DING DONG – SET-OFF IS GONE | SET-OFF IS NO LONGER AVAILABLE AS A DEFENCE TO AN UNFAIR PREFERENCE CLAIM

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For some time, the reliance on section 553C of the *Corporations Act 2001* (Cth) (Act) as a "set-off" defence to an unfair preference claim, under section 588FA of the Act, has caused much controversy in the insolvency profession. Defendants of preference claims loved it, liquidators disliked it and the courts did not provide clear direction about its applicability – until now.

The Full Court of the Federal Court (Full Court) in the decision of *Gavin Morton As Liquidator Of MJ Woodman Electrical Contractors Pty Ltd (In Liquidation) & Anor v Metal Manufacturers Pty Limited (MJ Woodman)* found that the defence of set-off is not available to a defendant of a liquidator's claim for the recovery of an unfair preference.

SECTION 553C SET-OFF

Section 553C of the Act sets out that where there have been mutual credits, mutual debts or other mutual dealings between a company that is being wound up and a creditor seeking to have their claim admitted in the winding up, an account is to be taken of what each party owes the other. Those sums are to be set-off against each other, and only the balance is admissible to proof or payable to the company, as the case may be.

Subsection 2 of section 553C goes on to say that set-off is not available where the creditor is on notice of the insolvency of the company now in liquidation.

BACKGROUND PRIOR TO MJ WOODMAN

The set-off defence has its genesis in 1997 when Justice Mansfield in *Re Parker*[1], notably held:

> "…the two debts are between the same companies. The burden of them would lie in the same interests. They are commensurable, in that they both sound in money. I see no reason why, having regard to the substance of the two debts, they should not be set-off."

Although *Re Parker* was not concerned with an unfair preference claim (rather it concerned an insolvent trading claim against a holding company), His Honour's decision stood as authority that section 553C could be applied to liquidators' claims under Part 5.7B. Since *Re Parker*, liquidators and their lawyers have continued to debate the application of set-off to claims under Part 5.7B, and have expressed criticism of *Re Parker*.

Later decisions of the Court did not make any real determination on the applicability of section 553C (with some decisions giving commentary that either set-off is applicable, or that there are in fact *"powerful arguments"* to suggest it is not) on the basis that the good faith defence already applied. Notwithstanding the lack of clear direction, criticism of *Re Parker* was re-enlivened by Justice Gleeson in the decision of *In the matter of Force Corp Pty Ltd (in liq)*[2]. In this decision, whilst being in obiter, His Honour said that there was *"much force"* in academic criticism of the cases that have held that the defence of set-off was available to an unfair preference claim.

In recent times where the issue has been raised, courts have decided, based on the evidence put before them, that the relevant creditor had "notice" of the insolvency, and so (in accordance with section 553C(2)) the set-off defence was not available. This meant that the fundamental question of whether the set-off defence applied to an unfair preference claim was left unanswered.

MJ WOODMAN

The issue was brought before Justice Derrington of the Federal Court on 24 March 2021, where His Honour reserved the question for consideration of the Full Court:

> "Is statutory set-off under s 553C(1) of the *Corporations Act 2001* (Cth) (Act) available to the defendant in this proceeding against the plaintiff's claim as liquidator for the recovery of an unfair preference under s 588FA of the Act?"

(Question)

On 30 August 2021, the Full Court heard the parties' arguments as to how the Question should be answered. Arguing that the answer to the Question should be "no", the Liquidator submitted the following main reasons that the defence of set-off under section 553C cannot be applied to an unfair preference claim (being noted by the Liquidator as the *"previously accepted approach to this issue"*). The reasons include:

- The text and the structure of section 553 and Part 5.7B of the Act suggest that they are intended to have separate spheres of operation – rather than the right of action under Part 5.7B being qualified by a provision contained in Part 5.6.
- The statutory purpose of the preference regime can be satisfied only if the full amount of any preferential payment is restored and by setting-off any unsecured debt, the distortion of the statutory order of priority continues.
- The accepted approach prior to 1992 in England and Australia was that there could be no set-off of a debt owed by a company in liquidation to a creditor against a preference claim.
- Extrinsic materials strongly suggest that the modern provisions of the Act were not intended to change the accepted approach to this issue.

- The requirement under section 553C of mutuality between the two claims is not satisfied. That is because a preference action (and its proceeds) do not form part of the ordinary assets of the company, but are held by the liquidator for the benefit of the general body of unsecured creditors.
- The requirement under section 553C that mutual obligations exist before the "relevant date" is not satisfied. That is because a preference action is not based upon a pre-liquidation obligation. Indeed, it gives rise to no legal obligation until a court order is made.

