

How demise of peak indebtedness rule resets clawback amounts

REGULATION

The High Court has abolished a convention that allowed liquidators to maximise the potential of unfair preference claims.

By [Trevor Withane](#) • 06 April 2023 • 10 minute read



Accountants advising clients who receive unfair preference demands need to be aware of the recent High Court decision in [Bryant v Badenoch Integrated Logging Pty Ltd \[2023\] HCA 2](#). So, too, do the liquidators who make such demands.

In Badenoch, the High Court confirmed that the so-called “peak indebtedness rule”, a feature of insolvency law for the last 60 years which benefited liquidators, can no longer be used to calculate the quantum of an unfair preference claim.

This is significant because liquidators were able to use the arbitrary peak indebtedness rule to claim the highest possible transaction value within the period of a continuing business relationship.

The abolition of the peak indebtedness rule now means that, in the context of a continuing business relationship, the liquidator will either be unable to claim an unfair preference or the

quantum will be lower. In some cases, this may mean that a demand that would otherwise have been pressed in court will no longer be commercial to do.



Badenoch also, critically, clarified the legal test for when a payment should be treated as falling within a continuing business relationship. For accountants guiding their clients through debt collection, being mindful of this test can mean the difference between particular payments being subject to individual clawback or the payments forming part of the more favourable running account balance in a continuing business relationship.

Unfair preferences

In simple terms, any transaction (not just cash) given by an insolvent company to an unsecured creditor in the six-month period before the debtor enters external administration is liable to be clawed back by a subsequent liquidator of the debtor company.

Creditors often find the unfair preference regime itself unfair. This is because there is difficulty reconciling on the one hand its right to be paid for goods or services already supplied on credit and on the other, its liability to return the money (or value) it received in discharge of the debt created by the supply. However, objectively viewed, the rationale is principled. That is, the purpose of the unfair preference regime is to create parity between unsecured creditors: the law's aim is to put those unsecured creditors who were fortuitously paid while the debtor company was insolvent during the relation back period in the same position as those creditors who were not so fortunate.

What's the 'peak-indebtedness rule'?

Where there is a continuing business relationship between an unsecured creditor and a debtor, all of the transactions that form a part of such a relationship (i.e. the debts and payments) must be netted and treated as one single transaction. Only in the event that the net effect results in a reduction in total indebtedness to the creditor would there be an unfair preference capable of clawback.

Therefore, the issue of deciding the boundaries of that continuing business relationship was (and is) a matter of paramount importance to the quantum of the unfair preference. The

higher the outstanding debt at the start of the period and the lower it is at the end of the period, the higher the quantum of the unfair preference. Conversely, the lower the outstanding debt at the start of the period and the higher it is at the end of the period, the lower the quantum of the unfair preference.

Before the Full Court's and now High Court's decision in *Badenoch*, the popular understanding was that a liquidator was at liberty to choose any point within the prescribed period (usually the six-month period ending on the day of the external administration) as the start of the continuing business relationship. The logical choice for liquidators is to always select the point where the debtor company was maximally indebted to the creditor — the "peak indebtedness" rule. The problem was that this practice of liquidators, although upheld by some lower courts, was arbitrary and found no support in the relevant statutory provision.

Badenoch

The facts

The respondent, *Badenoch*, supplied *Gunns* (the company in liquidation) with services in relation to harvesting and hauling timber.

Due to a decline in revenue, from about 2010, *Gunns* struggled to pay debts owed to *Badenoch*, frequently making late or only partial payments.

On or around March 2012, *Badenoch* issued *Gunns* a letter of demand and even ceased supply for a number of days, after which both sides entered into negotiations for a plan to pay off the invoices left outstanding. Importantly, however, *Badenoch* still believed that *Gunns* would be able to pay all of its invoices at this time.

However, the situation deteriorated further and, by August 2012, *Badenoch* agreed with *Gunns* to terminate the supply agreement contingent on further supply of some services for a short period thereafter, pending the involvement of a new contractor.

The liquidators were appointed on 25 September 2012 and sought to recover a series of payments as unfair preferences. The liquidators argued that there was a continuing business relationship and as such were entitled to use the peak indebtedness rule.

