

SET-OFF UNDER SECTION 553C - IT FORGES ON

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Restructuring & Insolvency Alert

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On 21 September 2018, the Supreme Court of Western Australia Court of Appeal delivered the eagerly anticipated decision in *Hamersley Iron Pty Ltd v Forge Group Power Pty Ltd (In Liquidation) (Receivers and Managers Appointed)*[1]. The appeal decision has come down on the side of what many considered to be the correct position for set off compared to the findings in the first *Hamersley Iron Pty Ltd v Forge Group Power Pty Ltd (In Liquidation) (Receivers and Managers Appointed)*[2] case.

BACKGROUND

Hamersley Iron Pty Ltd (Hamersley) as principal and Forge Group Power Pty Ltd (In Liquidation) (Receivers and Managers Appointed) (Forge) as builder entered into a contract for construction works at two power stations at West Angelas and Cape Lambert (Contract).

Forge subsequently obtained funding from ANZ and granted a security interest in favour of the Bank over all of its present and post-acquisition property, including Forge's rights under the Contract (Contractual Rights).

In 2014, following the appointment of voluntary administrators to Forge, the Bank immediately appointed Receivers and Managers to Forge. Approximately one month later, Forge was placed into liquidation.

Disputes arose in relation to claims made by each of Hamersley and Forge against the other pursuant to the Contract. Given the appointment of Receivers and Managers to Forge, the issues before the judge at first instance included the applicability of set-off under section 553C of the Corporations Act 2001 (Cth) (Corporations Act) in the circumstances.

THE FIRST HAMERSLEY DECISION

In brief, the main findings at the first instance in so far as they related to section 553C were as follows:

section 553C operated in an insolvency context to the exclusion of all other forms of set-off, contractual, equitable or otherwise

the requisite "mutuality" under section 553C was terminated upon the attachment of the Bank's security interest to Forge's rights under the Contract which transferred the equitable interest in those rights to the Bank

Hamersley was therefore unable to set-off the debts owing to it by Forge and was instead required to pay the full amount claimed against it by Forge, while only being able to lodge a proof of debt in Forge's liquidation for amounts owing to it.

Clearly, this decision would have had a huge impact if it had not been overturned on appeal. The commercial reality is that almost every corporate contracting party will have granted a General Security Agreement to a financier registered under the *Personal Property Securities Act 2009* (Cth) (PPSA). Based on the first Hamersley decision, such an interest would have the effect of displacing the requisite "mutuality" under section 553C, should the debtor go into liquidation. This would leave the contracting party having to pay its debt owing and prove in the liquidation for what the company owed. Clearly a situation that section 553C seeks to overcome.

THE APPEAL

Hamersley appealed against the primary judge's findings that:

there was no mutuality for the purposes of section 553C of the Corporations Act

section 553C was an exclusive code such that even if section 553C did not operate due to the Bank's security interests, Hamersley could not rely on general law or section 80(1)(a) of the PPSA to set off amounts owing to it under the Contract

Hamersley could not invoke section 80(1) of the PPSA against the Bank's rights

THE COURT OF APPEAL DECISION

In relation to each of these grounds of appeal, the Court of Appeal found that the primary judge had erred in his decision.

Mutuality

The Court found that the Bank's rights which accrued on the attachment of the security interest to the Contractual Rights were not inconsistent with the continuance of mutuality between the two contractual parties.

The time for assessing mutuality is the date of insolvency, which in this case was the date when the administrators were appointed to Forge. Despite the Bank's security interest, upon the appointment of the voluntary administrators, Forge retained the right to apply funds paid under the Contract for its own benefit, rather than for the benefit of the Bank. Therefore the mutuality of the dealings under the Contract was not destroyed by the Bank's security interest.

Consequently, the Court found that section 553C did apply and could be used by Hamersley to set off the amounts owing to it by Forge.

In considering the issue of whether the Bank's security interest destroyed the mutuality between the parties, the Court looked closely at the terms of the General Security Agreement. The terms of the General Security Agreement in this case are largely consistent across the major banks and financiers and it is likely that the Court's decision would be applicable to the majority of financing arrangements. Clearly though the terms of the financial documents will need to be analysed in each case to ensure a contracting party can rely on this decision.

Interestingly, the Court left open the conclusions reached by the primary judge that section 19 of the PPSA conferred a proprietary interest on the Bank in the collateral at the time of attachment and that the concept of

crystallisation of a floating charge was made redundant by the PPSA. In avoiding the need to decide these points the Court noted that "those conclusions do not answer the question of whether attachment of a security interest destroys mutuality"[3].

Section 553C - a code?

In determining this question, the Court put to one side its findings that section 553C did apply in the circumstances and approached this issue on the assumption that the primary judge had been correct in finding no mutuality was present between the parties.

The Court noted the widely accepted principle that, where the statutory set-off applies, it is to the exclusion of any contractual or general law rights to set-off. However, the Court determined that in circumstances where section 553C does not apply and the Bank "stands outside the administration of the insolvent", section 553C does not operate to exclude equities that would otherwise have applied to the debt which the Bank sought to recover.

The Court looked to the intention of Parliament in drafting section 553C and found that the primary judge's finding would have in fact created "an injustice of the character which insolvency set-off is itself designed to avoid".[4] Moreover, to find that section 553C did not apply would have placed the Bank in a better position than it would have been if Forge had remained solvent.

The Court therefore determined that, had section 553C not applied in the circumstances, the Bank would have taken the Contractual Rights subject to any rights of set-off Hamersley may have had under general law or section 80(1) of the PPSA.

Could Hamersley rely on section 80(1) of the PPSA?

Further, in relation to section 80(1) of the PPSA, the Court found that this provision applied to circumstances where a security interest had been granted over the relevant collateral. Section 80(1) provides where the rights of a transferee of an account or chattel paper will be subject to contractual rights of the contracting party (in this case Hamersley). The Court rejected Forge's argument that the Contractual Rights had not been transferred to the Bank and held that "'transfer' is wide enough to comprehend an assignment by way of security".[

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Therefore, even if Hamersley had been unable to rely on section 553C of the Corporations Act, given the Court's finding that section 553C did not preclude other forms of set-off where that section did not apply, Hamersley could have relied on the 'statutory equities' under section 80(1) of the PPSA.

IMPACT OF THE DECISION

The Court of Appeal has confirmed what many in the insolvency field thought about the primary judge's decision. That is, the initial findings appeared contradictory to the intention of section 553C of the Corporations Act.

While the primary judge's decision had not yet been followed in other States and was not binding in those jurisdictions, it did create a degree of uneasiness among some creditors and their legal advisors and opened the door to disputes about creditors' rights of set off.

Based on the quantum of the money involved and the importance of the decision, one would imagine that there will be an application for special leave to the High Court.

Notes:

1 [2018] WASCA 163

2 [2017] WASC 152; (2017) 50 WAR 90

3 Hamersley Iron Pty Ltd v Forge Group Power Pty Ltd (In Liquidation) (Receivers and Managers Appointed) [2018] WASCA 163, paragraph 136

4 Ibid, paragraph 176

5 Ibid, paragraph 226

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