PREFERENCE PAYMENTS

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Unsecured creditors are at a risk of losing everything, especially if the debtor company becomes insolvent and enters liquidation.

A liquidator has the ability to recover, for the benefit of all creditors, certain payments (known as unfair preferences) made by the company to creditors in the six months before the start of the liquidation.

These unfair preferences usually involve transactions that discriminate in favour of one creditor at the expense of other creditors.

WHAT ARE THE FOUR ELEMENTS OF A PREFERENCE CLAIM?

- ☑ The company was insolvent when the transaction was entered into or became insolvent as a result of entering into the transaction
- ☑ The creditor and the company were parties to the transaction
- ☑ The transaction resulted in the creditor receiving more than it would have if the transaction were set aside and the creditor proved for the debt in the winding up of the company.
- ☑ The transaction was entered into within six months before the commencement of the winding up (this is extended to four years for payments to related parties).

WHAT ARE THE COMMON SIGNS OF A POTENTIAL PREFERENCE PAYMENT?

- ☑ Payments made after supply has stopped or threats are made to stop supply.
- ☑ Payments made outside normal trading terms.
- ☑ Payments made after legal recovery action has commenced.
- ☑ Payments are made in lump or rounded sums.

HOW CAN A CREDITOR DEFEND A PREFERENCE CLAIM?

It must establish:

- ☑ It became party to the transaction in good faith;
- ☑ At the time it became party to the transaction, it had no reasonable grounds for suspecting the company was insolvent;
- ☑ It provided valuable consideration as part of the transaction.

Another common defence is the running account defence. This defence is available where there are a series of transactions which form an integral part of a continuing business relationship. In this case, the series of transactions are treated as a single transaction for the purpose of determining whether a creditor has received a preference. If the net indebtedness of the company to the creditor increases, there is taken to be no preference. If net indebtedness decreases, the net reduction is to be treated as a debt in respect of which the company has received full payment and thus the reduction constitutes an insolvent transaction.

This information is provided as a guideline only and should not be relied on as a substitute for legal advice.

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