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Claim *after carnage*

K&L Gates' **Nicole Ward** and **Rebecca Murray** give some tips about protecting your business when a customer collapses.

I T HAS BEEN a difficult time for the retail fashion industry as evidenced by the recent collapse of international brands American Apparel and Valleygirl. The Australian industry is no exception with reputable fashion brands Laura Ashley, Josh Goot, and Seduce all falling into some form of external management in recent years.

These circumstances impact on a wide range of participants in the fashion retail sector. In particular, creditors of the failed enterprise (usually suppliers or designers) are often left with substantial unpaid accounts. Even if a creditor is fortunate enough to be paid by the indebted company before a liquidator is appointed, these amounts may later be clawed back as 'unfair preference' payments.

What is an unfair preference?

By law, a failed company's liquidator can seek to clawback certain payments made within a six month period preceding the company's administration or liquidation. These payments are known as 'unfair preferences' and are said to occur where a creditor has 'jumped the queue' by receiving payment of their debt (or part of their debt) at the expense of other creditors of the company. A payment will be an unfair preference if it is shown that the creditor received more money from the indebted company than it would receive in liquidation.

This can seem extremely unfair to a creditor who has done no more than been diligent in its cash flow management by chasing up and putting pressure on its customers to pay debts properly due and payable.

Unfair preference claims, once commenced, can be difficult and costly for creditors to defend.

Defences

Creditor suppliers or designers may be able to defend an unfair preference claim in the following ways:

Good Faith: creditors can defend an unfair preference claim by proving that it did not suspect that the company was insolvent at the time that it received the alleged unfair preference payment and that any other reasonable person in their position would not have held that suspicion. This is known as the 'good faith' defence.

Running Account: where parties have an ongoing commercial relationship pursuant to which the creditor continues to supply goods or services over a period of time and the company makes payments throughout that period a 'running account' will be established. In these circumstances, instead of

assessing each transaction separately to determine whether they are unfair preferences, the net value of all of the relevant transactions is assessed as if it were one transaction. Essentially, if the creditor has supplied goods or services to the company during the previous six months then the payments it received and the services supplied are essentially 'netted off' so that only the balance is recoverable from the creditor as a preference payment.

Protecting yourself

While defences are available, the best course of action is to avoid becoming the subject of an unfair preference claim in the first place. Taking the following actions may help to protect your business:

Cash in advance or cash on delivery: If you require payment at the time you supply your goods or services, your business will never be a creditor of its customers. This means that the payments your business receives cannot be considered unfair preferences.

Taking security: a liquidator can't pursue a secured creditor for unfair preferences. So, if it's not realistic for you to demand cash in advance or on delivery, it's best to position yourself as a secured creditor. If you are a supplier, consider incorporating a retention of title clause into your credit terms and ensure that it is properly registered on the Personal Property Securities Register. Recent cases suggest this form of security will provide a defence to an unfair preference claim up to the value of the security.

Cash flow management: where possible, do not allow your creditors to operate outside payment terms, regularly follow up creditors for payment rather than waiting until the company is approaching financial difficulty.

What to do if you received an unfair preference demand?

If you receive a demand for the repayment of a preference, seek legal advice immediately. Often the claim can be defended by relying on one of the matters mentioned above or a commercial resolution can be reached, avoiding the need for your business to repay all or some of amount demanded. ■

For more information about issues relating to unfair preference claims and how to best protect your business please contact Nicole Ward, Special Counsel at K&L Gates (Nicole.Ward@klgates.com). This article is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

