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CHAMBERS



# **Insolvency Law Update – Badenoch and the End of the Peak Indebtedness Rule**

**Paul McQuade QC, Sean Russell and Hannah Lilley**

**Tuesday 8 June 2021**

## >> 588FA(3) Unfair Preferences – Running Account

(3) Where:

(a) a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor of the company (including such a relationship to which other persons are parties); and

(b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship;

## >> 588FA(3) Unfair Preferences – Running Account

(3) Where:

(a) a transaction is, for commercial purposes, an integral part of a **continuing business relationship** (for example, a running account) between a company and a creditor of the company (including such a relationship to which other persons are parties); and

(b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship;

## >> 588FA(3) Unfair Preferences – Running Account

then:

(c) subsection (1) applies in relation to all the transactions forming part of the relationship as if they together constituted a single transaction; and

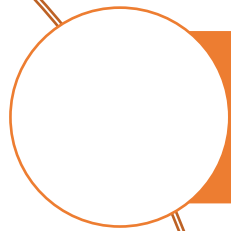
(d) the transaction referred to in paragraph (a) may only be taken to be an unfair preference given by the company to the creditor if, because of subsection (1) as applying because of paragraph (c) of this subsection, the single transaction referred to in the last-mentioned paragraph is taken to be such an unfair preference.

## >> ***Airservices Australia* – Doctrine of Ultimate Effect**

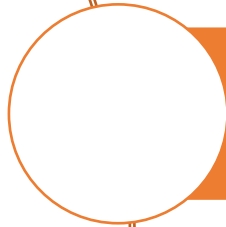
“If a payment is part of a wider transaction or a “running account” between the debtor and the creditor, the purpose for which the payment was made and received will usually determine whether the payment has the effect of giving the creditor a preference, priority or advantage over other creditors. If the sole purpose of the payment is to discharge an existing debt, the effect of the payment is to give the creditor a preference over other creditors unless the debtor is able to pay all of his or her debts as they fall due. But if the purpose of the payment is to induce the creditor to provide further goods or services as well as to discharge an existing indebtedness, the payment will not be a preference unless the payment exceeds the value of the goods or services acquired. In such a case a court, exercising jurisdiction under s 122 of the Bankruptcy Act, looks to the ultimate effect of the transaction. Whether the payment is or is not a preference has to be “decided not by considering its immediate effect only but by considering what effect it ultimately produced in fact.”



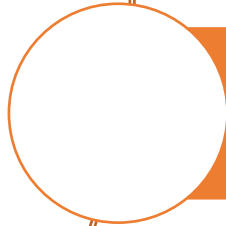
# Continuing Business Relationship



Mutual assumption of continuing relationship of creditor/debtor



Purpose of payment?



Significance of application to invoices, stop on account?



Substance over form

## >> The Peak Indebtedness Rule

“In my opinion the liquidator can choose any point during the statutory period in his endeavour to show from that point on there was a preferential payment and I see no reason why he should not choose, as he did here, the point of peak indebtedness of the account during the six months period.”

- *Queensland Bacon v Rees* (1967) 115 CLR 266, 220-221 (Barwick CJ)



## >> Peak Indebtedness Abolished: Three reasons

Plain language of the Act

Doctrine of Ultimate Effect

Purpose of Pt 5.7B – Fairness between unsecured creditors

## >> **First Reason – The text of the Act**

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(b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship;

## >> **First Reason – The text of the Act**

then:

