PREFERENCES - RUNNING ACCOUNTS

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As the Chairman advised you, I am going to give you just an overview of preferences. And having done that I am going to go through about five relatively recent preference cases to indicate to you how some of the fundamental principles of voidable preferences are actually applied when they find their way to the court. That is the topic and if I can operate the projector from here we will be away.

Just to put it into context, particularly for those who don't get involved in preferences on a day to day basis, we are talking about s.122 of the Bankruptcy Act made applicable to liquidations by s.451 of the Companies Code. There are two things that you could say might be the parliamentary purpose. They are slightly different. I want you just to look at them. Firstly you might say that the reason for preferences is to aid equal distribution amongst creditors and secondly, even though it might sound exactly the same thing, it does vary slightly, to prevent the statutory order of priorities from being disturbed. This slight difference, if you can perceive one, becomes quite important when you talk about secured creditors. So here are very briefly the fundamental elements of a preference.

It is up to the administrator, let us call him the liquidator for simplicity, to prove a payment or conveyance of some kind by or on behalf of the debtor in favour of a creditor which gives the creditor some kind of advantage - and the words "preference", "priority" or "advantage" are used, I often find it less confusing if you confine that particular aspect to the word "advantage" - that takes place within a relevant period, a period of six months from some date like the commencement of a winding up and occurs when a debtor is insolvent. Now they are the things that the administrator has to set out to prove and the onus of proof is on him and if he does that you have a prima facie preference. But of course that is not the end of the story because there are some defences available to a creditor even if the administrator gets up on those aspects.

Just concentrating on one of the fundamental elements - and there were about five or six of them then - just on the fourth one,

preference, priority or advantage, the essence of this the courts have said is discrimination in favour of one creditor against other creditors. So you compare what the creditor received when he was paid, when he got the impugned transaction, with what he might have received had he not been paid. So you compare his situation with everyone else. It is important to note that a payment to secure future supplies or a charge to secure future advances does not give an advantage because you are not talking about a payment for something that has already been supplied but something that is about to be received. And this gets important when you look at a case like the State Bank v. Judson which we will do a little later. And then we also run into, particularly under this heading of does the creditor get an advantage, we run into the heading of how do you define the advantage if you are talking about a bank and you are talking about a running account. And then you will find that perhaps you have to get into situations where you look at more than one payment but a series of payments because the payment that you might be after is integral to a set of wider transactions and I believe Sek Hulme will be talking about some of these things later on.

The court again looks for discrimination between a running account creditor and other creditors and may come up with a single payment or a series of payments or in fact the whole transaction over a period of time as being the essence that gives the advantage.

So just leaving that one behind and going on to the defences by the creditor, it will be up to the bank or whoever it is that gets paid to demonstrate if the administrator can get up on all of the positive factors that nevertheless he acted in good faith, he acted in the ordinary course of business or the transactions were in the ordinary course of business and there was valuable consideration. But the liquidator gets another shot at it if he can demonstrate that this absence of good faith and it is deemed to be absent because he proves the existence of circumstances which would have led an ordinary creditor, the objective creditor, to an awareness of the company's insolvency and of the fact that he was being preferred. So, that is the opportunity, or one of them, for the liquidator to work on the basis of the reasonable man and upset the good faith defence of a creditor. And I emphasise that all three such defences are needed. So if you lose one you have lost on your defensive element. Of course I am not trying to under-emphasise the fact that the creditor will be trying to prevent the liquidator from proving the five positive factors.

Now if we can just concentrate on one of the defences which will be talked a lot about this morning and that is the defence of ordinary course of business. The classic phrase from one of the High Court cases, and it gets repeated in every one so it is difficult to remember which one it was, is that the transaction must fall into place as part of the undistinguished common flow of business done, calling for no remark and arising out of no

special or particular situation. Now what you will find in fact is that transactions often fall outside the ordinary course of business, this is the most common way in which they do it, if it is obvious that either one or both of the parties have been influenced by the knowledge of the impending demise of the debtor and the court will have regard to the knowledge by the creditor or the debtor or both.

