VOIDABLE PREFERENCES

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INTRODUCTION

The law relating to voidable preference in this country is, to a very large extent well settled. Section 122 of the *Bankruptcy Act* 1966, and its precursor, s 95 of the *Bankruptcy Act* 1924, have been explained and applied in many cases in the High Court and other courts. There have been very many cases in the High Court between 1932 and 1987, which are of particular importance and which seem to have settled the law for this country.

One can therefore do little more in a paper such as this than to restate the principles and examine some of the difficulties that have arisen and consider some of the problems left unresolved. And, having regard to the present economic climate and the frequent insolvencies that are occurring, it is as well to commence by a restatement of the established principles.

Sub-section 122(1) of the *Bankruptcy Act* 1966, coupled with sub-s 451(1) of the *Companies Code*, decree that a payment made to a creditor by a debtor-company which is unable to pay its debts as they fall due from its own money, having the effect of giving the creditor a preference over other creditors, is void against the liquidator of the company if the payment be made within six months of the commencement of the winding up.

This seemingly simple decree of the Parliament has given rise to a great body of judicial authority and learned academic writing. It is made subject to the protection given to creditors by sub-s 122(2)(a) which has the effect that a payment which otherwise would be voidable as a preference is not voidable where it is received -

(a) in good faith;

(b) for valuable consideration; and

(c) in the ordinary course of business.

To make the task of a liquidator easier, sub-s 122(4)(c) deems the creditor not to be a payee in good faith for the purposes of sub-s 122(2)(a) if the payment was made under such circumstances as to lead to the inference that the creditor -

(a) knew; or

(b) had reason to suspect, that

(i) the debtor was unable to pay his debts as they became due from his own money; and

(ii) the effect of the payment would be to give him a preference, priority or advantage over other creditors.

Where a court is confronted with a claim by a liquidator, seeking to impugn as a voidable preference a payment by a company in winding up, made within the statutory six months of the commencement of the winding up, the court is confronted with three sets of questions.

First, there are the questions in respect of which the liquidator has the onus of proof. The are whether -

(a) the transaction sought to be attacked falls within the classes of transaction enumerated in sub-s 122(1);

(b) the company was, at the date of payment, unable to pay its debts as they became due from its own money ("the insolvency question");

(c) the payment was made to a creditor;

(d) the payment had the effect of giving the creditor a preference over other creditors.

Secondly, the liquidator having established the abovementioned requirements, the onus shifts to the creditor, if he wishes to rely upon the protective provisions of sub-s 122(2)(a), to show that he was a payee -

(a) in good faith;

(b) for valuable consideration; and

(c) in the ordinary course of business.

These three criteria are cumulative and the onus of establishing them lies upon the creditor who received the subject payment: sub-s 122(3).

Thirdly, if the liquidator wishes to rely on the deeming provisions of sub-s 122(4)(c), it is for him to lead evidence of such circumstances as to lead to the inference that the creditor knew or had reason to suspect that (i) the debtor was unable to pay his debts as they became due from his own money; and (ii) the effect of the payment would be to give the creditor a preference, priority or advantage over other creditors.

NATURE OF TRANSACTION: PAYMENT

As the first step in the process of impugning a transaction as a voidable preference, the liquidator will need to show that the transaction in question falls within the classes of transactions enumerated in sub-s 122(1), that is to say that the transaction was "a conveyance or transfer of property, a charge on property, or a payment made, or an obligation incurred". These terms have been explained in many cases and much of what has been said in the cases has been applied often enough to be accepted as settled law. I will therefore not dwell on the cases as to the meaning of a conveyance, transfer, charge or obligation. However, in the context of banking transactions, an interesting question has recently arisen as to whether the nature of the transaction in question constituted a payment to the bank by the insolvent debtor. I will take a little time to consider two recent cases: *Ramsay v National Australia Bank Ltd* [1989] VR 50 and *National Australia Bank Ltd v KDS Construction Services Pty Ltd* (1987) 163 CLR 668, in each of which the bank was successful in defeating the claims of the liquidator for recovery of an alleged preferential payment.