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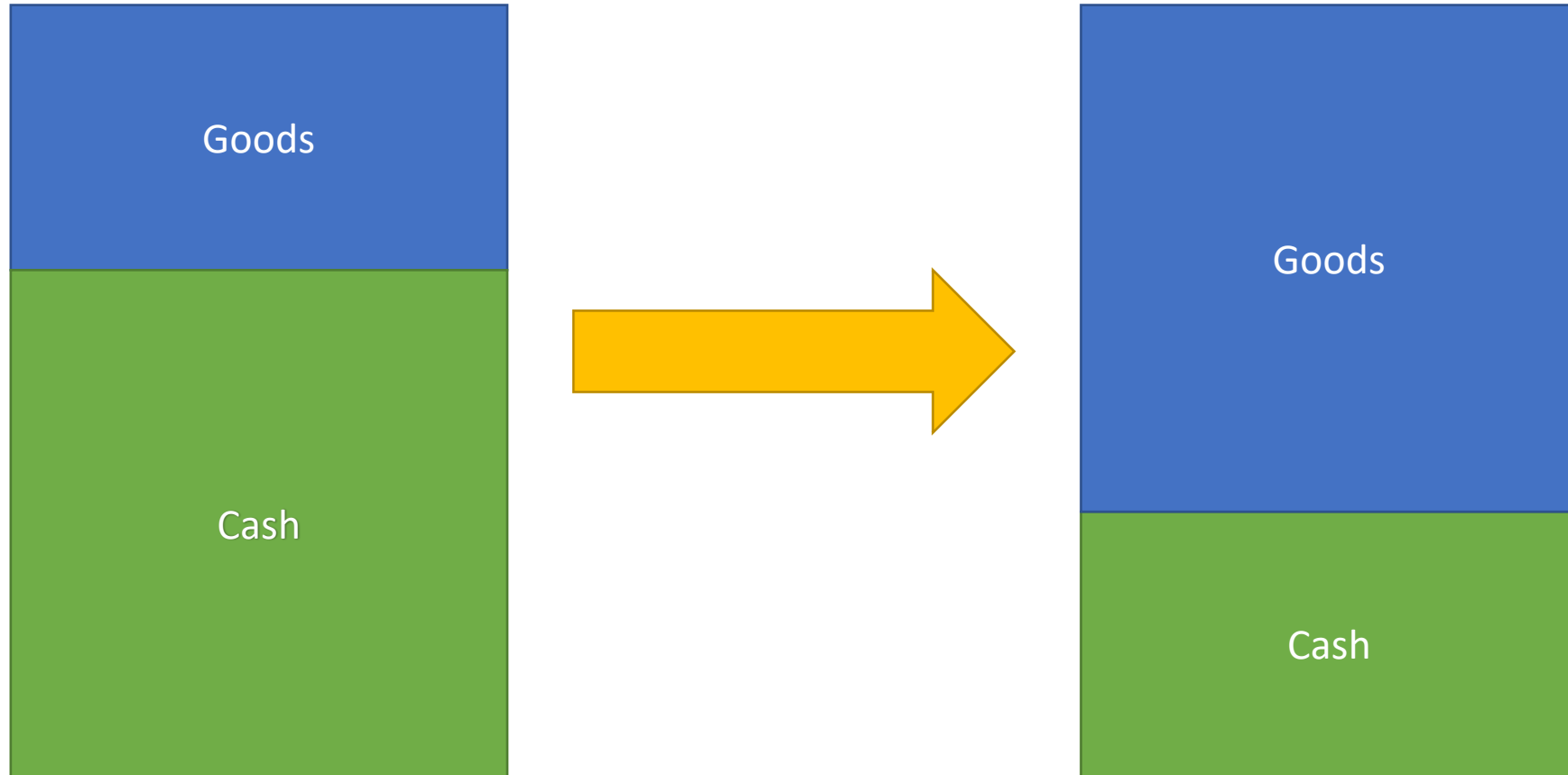
## >> First Reason – The text of the Act

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## >> Second Reason – Ultimate Effect



