Parliamentary Joint Committee on Corporations and Financial Services
Inquiry into Corporate Insolvency in Australia

Question:

In respect of unfair preference claims, what is happening now in current practice and what adjustments might you see as appropriate or not?

Answer:

The issue of unfair preference payments in corporate insolvency is a complex and contentious one. The purpose of the unfair preference regime is to ensure that all unsecured creditors including employees are treated equally in a winding up, and none are given preferential treatment over others. This is an important tenet of insolvency law, as it helps to maintain a level playing field for all creditors and prevents powerful, informed, creditors from leveraging their position to gain an unfair advantage.

We are aware that concerns have been raised that the unfair preference regime can undermine good credit management. Credit professionals have a responsibility to assess the risk of those they are providing trade credit to and manage credit levels and get their debts paid. Similarly, sole traders, and small businesses should exercise good credit management and follow up payment of invoices as they fall due.

It may appear that the current unfair preference regime penalises good credit management, but payments can only be claimed back if the creditor should have reasonably known that a business is insolvent. In the construction industry, additional protection for payments received is afforded to sub-contractors through state based security of payments legislation.

The unfair preference regime is the vehicle that allows a registered liquidator to return funds to the business to maximise returns to all unsecured creditors. Yet, even with all possible funds recovered, the waterfall of priority payments under section 556 of the *Corporations Act 2001*, leaves unsecured creditors as the last to be paid. Section 556 requires the registered liquidator to satisfy employee entitlements first, consider state-based claims that environmental remediation obligations should have priority, and payments covered by State-based Security of Payments to construction industry subcontractors. Each of these exceptions reduces the available funds to pay general unsecured creditors.

To maximise the funds available for distribution, and to mitigate a potential bias of directors to pay related parties ahead of other creditors when under financial stress, we propose that all related party payments within the relevant period could be designated as unfair preferences in the first instance. This would place the onus on related parties to demonstrate to the registered liquidator that payment received within six months of the relation back date was not an unfair preference. This would help to ensure that related parties, who have access to trading data and are ordinarily aware of any financial distress, are less likely to avoid repayment of preference payments simply because a registered liquidator has insufficient information or funds to pursue the claim.

Despite the complexity of these issues, it is important to ensure that the insolvency system operates fairly and efficiently. Registered liquidators are often unfairly maligned with a belief that unfair preference recoveries are only claimed to pay their remuneration. However, unfair preference claims play an important role in maximising the return to all creditors, including employees as best as possible, on a *pari passu* basis.

In the short term, there are steps that can be taken to better inform sole traders and small businesses, we recommend the law be amended to prescribe the minimum information to be included in an unfair preference claim raised by a registered liquidator. This information includes why a payment is considered a preference and the defences available.

In addition, excluding small payments from recovery (say those consisting of payments totalling less than $10,000 [indexed]) could help to address some of the issues with the current system where creditors believe they are being forced to settle with registered liquidators in respect of claims brought for amounts too costly to defend or obtain legal advice.

During the hearing it was also put to the Professional Accounting Bodies that recommendations had been made to:

- introduce a minimum preference claim amount to $30,000, being consistent with the amount applicable in a Simplified Liquidation;
- reduce the timeframe in which a preference payment must be claimed from three years to six months; and
- amend the knowledge threshold prescribed in defence provisions set out in section 588FG(1)(b(ii) from

> *at the time when the person received the benefit:*
> *(A) 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*
> *(B) a reasonable person in the person's circumstances would have had no such grounds for so suspecting.*

to being necessary for there to be actual knowledge of insolvency.

We do not accept these propositions.

In particular:

- *introduce a minimum preference claim amount to $30,000, being consistent with the amount applicable in a Simplified Liquidation;*

We are of the opinion that a minimum of $10,000 is applicable to raise a claim against an unrelated, unsecured creditor. This amount strikes an appropriate balance between limiting small claims which can be uncommercial for a registered liquidator to recover from those that, where a strong case for recovery exists, represent a suitable opportunity for funds to be recovered for the benefit of all unsecured creditors. This is also of value at which it is commercial for creditors to take appropriate legal advice to dispute a preference claim.

- *reduce the timeframe in which a preference payment must be demanded from three years to six months; and*

Registered liquidators already have significant time pressures to complete the statutory requirements in external administrations. This time can rapidly expire waiting on a response from the Australian Taxation Office or if matters must be taken through the court system.

Prior to undertaking a preference recovery, it is necessary for the registered liquidator to, among other tasks;

- obtain the company's books and records
- examine the company's accounts
- review the trading history between the company and its creditors
- review email communications and other correspondence
- establish the date upon which a company was insolvent
- obtain legal advice
- interview directors
- potentially undertaking public examinations through the Court system

Such tasks make it prohibitive for a registered liquidator to identify which creditors if any, can be pursued for being in receipt of preferential payments within a six-month period.

Limiting to a six-month period would also assume that the registered liquidator has the cooperation of the director, access to the company's records and sufficient resources and capacity to adequately investigate and assess each payment made to a creditor during the six months prior to the date of insolvency. Without adequate time to undertake thorough investigations, a reduced timeframe may have the unintended consequence of registered liquidators needing to send claims to all creditors paid in the 6 months prior to the relation back date.

Accordingly, we are of the opinion that no change should be made to the period in which a registered liquidator can bring a claim.

- *amend the knowledge threshold prescribed in defence provisions set out in Section 588FG(1)(b(ii) from suspicion of insolvency to actual knowledge*

Reasonable suspicion is a legal standard used to justify certain actions. It refers to a belief, based on specific and articulable facts, that an action has been committed. The standard is higher than a hunch or mere suspicion. Actual knowledge, on the other hand, refers to having concrete and definite information or evidence about a particular fact or situation. It is a higher standard of certainty than reasonable suspicion and is often required in legal proceedings to prove or refute a claim.

In the event that litigation of a preference claim occurs, it is necessary for a registered liquidator to demonstrate that a creditor who is a "reasonable person" had reasonable suspicion of the company's insolvency having regard to the specific facts available. Any increase in the knowledge threshold limit for insolvency will result in little to no unfair preferences able to be recovered due to the high threshold being set. A company's financial circumstances are private and not for public knowledge. Therefore, setting a threshold that would require a creditor to have actual knowledge of a company's insolvency would be unachievable in many instances.

We believe the legislators were sufficiently confident in the threshold enshrined in legislation for this to strike the appropriate balance between the liquidator's ability to recover the money without rendering the creditor defenceless.