Usually it will not be difficult to establish whether a transaction constitutes a payment. Indeed the word "payment" has been held in the cases to have the widest significance: *Re Hardman* (1932) 4 ABC 207, at p 210. The section seeks to catch not only direct payments by the debtor but also indirect payments by third parties on behalf of the debtor or by his direction or acquiescence: *Re Stevens* (1929) 1 ABC 90; *Re Ruwaldt* (1931) 3 ABC 245; *Re Smith* (1933) 5 ABC 49; *Re Lynch* (1937) 9 ABC 210. However, *Ramsay v National Australia Bank Ltd* shows how an arrangement may be devised to effect payment by a debtor to a preferred creditor falling outside the scope of s 122.

The facts of *Ramsay* were these: A company, Distributors, was a customer of the bank which had extended to the company an overdraft facility. As at the end of March 1984, the overdraft with the bank stood at $32,000. As at that date, Distributors owed a trade creditor approximately $70,000. It was found that as at March 1984, the company was legally insolvent.

By an agreement of 31 March 1984, Distributors sold to a related company, Industries, for $1 the whole of its undertaking. Under the agreement, Industries covenanted to take over the liabilities of Distributors and to indemnify Distributors in respect of them. The purpose of the arrangement was to defeat the claim of the trade creditor who was owed $70,000.

The transaction was effected without the knowledge of the bank. In August 1984, the bank lent to Industries (the purchaser of Distributors' business) by way of bills and overdraft facility the sum of $50,000 and the bank credited the $50,000 so lent to

Distributors' account thus extinguishing the overdraft. Within 6 months of this transaction Distributors commenced to be wound up.

The liquidator challenged the payment by Industries to the bank as an undue preference. It was argued on behalf of the liquidator that the payment by Industries to the bank of $50,000 extinguishing the overdraft was in truth a payment by Industries on behalf of Distributors to the bank.

The trial judge, Marks J, and the Full Court of the Supreme Court of Victoria, rejected the liquidator's claim. It was held that the payment was not made by or on behalf of Distributors. It was made by Industries to discharge a contractual obligation it had to Distributors to discharge Distributors' debt to the bank. The payment was therefore a payment by Industries and not by Distributors, and therefore not caught by s 122.

The proposition laid down by the Full Court was as follows:

> "A payment out of his own money by B to C, pursuant to an obligation imposed by contract between A and B to discharge A's debt to C is not a payment made by A to C within the meaning of s 122".

The question of whether a transaction constituted a payment is important not only to determine whether the transaction is within the section and to fix the date of payment as being within the six months period, but also for the purpose of determining whether the payment constituted by the transaction was received in good faith in the ordinary course of business. *National Australia Bank v KDS Construction Services* shows that if payment was received on day one, it would have been received in the ordinary course of business, but if it was received on day two, it would not.

In that case, the bank's customer, on 3 September 1981, deposited a cheque of approximately $100,000 in its account with the bank. The effect of the deposit was to extinguish the overdraft and leave the account in credit to the extent of some $30,000. The trial judge accepted that when the deposit was made on 3 September 1981, it was received by the bank in good faith and in the ordinary course of business and the bank had no reason to suspect that the customer was in financial difficulties.

However, after the deposit was made on 3 September but before the cheque was cleared through the clearing house system, the director of the customer had a conversation with the bank's manager which caused the manager to suspect that the customer could not pay its debts. The next day, 4 September, the cheque was cleared.

If payment was held to have occurred upon the deposit of the cheque on 3 September, the bank would have received payment in good faith and in the ordinary course of business and it could then have relied upon the protection in sub-s 122(2)(a).

However, if payment was held to have occurred only upon clearance of the cheque the protection would not apply to the bank and it would be required to disgorge the preference.