Now while I've said that, that is not the only circumstance in which a transaction will be deemed to be outside the ordinary course of business. For example we will spend a little time this morning talking about the case of KDS Nominees and in that case transactions were found to be outside of the ordinary course of business even though the court suggested that the bank had no idea that the company was insolvent.

So just a little more again about the defence of ordinary course of business. Even if the creditor is unaware of insolvency the transaction might be non-ordinary. For example as happened in the KDS case, where special arrangements were made to clear a cheque and serious differences of opinion existed between directors and this was brought to the attention of the bank. Moneys received in response to some kind of demand notice are invariably held to be transactions outside the ordinary course of business. And what is very important in this situation is the principle that seems to be emerging from the Kyra case that if the debtor, if the company, makes a payment with the sole or dominant intention of preferring the creditor then that alone takes the transaction outside the ordinary course of business, which is a tremendously important principle for a bank who may simply be sitting there receiving the payment.

So we have considered I think the framework. Now I would just like to apply these to a couple of particular situations and then to about four cases. Firstly think about the person who is a secured creditor and let us just assume that the security is valid, otherwise the possibilities of proving preference will probably be quite easy. The general feeling is that if a repayment in an ordinary sense to a secured creditor does not prefer him, does not give him an advantage over and above unsecured creditors then he has not got a preference. For example if he were paid in the ordinary course and his security was valid then when the liquidation takes place he simply relies on his security and he is paid ahead of the unsecured creditors anyway. If you take one viewpoint you think that he would not get an advantage. However, if you take the notion that the reason for the section is so that the priorities of winding up won't be disturbed then you get the curious situation where you might think that a secured creditor who has a valid security and who has been repaid prior to the winding up might find himself with a liquidator who is acting on behalf mainly of the Deputy Commissioner of Taxation, who sees himself as being a s.221P preferred creditor in a winding up, setting out to fund the liquidator so that the liquidator can get money back from the

secured creditor so that he can redistribute it to the person who might have been paid in priority in the winding up, being the Deputy Commissioner of Taxation.

The situation is a little extreme, but it has been tried out though not under this section. It was tried in Re Margart; Hamilton v. Westpac in Sydney but was it tried under s.368 as a disposition and there the judge said that this repayment to the secured creditor just was not a disposition of company property because the bank effectively owned the property at the time because of its charge. Nevertheless it is something that might be done in the future.

And the other way in which you can look at a secured creditor is what if he gets back more than his security is worth? And you will find when we talk about the Yeomans case we talk about a leasing creditor who was paid out on the lease only a few weeks before the winding up and the payout figure was probably twice the value of the equipment that he was paid out on. So the question is whether he got a preference.

I want to mention this relatively new section of the Companies Act, s.453(5) - it came in with the Code. This allows you to go behind the creditor to the officer of the company who has been relieved of a liability. So you need to prove that there has been a disposition within six months before commencement of a liquidation, you need to prove that this disposition on the one hand confers an advantage on the company creditor (e.g. a bank) and on the other hand it releases an officer from liability (e.g. a director who has guaranteed the bank). If you can prove all those three things you can recover from the director and god willing you will have some money.

Now remember the unlikelihood of the suitability of this section if you are talking about an officer who has given outside security or guaranteed an company debt where the bank already has security over the company, because the bank is not really getting an advantage perhaps if it is already a secured creditor. So really this section sets out in circumstances where the prime creditor is someone who is an unsecured creditor. And this section has been tested in the case of Matthews v. Geraghty in the South Australian Supreme Court and we will deal with that case.