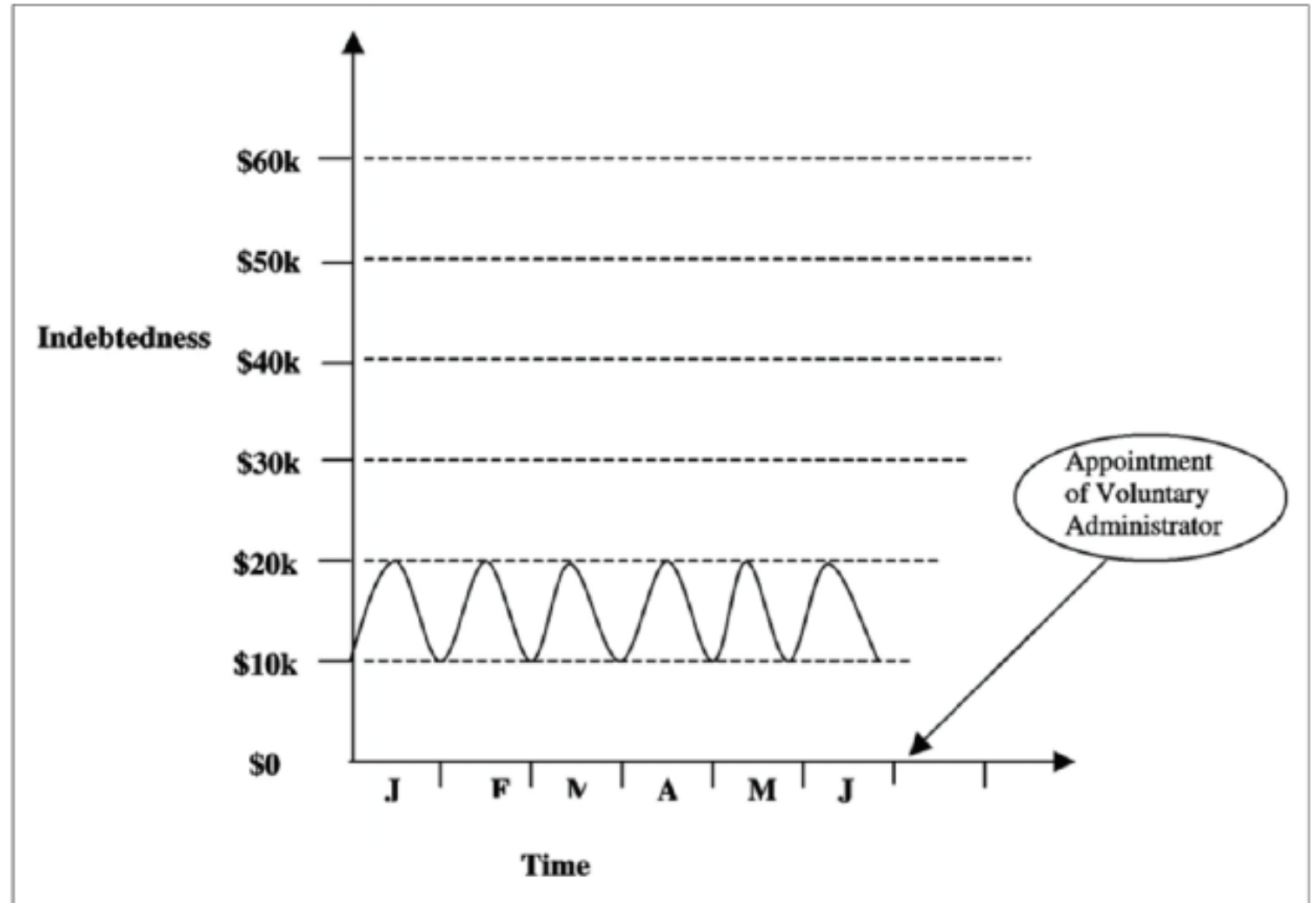
## >> Third Reason – Unfairness

- Each example has:
  - Creditor has given the debtor a \$10,000 credit limit
  - At the beginning of the six month period, \$10,000 indebtedness
  - Creditor provided \$60,000 of goods
  - Debtor company paid \$60,000

