test which is to be applied by considering whether a hypothetical person with the assumed knowledge and experience of the average business person (as opposed to the acumen, perspicacity and resources of the particular creditor) would have

suspected insolvency.”

Accordingly, where a court concludes that, despite the absence of any understanding of the creditor as to the financial position of the company, in the event that a reasonable person in the creditor’s circumstances ought to have suspected that the company was insolvent at the relevant time, then the statutory defence under section 588FG will not be available to the creditor.



Summarising the respective operation of para’s (2)(b) (i) and (b)(ii)

A number of courts have sought to describe the respective tests in para’s (2)(b)(i) and (ii).

It is now widely accepted that the test in para (b)(i) is essentially a subjective test, albeit measured against an objective criteria, insofar as it envisages consideration of whether a creditor’s own inquiries and investigation reasonably led the creditor to the conclusion that the company was not insolvent, in which event the statutory defence will have been satisfied. On the other hand, para (b)(ii) is not principally concerned with evaluating the inquiries and investigation of the creditor, rather it requires consideration of whether a hypothetical person in the creditor’s circumstances

Defending an unfair preference claim – the hybrid and objective nature of the statutory defence

ought to have suspected insolvency, and becomes particularly relevant where the creditor seeks to establish the defence based on its ignorance of the financial position of the company: see *D'Aloia v Federal Commissioner of Taxation* [2003] FCA 1336.

At this stage we are in a position to review the manner in which these principles have been applied in the recent *Alsaf Security Products* case from the NSW Supreme Court.

In the matter of Alsaf Security Products Pty Ltd atf the Alsaf Trust (in liquidation) [2016] NSWSC 428.

The facts

The company, Alsaf Security Products Pty Ltd (in liq), as trustee for the Alsaf Trust, and its liquidator sought a declaration that payments by the company totaling \$98,628.58 to the defendant constituted an unfair preference under section 588 FA, Corporations Act and sought an order for payment of that amount to the company.

For present purposes the defendant sought to rely on the defence under section 588FG (2), Corporations Act to the effect that it received the payments in good faith; at the relevant time, in light of the information at hand, it did not have reasonable grounds for suspecting that the company was insolvent (sub-para (2)(b)(i)); at that time a reasonable person in its circumstances would not have had reasonable grounds for such suspicion (sub-para (2)(b)(ii)); and it had provided valuable consideration for the payments.

In its submissions concerning payment arrangements with the company the defendant argued that the information possessed by the company and its officers was such that they were not on notice of any change in the trading relationship with the company or that the pattern of payment by the company was indicative of insolvency; that common building industry practice allowed for flexible credit terms; that the company offered an explanation that it was waiting on payments due to it; and the company had also made representations to the defendant as to its viability and

corporate health: see para 38.

The liquidator's response to these submissions was that the defendant had placed the company on "credit hold" as a result of the company's failure to meet payment of substantial amounts due to the defendant; the company was generally paying rounded amounts not linked to specified invoices; and the company was generally being supplied on a cash before delivery basis: see para 42.

In finding that the defendant had not established a defence under section 588 FG(2), the court concluded with respect to both para (2)(b)(i) and (ii) that the defendant:

"...had reasonable grounds for suspecting the company was insolvent for the purposes of s 588FG(2)(b)(i) even if the evidence of (the defendant's officers) that they subjectively did not form that suspicion could be accepted. I am also satisfied that, given those matters, a reasonable person in (the defendant's) circumstances would also have had such grounds for so suspecting for the purposes of section 588 FG(2)(b)(ii) of the Corporations Act." (see para 43).

As a result, having failed to satisfy both para (2)(b)(i) and (ii), the defendant was required to pay the amount of \$97,628.58 (as agreed by the parties) with interest, as well as the plaintiff's costs of the proceedings.

Concluding comments

In our discussion we have touched on the nature of the unfair preference claim; however emphasis has been given to the terms of the statutory defence available to a defendant the subject of such a claim, and in particular the operation of section 588FG(2)(b) (i) and (ii).

In this regard the article has sought to highlight the objective nature of the defence, as opposed to a defence premised purely on the subjective beliefs of the defendant creditor.

As a consequence we have observed, as occurred in the *Alsaf Products* case, that the statutory defence

Defending an unfair preference claim – the hybrid and objective nature of the statutory defence

will not be satisfied either where the subjective beliefs held by the defendant as to the solvency of the company, even if accepted by the court as being genuine, are found not to be reasonable; or that a reasonable person would have suspected the company's insolvency, irrespective of any beliefs held by the defendant.

Important notice. The information contained in this bulletin is by way of general comment only and is not intended as a substitute for specific advice that addresses your particular circumstances. You should seek specific advice before acting. The information contained in this newsletter remains the exclusive intellectual property of BRI Ferrier and any reproduction, publication, communication or adaptation of this information, without the prior written consent of BRI Ferrier, will constitute an infringement of The Copyright Act 1968.

About BRI Ferrier

BRI Ferrier is a unique affiliation of expert business recovery, insolvency, forensic accounting and advisory firms. We provide practical, innovative services that help financially distressed businesses to recover or at least minimise the negative impacts of insolvency.

With over 160 staff and eleven practices in Australia, New Zealand, Hong Kong and the United Kingdom, we work with clients of all types – from individuals, sole traders and small businesses to public corporations and government entities.

We also work with financiers, solicitors, accountants and creditors to address the needs of all stakeholders when businesses face financial challenges.

BRI Ferrier's team has the expertise and resources to meet any client challenge. By combining our skills and enthusiasm, we achieve the best possible outcomes in all cases where a business experiences financial distress.

How BRI Ferrier can help

BRI Ferrier can assess your current situation and advise on a path forward to minimise further risk.

Early intervention is often the key for a successful restructure of your business. If you or your client is experiencing financial challenges then don't delay, contact us today.

For positive solutions to financial difficulties please contact us.

The initial consultation to your client is free, strictly confidential and without obligation.

Sydney

T: 02 8263 2300
info@briferriernsw.com.au

Melbourne

T: 03 9622 1800
info@briferriervic.com.au

Adelaide

T: 08 8233 9900
info@briferriersa.com.au

Perth

T: 08 6316 2600
info@briferrierwa.com.au

Brisbane

T: 07 3220 0994
info@briferriersq.com.au

Cairns

T: 07 4037 7000
info@briferriernq.com.au

Townsville

T: 07 4755 3300
info@briferriernq.com.au

Mackay

T: 07 4953 7900
info@briferriernq.com.au

www.briferrier.com.au