The respondent disagreed with this approach which, ultimately, resulted in the dispute being heard by Australia's highest court.

The decision

The three issues that the High Court decided were:

1. Whether the peak indebtedness rule could be applied under Australian law and, if not, the correct start date of the continuing business relationship
2. The relevant test for determining whether or not a transaction falls within the continuing business relationship
3. For the purposes of this particular case, which payments fell within the continuing business relationship and the final quantum of the unfair preference received by Badenoch
4. **Validity of the peak indebtedness rule**

The High Court found that there is no basis for the peak indebtedness rule in the statutory text that suggests a court is compelled to adopt the liquidator's choice as to the start of the continuing business relationship. Therefore it found that the peak indebtedness rule is not valid.

Importantly, the High Court held that the start of the continuing business relationship will be the latest of these three options:

1. The beginning of the prescribed period
2. Where the date of insolvency is after the beginning of the prescribed period, the date of insolvency
3. Where the relationship started after the beginning of the prescribed period and the date of insolvency, the beginning of the continuing business relationship
4. **Test for continuing business relationship**

In answering the question as to which payments fall within a continuing business relationship, the High Court overruled some of the previous authorities and held that whether a transaction falls within a continuing business relationship will depend on "an objective ascertainment, on the whole of the evidence, of the business character (for commercial purposes) of the transaction in issue".

For practical purposes, the court will closely consider the correspondence and communications between the parties to determine whether the true nature of the payment was to retire old debt or whether it was (at least in part) to entice future supply. This is a highly fact-specific inquiry and the documentation created around the relevant time will be of defining significance. Creditors will therefore want to carefully consider the wording it uses, the threat it makes, and the accommodation it offers when chasing old debts. This can make the difference as to whether the liquidator has to claw back the transaction.

3. Which payments were part of the continuing business relationship

Out of the 11 payments in issue at first instance, only payments one and two and five to 11 were challenged on appeal (i.e. both parties agreed that payments three and four were part of the continuing business relationship).

In respect of payments one and two, the High Court upheld the conclusion of the Full Federal Court below that they were part of the continuing business relationship. This is because, objectively viewed, notwithstanding a temporary cessation of supply and the execution of a progressive payment plan, the "controlling minds" of Badenoch still believed that Gunns would ultimately be able to pay all invoices and the cessation of supply did not cause either party to consider that the continuing business relationship was to end.

Significantly, it did not matter that inherent in that payment plan was an intention on the part of both parties to reduce Gunns' past indebtedness.

On the contrary, the High Court also agreed with the Full Federal Court below in holding that payments five to 11 were not part of the continuing business relationship. This is because these payments occurred after the time where, objectively viewed, the parties had already agreed that the relationship would end and that the continued supply was only for the purpose of reducing Gunns' debt before the handover to a new contractor.

The High Court also ruled on a subsidiary question that an invoice relating to work done before the end of the continuing business relationship was part of the continuing business relationship, notwithstanding that the invoice itself was issued after the end of that continuing business relationship.

In conclusion, as a consequence of all the above, the High Court held that because there was no reduction in net indebtedness from Gunns to Badenoch (in fact there was a clear increase), there was accordingly no unfair preference.

Takeaways

- Liquidators should not disregard the point of peak indebtedness. This is because while it is no longer the appropriate start of the continuing business relationship, it may well be the point at which the relationship in fact ended. If this is the case, then each individual payment thereafter may be recoverable.
- Similarly, liquidators should look out for flags such as "stop supply" notices, a change to cash-on-delivery terms or debt repayment demands from a solicitor, all of which may be suggestive that the continuing business relationship ended.
- Creditors faced with an unfair preference demand should carefully scrutinise it to ensure the liquidator has, or can, meet every element of the test. A failure to meet an element of the unfair preference test could be fatal to the liquidator's claim.
- In light of the primacy that the High Court afforded to "objectivity" in determining the nature of a transaction, careful thought must go into framing correspondence with debtors at risk of insolvency. It is vital for the parties to maintain records about the business relationship, especially any such records that show a change in the position of either party.
- Similarly, creditors should carefully consider whether the good faith defence might assist them in an unfair preference claim. Think carefully before creating any documents that suggest that the creditor suspects that the debtor company is or may become insolvent.

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