Scenario 1



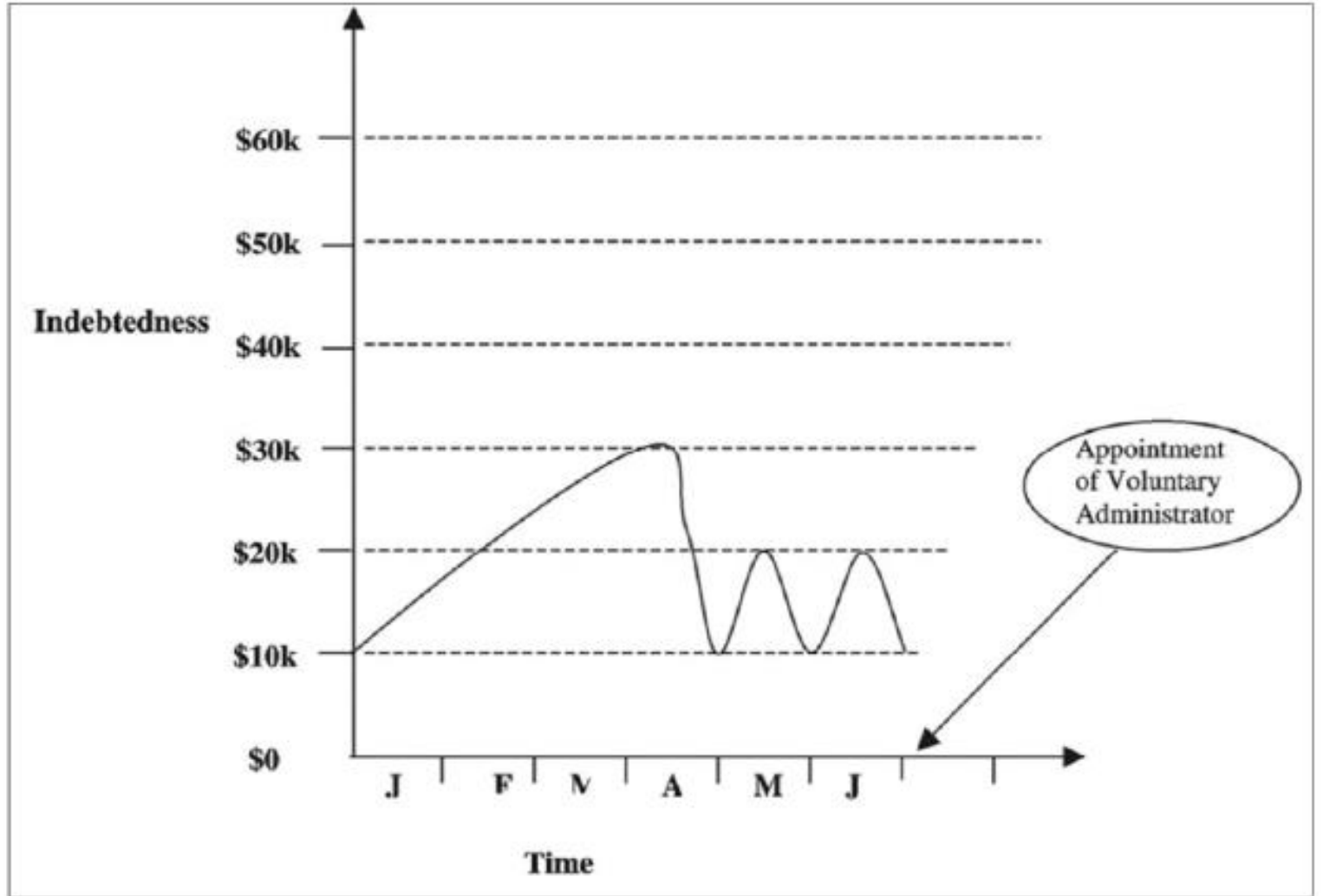
Third Reason  
– Unfairness



Scenario 2



Third Reason  
– Unfairness

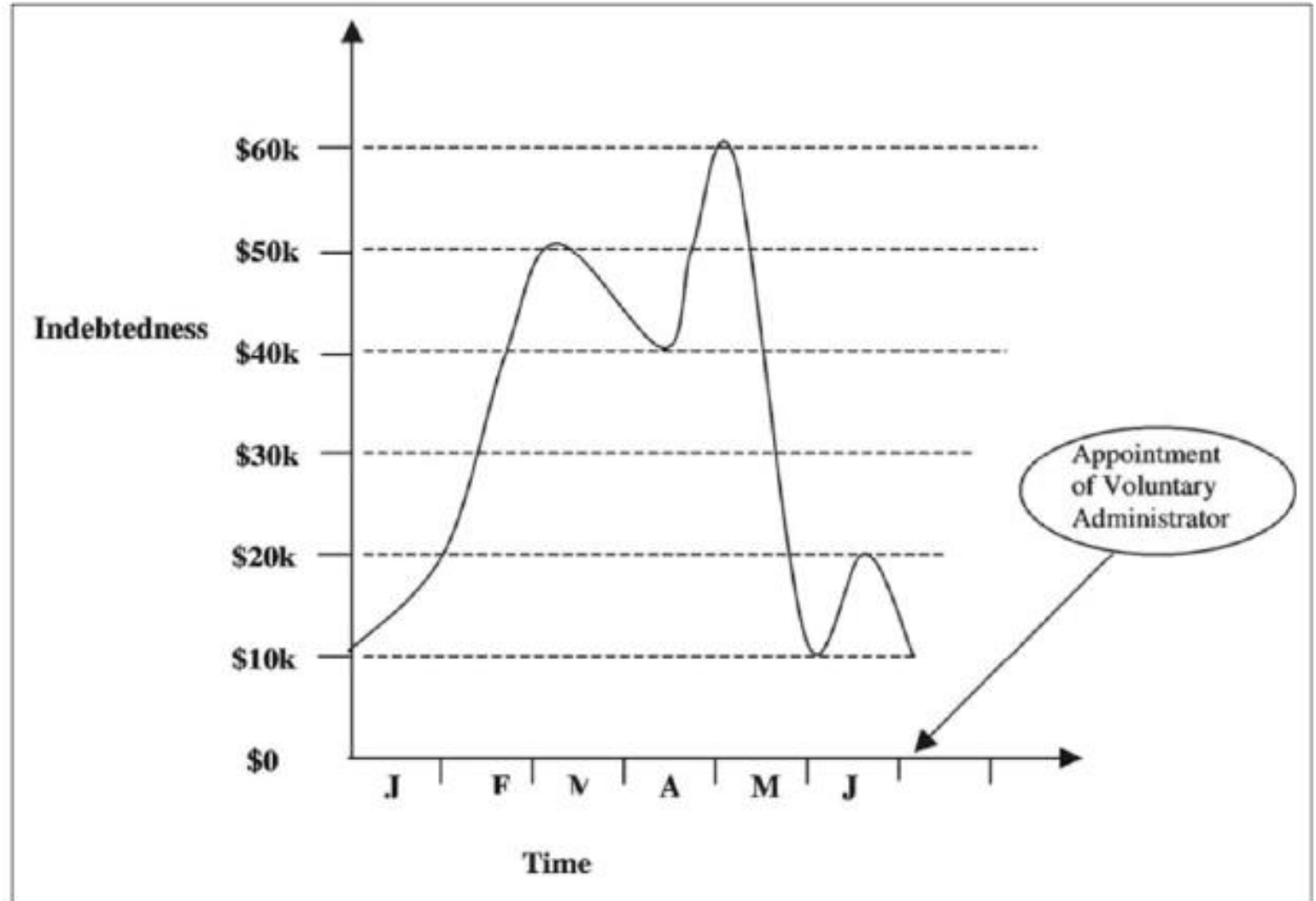




Scenario 3



Third Reason  
– Unfairness



## >> 553C Insolvent companies – mutual credit and set-off

- (1) Subject to subsection (2), where there have been mutual credits, mutual debits or other mutual dealings between an insolvent company that is being wound up and a person who wants to have a debt or claim admitted against the company:
  - (a) an account is to be taken of what is due from the one party to the other in respect of those mutual dealings; and
  - (b) the sum due from one party is to be set off against any sum due from the other party; and
  - (c) only the balance of the account is admissible to proof against the company, or is payable to the company, as the case may be.
- (2) A person is not entitled under this section to claim the benefit of a set-off if, at the time of giving credit to the company, or at the time of receiving credit from the company, the person had notice of the fact that the company was insolvent.

## >> 553C: Three elements

The respective claims must exist at the commencement of the winding up.

The respective claims must be '*commensurable*'.

There must be '*mutuality*' between the respective claims.

## >> Set-off example

1. Company A supplies \$100 of goods to Company B
