

High Court makes preference claims harder for liquidators.



– Peak indebtedness rule abolished

In February the High Court of Australia delivered judgment in *Bryant v Badenoch Integrated Logging Pty Ltd* [2023] HCA 2 in which the Court considered the application of the “*peak indebtedness rule*” under Part 5.7B of the *Corporations Act 2001 (Act)*. In the result, the High Court upheld the decision of the Full Federal Court that Part 5.7B, particularly s 588FA(3), does not incorporate the peak indebtedness rule.

Section 588FA(1) of the *Corporation Act 2001 (Act)* provides that a transaction (most commonly a payment) is an unfair preference given by a company to a creditor which results in the creditor receiving more than the creditor would have received if the creditor had proved in the winding up of the company. The provision applies to payments made by a company to a creditor within 6-months of the relation-back day (most commonly the date the company entered liquidation). Payments of this kind are voidable, and therefore recoverable by the liquidator, if the company was insolvent at the time or became insolvent because of the payment.

Section 588FA(3) applies to circumstances where a company and a creditor have a continuing business relationship in which those transactions serve to increase and reduce the net indebtedness by the company to the creditor. The provision embodies what is commonly referred to as the running account principle which operates to treat all of the transactions as single transaction to determine whether or not the “transaction” is an unfair preference.

Following the decision in *Rees v Bank of New South Wales* (1964) 111 CLR 210, liquidators were, able to nominate the date and therefore the value at which the running account commenced. This greatly favoured liquidators in that it allowed the liquidator to nominate the date at which the debt owed by the company to the creditor was at its highest (“peak indebtedness”) and to thereafter recover all payments made to the creditor in that period between the peak indebtedness day to the relation-back day. If the payments made to the creditor reduced the indebtedness of the company to the creditor, the payments (or the transaction) would be unfair preferences and voidable at the suite of the liquidator.

At first instance the Federal Court found that the payments made by the company in liquidation within the 6-month prescribed period were unfair preferences by applying the peak indebtedness rule. The creditor appealed to the Full Court of the Federal Court, which overturned the decision and rejected the peak indebtedness rule.

Further the Full Court found (and the High Court subsequently agreed) that the peak indebtedness rule was inconsistent with:

- The language of s 588FA(3) which requires all transaction to be treated as a single transactions;
- The doctrine of the ultimate effect; and
- Running account principle.

The High Court held that the correct date was the first day of the prescribed 6-month period (if the company in liquidation satisfied the other criteria of s 588FE of the Act). The High Court rejected the argument that a liquidator is allowed, due to the function of their office, to choose the peak indebtedness date and disregard all prior transactions which rightfully form part of the ongoing business relationship between the creditor and company in liquidation.

The High Court noted that the purpose of the running account principle is not to maximise the potential for clawback of payments from creditors, but that was the effect of applying the peak indebtedness rule and therefore rejected the application of the rule. The determination in

Rees was correct for the law at that time, but the legislature had purposefully removed this power from the liquidator and instead prescribed a date by virtue of the interaction of s 588FE and 588FA of the Act.

But what does this mean? This means that the net indebtedness, for the purposes of section 588FA, of a running account between a company in liquidation and a creditor is calculated as the difference level of indebtedness at the start of the 6-month relation-back day period (or a later date if the company in liquidation is deemed insolvent on a later day) and the date the cessation of the business relationship.

This will likely reduce the instances in which liquidators would otherwise seek to recover amounts by operation of s 588FA.

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