So we have set the pattern I think for preferences, now let us deal with about four of these cases. All of these are reported in Australian Company Law cases. The first one is the State Bank v. Judson where a company went into liquidation in May 1983. Only a few months before that a debenture had been created in favour of the bank which secured an overdraft. The overdraft had been running, if you look at the overdraft history, for quite a few years and it had not done a lot. It climbed to $35,000, it was sitting at about $40,000 when the bank got nervous, I assume, about the company's solvency and decided to take security.

It came out in the evidence in the case that the bank was perfectly aware of the company's insolvency, that was obviously the reason why it took security, and in this case the liquidator at first sight before he picked up the law books I guess, decided that he could invalidate the charge under s.452 of the Companies Act. And of course it seemed pretty obvious to him anyway that it had been created within the last six months and he thought that it was probably just created in his mind to secure past consideration.

However, on consulting the law books he found that he would not be able to succeed in that defence and we will just have a look why. So above the drawn line are the arguments that I think he thought about and below is the argument that he actually used. Firstly he said "well, the charge should be void and therefore I won't allow the bank to come and take their money to which they claim to have security". The bank went for a validating order. The answer to that question would have been if it were argued in court, which it wasn't, that no, on the principle in the Yeovil Glove case and I think arising from Clayton's case a long time before it, deposits into this overdraft account of $40,000 effectively destroy the balance and then payment out of the account creates new cash advances. So what effectively you have got is cash advances, new cash advances secured by the charge after the charge is created or at the time the charge is created. So they would have avoided invalidation under s.452.

He also thought, I think, about suggesting that the charge itself was a voidable preference, but he decided not to argue that and I think these were the comments given to me by Ray Finkelstein who argued this case, he decided not to argue that because on the authority of I think Re Fallon; Burns v. Stapleton in the High Court, it would have been found that similarly the charge was given to secure future advances.

So what he did was he argued that payment made by the company to the bank, essentially the deposits, that happened to touch on $40,000, the next ones coming in, actually created a voidable preference. But the court said no, that is not true. Both the judge in this case and counsel for the liquidator agreed on the point that you don't just examine some mere reduction of the account to nil but you look at the whole account to try and see your final reckoning. So there they agreed. But the liquidator argued that we simply pause at the first reduction to nil. And here the relationship ends, if artificially and temporarily.

The court said no, the relationship does not end there, the relationship continues. All that happened was that it was a charge and that there was a change in security status and the change in security status was effected by the charge and deposits made. The liquidator was relying on the deposits, not the charge, and the court was not going to allow him to simply select the next $40,000 that was deposited and say that you could isolate those, it was much more concerned to look at the wider

transaction and it said that the relationship continued. So that was State Bank v. Judson.

The next case I want to talk about is Kyra Nominees where again you have a creditors' voluntary liquidation in July. The bank overdraft had crept up to $292,000 in April, it took a nosedive to $103,000 over a period of less than a month, the bank itself was unsecured except it had a term deposit for security to the extent of $130,000. You will see that when the liquidator looked at the facts he said that what had happened was the bank overdraft had been reduced from $292,000 to $103,000, the bank has no longer any problems itself because it has got security to the tune of $130,000, it would have been quite exposed at $292,000. The bank held security from the directors themselves by way of real estate. I take it that the liquidator formed the opinion that the directors had orchestrated the the repayment to the bank. He was helped in that conclusion by the fact that there were about $120,000 worth of cheques that were signed and drawn but not sent out - they were sitting in someone's drawer and that came from evidence from the book-keeper.

The court also found that the bank manager did not address himself to the company's solvency. He found that he really did not have to because he had security. And when it came to court there was no argument that there was actually an advantage of $188,000 - that was not disputed - it was a question of whether it was a voidable preference or not.

So the arguments put up were, the liquidator said that payments totalling $188,000, being the deposits, were made with the intent to prefer the bank and because they were made with that intent they were outside the ordinary course of business. And the court agreed. I am talking about an appeal court, three judges on Appeal in Western Australia. They agreed and they drew on authority from the High Court case of Taylor v. White and they said that if you make a payment with an intent to prefer that is totally inconsistent to any idea of making a payment in the ordinary course of business.