In response, the Creditor argued the following responses to the Liquidator's submissions:

- There is no reason of text or structure why Parts 5.6 and 5.7B of the Act cannot operate together to permit a set-off of a separate debt against a preference claim.
- The statutory purpose of the preference regime is not to be viewed in isolation. It must be recognised that there also exists a set-off regime which is designed to achieve substantial justice between the parties.
- The so-called *"accepted approach"* to the issue of set-off under prior legislation collapses upon the necessary close examination of the earlier cases which the plaintiff declines to conduct.
- Mutuality of the set-off is not denied by the fact that the Liquidator is the party suing for the preference nor by the form of the order made for recovery.
- The timing requirement for a set-off is met – it is sufficient that there were mutual dealings between the company and the creditor in the form of a vendor/purchaser relationship prior to the winding up, under which, relevantly, on a taking of accounts, one debt was due in favour of the creditor which remained unpaid at the commencement of the winding up; and on the other side of the account, the creditor was under a contingent obligation to make a repayment to the company under a later preference claim in respect to a different underlying debt.

In summary, the conclusion that the set-off applies maintains fidelity to the language of the statute, is not discordant with principle and is consistent with the reasoning explored in the decisions before and after *Re Parker*.

THE FULL COURT'S DECISION

On 16 December 2021, the Full Court handed down its decision and answered the Question "No": set-off was not available as a defence to an unfair preference claim.

The decision, handed down by His Honour Chief Justice Allsop on behalf of the Full Court, went through an exhaustive analysis of the submissions referred to above, the history before section 553C was enacted (including the *Corporate Law Reform Act 1992* (Cth) (1992 Act and Harmer Report), the unfair preference regime and its interplay with section 553C, to come to this conclusion.

His Honour spent some time on the fundamental issue of mutuality, as this goes to the very heart of the ability to set-off. His Honour found that there is a lack of mutuality between what is owed by the company in liquidation to the creditor, and the liability of the creditor pursuant to a court order to pay the company at the suit of the Liquidator. Accordingly, His Honour concluded that the essential requirement of mutuality under section 553C of the Act is absent. His Honour eloquently put it as:

> "[154] There is simply no mutuality between debtor and creditor in respect of the obligation of the creditor to comply with an order of the Court made under s 588FF on the application of the liquidator. It is a new right; and a new obligation; one to cure the dislocation to the order of priorities made by the payment, which discharged the debt, subject to the operation of the statute. The obligation to pay under s 588FF is not owed to the company by virtue of a right it has against the creditor. It is an obligation found in a judgment or order of the Court of which the company is the recipient pursuant to a successful application brought by the liquidator in his or her own right."

In arriving at this decision, His Honour found that there was no change in the underlying principles affecting mutuality and unfair preferences. That is, that the text itself and context of changes made by the 1992 Act (including its enactment history and secondary material) lacked any statutory purpose to bring about change from the position that the relevant provision of the 1992 Act is not consistent with section 553C being applied by a creditor to *"disgorge"* a preference.

His Honour found that the question was ultimately one of statutory construction. He stated that the words of section 553C are to be read in the context of the Act as a whole in a way that conforms with its operation:

> "recognising the importance of the vindication for the general body of creditors of remedies to cure efficaciously the effect of a preferential transaction, of equality of distribution and of the statutory regime of administration."

His Honour continued at paragraph 155:

> "A conclusion of mutuality for the purposes of s 553C as propounded by the creditor would see … the consequence that proceeds of a preference recovery action under s 588FF would go first to pay (by a set-off) an erstwhile preferred creditor in priority to priority creditors, such as employees of the insolvent company. Such a conclusion offends the notion of fairness that underpins mutuality in s 553C and the statutory order of priority of certain creditors, built in respect of some (in particular employees) upon the protection of the vulnerable."

His Honour reflected on the decisions of *Re Parker* and *Buzzle*, and found that these cases concerned sections 588M, 588G, 588V and 588W of the Act, and that these provisions were *"not directed to the protection of the access of all creditors of the company to equality of distribution"* as the preference regime is. Accordingly, His Honour's view was that the Court did not need to determine the correctness of those decisions.

WHERE TO FROM HERE?

The Full Court's decision now gives clear direction to creditors and liquidators alike — that a defence of set-off is not available to a defendant of a claim by a liquidator for an unfair preference.

For a long time liquidators and their lawyers have had difficulty accepting that the defence was available. The Full Court has now vindicated those views in a sensible and pragmatic way. While liquidators lamented the loss of the "peak indebtedness rule" (although that is still the subject of an appeal) as part of their armoury in preference claims, this decision will more than make up for their concern, and will potentially see better outcomes for liquidators and unsecured creditors alike.

FOOTNOTES

[1] (1997) 150 ALR 92.

[2] [2020] NSWSC 1842.

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