2. Company B makes a part payment of \$60 to Company A
3. Company B goes into liquidation
4. The liquidator claims the \$60 payment from Company A as an unfair preference
5. Company A sets off the \$40 still owing to it, so it only pays back \$20
6. The \$40 that was set off is treated as a secured debt in the insolvency

## >> Relevant authorities

- > *Re Parker* (1997) 80 FCR 1
- > *Hall v Poolman* (2007) 215 FLR 243
- > *Buzzle Operations Pty Ltd v Apple Computer Australia* [2011] NSWCA 109
- > *Smith v Boné, in the matter of ACN 002 864 002 Pty Ltd* [2015] FCA 319
- > *Morton & Anor v Rexel Electrical Supplies Pty Ltd* [2015] QDC 49
- > *Hussain v CSR* [2016] FCA 392
- > *Stone v Melrose Cranes & Rigging Pty Ltd, in the matter of Cardinal Project Services Pty Ltd (in liq) (No 2)* [2018] FCA 530
- > *Re FORCE CORP PTY LTD (in liq)* (2020) 149 ACSR 451

## >> Academic criticism

Set off under section 553C of the Act should not be available because:

It is contrary to the statutory purpose of claims, being to benefit unsecured creditors.

There is a lack of mutuality.

The statutory claims are not properly characterized as contingent.



Liquidators should be alive to the potential for creditors to raise set-off claims under section 553C of the Act.

This is an area of law which is ripe for appellate level review.



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