One of the bank's arguments was that the deposits were simply ordinary deposits that any customer might make and that the withholding of cheques was a separate matter, so you divided them up. And that argument did not get very far. The judges decided that whatever the outward appearance these deposits had they were made with the dominant purpose of giving priority and not of continued trading and they should be viewed in that light as being outside the ordinary course of business.

It had been argued that the bank manager had not adverted to nor did he known of the insolvency of the company, nevertheless that was basically irrelevant once you miss out on the ordinary course of business test because you need all three defences to stand up. But in any case, the judges ultimately said that there was a case here of deemed lack of good faith because an objective manager ought to have known that the company was insolvent.

So it is very important this Kyra case because it means that if a director sets out to relieve himself from guarantees by making sure that the company repays the bank then even if the bank is totally unaware of his orchestration nevertheless the payments may be held to be outside the ordinary course of business. And I mean it just seems to me that it has perhaps gone a little too far. And I understand that there was a request for the case to go to the High Court but the High Court refused to give leave. But I think there is a case going shortly on a similar issue.

The next case is Matthews v. Geraghty, it is a South Australian case on appeal and this involves s.453, the indirect preference situation. If you can just draw an imaginary line down the centre of those figures you will see that Geraghty and a co-director had guaranteed a bank overdraft and the company had two bank accounts. On the one hand a current account with virtually nothing in it at the relevant date and on the other hand an advance account with a $10,000 debit. Now on a certain day, 11 or 16 days prior to liquidation, a deposit of $20,000 was made. Four days later $10,000 was transferred out of the current account. It cancelled the debit in the advance account so the net result was the overdraft was extinguished. The bank of course had a letter of set-off which had been executed some six months before the liquidation and amongst other things said it was just exercising that letter of set-off.

Two argument were put forward by the directors. They said that there was no preference here or the liquidator had not established it because for the liquidator to establish that the bank has received a preference in terms of s.453 you have got to open up the pandora's box of s.122 which provides the six positive factors and all the three defensive factors and you have got to get into that area. The court said no, that is not true, the liquidator can totally rely on the terms of s.453. He need only prove that the bank got an advantage. He of course has to prove the other factors.

So it has made it, at least for liquidators, a little easier to chase officers who have been relieved from obligations and therefore I think it has been an advantage to the bank.

The second and more major point here was that it was argued that the disposition being the $20,000 banked into the current account did not of itself prefer the bank or release the officer. It was in fact a transfer of funds pursuant to the letter of set-off that had that effect. However, for varying reasons all the judges found that there was a disposition. They said that the disposition, the deposit of $20,000, put the bank in a position to act and it did act to be preferred and that the disposition played a significant part in the preference and guarantor release. One of the judges said that the disposition or the end transfer was a natural and foreseeable consequence.

So I think in that case the court went a fair way to sheet the civil responsibility home to the director.

Yeomans v. Lease Industrial Finance is a single judgment from the ACT Supreme Court. The company was wound up and shortly prior to being wound up he paid out $61,000 to a lessor. The circumstances were very interesting. It received a payment from a debtor of its own, endorsed the cheque, did not bank it, signed it in favour of the lessor and got a refund from the lessor a week later because it paid him too much, being the size of the cheque. So it seems like they were in a fair hurry to pay off this amount. The directors of course had guaranteed the leasing company and it was evident, subsequently found out by the liquidator, that the leased equipment was only worth $30,000. So the liquidator decided to claim a preference.

There were many arguments used. The first one was that the lessor was not a creditor and in answer to that the court said no, a creditor is one who would have had a provable debt if bankruptcy occurred straight after the payment. A contingent creditor has a provable debt in both bankruptcy and liquidation, therefore he was a creditor and of course he was a contingent creditor from the day that the company signed the lease. Secondly, that no advantage had been obtained, because there was merely a bargain and sale of chattels. The court disagreed and said that the payment not only provided them with the chattels but also released the company from its lease performance obligations. Therefore it was more than just a bargain and sale of chattels.

The third argument used was that a secured creditor cannot get an advantage. As I mentioned before this is quite a common one. The court said no, a lease creditor is not a secured creditor. If you look at s.5 of the Bankruptcy Act he is simply a lessor or a bailor or the equivalent. But, said the court, even if he were a secured creditor, the amount paid to him exceeded the value of his security and that gave him an advantage.

And finally, the lessor reverted to the defences of good faith and in the ordinary course of business etc. Now one would have thought here that the Kyra principle was directly relevant, and that the payment seemed to have been made with the intention of releasing the directors from the guarantees. Nevertheless it was virtually not mentioned. What was relied upon, the judge said that the lessor did not act in good faith and the transactions were outside the ordinary course of business but the judge concentrated on good faith and said that the use of an endorsed cheque for value greater than the payout, knowledge of value of the goods and of the guarantee led to a deemed absence of good faith and the transaction was also outside the ordinary course of business.

Now the final case is KDS Constructions. This went to appeal to the Queensland Supreme Court and I understand this is to be appealed to the High Court. You will see the facts there [on the slide]. There was a deposit of $102,000 made into a bank account. Prior to that it was $60,000 overdrawn. It was done on

Thursday, September 3 and the next day a $40,000 cheque was withdrawn from that account and placed on suspense in a transaction the judge described as "curious". A few days after the liquidation that $40,000 itself was withdrawn to pay off guarantee obligations to the bank.

The liquidator put two arguments. He said that the payment of $102,000 itself was a preference and ultimately it was agreed that that was a preference but of course the bank only got an advantage to the extent of $60,000 being its overdraft balance at the time. A separate argument was that the $40,000 payment that was a payment to set up a suspense account was a preference. And the answer to that was no, the bank had simply permitted a withdrawal by an authorised agent, the directors, who had signed the cheque and it was not a payment by the customer to the bank but rather a payment by the company to a customer.

More important is I think the $60,000 preference. The bank's defence was that it acted in good faith and in the ordinary course of business and for valuable consideration even if the positive factors were established.

The time became very important. In the primary judgment it was assumed that the payment was made on September 3. In the appeal it was assumed that the payment had not been made before the proceeds of that cheque deposited for $102,000 became available. This opened up for evidence the relationships and the conversations and the dealings between the bank and the company on the afternoon of the Thursday and the morning of the Friday. And amongst other things the director had come in and said he was thinking about appointing a receiver, he had said that he had differences with his fellow directors, he said that he wanted to transfer $40,000 to his own account so that the other directors would not spend any money.

So all of these things became available as evidence of the transactions provided you accepted that the payment had not been made on the Thursday but later, on the Friday or thereafter. And as a consequence the court found that the transactions were not made in the ordinary course of business even though the bank may not have been aware of the company's insolvency. It was aware that there was something strange going on and they were outside the ordinary course of business. It did not consider good faith.

Now once again the court had the opportunity, because guarantees were involved here, to think about the Kyra principle and simply say the transactions were outside the ordinary course of business because they were made to release an officer but they did not do so.

That is just the background to some of the recent cases. I suppose if we draw a conclusion from those, some of those decisions seem to be, it is wrong to say they are just favourable to a liquidator, they seem to be moving in an area where the

civil responsibility is starting to be sheeted home to directors who have guaranteed, yet do their utmost to make sure that they are relieved from their outside guarantees and sacrifice company property. They also indicate that the defences are very much mixed up. This is not of course the fault of the courts, it is just the way they are worded. You will find the insolvency factor coming in again and again whether you are putting it under the heading of good faith or the heading of ordinary course of business. And there is a certain amount of uncertainty that is coming about.

I would like to say something about the operation of s.218 of the Income Tax Assessment Act but I think I will defer that until sometime later on in the session.