The High Court held that on the facts of that case, payment did not occur until after clearance. There was nothing in the contract between the bank and its customer to exclude the prima facie rule that upon deposit the bank was only an agent for collection, and the customer was not entitled to draw against the proceeds of the cheque before clearance. Hence, the deposit of the cheque on 3 September did not amount to a payment on that day. Payment occurred on the next day when the bank was aware of the customer's financial difficulty. Hence, it could not rely on the protection in sub-s 122(2)(a).

In the end, the bank was saved from disgorgement by its lien. The court held that the bank had a lien over the cheque for the general balance of moneys due from the customer, and applied *In re Keever* [1967] Ch 182 which decided that so long as the cheque was received in good faith and in the ordinary course of business, a payment made to the collecting bank by the paying bank in discharge of that lien cannot amount to a preference, priority or advantage.

INSOLVENCY

The next step in the process of attacking a payment as a voidable preference is to prove that, as at the date of payment, the company was in fact unable to pay its debts as they became due from its own money, that is to say, it was insolvent. The onus is again on the liquidator.

Here again, the phrase "unable to pay ... debts as they become due from ... own money" has been explained in many cases in the High Court and other courts, and the meaning and import of the phrase should now be regarded as well settled.

The most favourable explanation of this phrase from a creditor's point of view, and the most frequently applied, is that of Barwick CJ in *Sandell v Porter* (1965) 115 CLR 666. Other important pronouncements appear in *Rees v Bank of New South Wales* (1964) 111 CLR 210, again by Barwick CJ and *Hymix Concrete Pty Ltd v Garritty* (1977) 13 ALR 321, by Jacobs J. The following propositions can be distilled from the cases.

You must consider the debtor's financial position in its entirety. You do not undertake a mechanical comparison of assets and liabilities. You must consider the nature of the assets and how realisable they are, and in the case of a trader the nature of his business. You must consider the nature of the debts or liabilities and when they are to be paid or satisfied.

A debtor's own moneys for the purposes of the section are not limited to his cash resources immediately available. They include moneys which he can procure by realisation by sale or by mortgage or pledge of his assets within a relatively short time. That is to say they include such cash resources as he can command by use of his assets.

Generally speaking the conclusion of insolvency ought not to be drawn from evidence of a temporary lack of liquidity. But a temporary lack of liquidity must be distinguished from an endemic shortage of working capital whereby liquidity can only be restored by a successful outcome of business ventures in which the existing working capital has been deployed.

It is appropriate to consider the terms of credit available to the debtor in the sense of the time available to him to pay debts owed to creditors.

Money which can be raised by unsecured borrowings is not treated as the debtor's own money. This was so held in *Re Armour* (1956) 18 ABC 69, at p 74, and it seemed to follow from Barwick CJ's statement in *Sandell v Porter* that a debtor's money includes money he can obtain by mortgage or pledge of his assets. More recently, in *Taylor v ANZ Banking Group Ltd* (1988) 13 ACLR 780, at p 784, it was expressly held that "money obtainable by unsecured borrowing is not treated as the debtor's own money", and Burt CJ, in the Western Australian Supreme Court was of the same view in *Kyra Nominees Pty Ltd v National Australia Bank Ltd* (1986) 4 ACLC 400, at p 405.

Why should this be so? What is the logic behind the rule? This is a question which this conference might wish to take up.

Take the case of a company, which on an objective analysis of the facts, is unable to pay its debts from its own money under the received doctrine. But its creditors, mainly its bankers, are so confident in its management and in its prospects of overcoming its financial difficulties that they are prepared to lend to it on an unsecured basis. Is the company insolvent?

What of the situation where, although the company is insolvent in the received sense, it could raise funds on the security of guarantees by its directors supported by mortgages on the directors' properties? Is the company insolvent?

What if a bank was prepared to lend that company $100,000 on the security of property worth only $50,000, so that there was partial security only?

PREFERENCE

In determining whether a payment had the effect of giving a creditor a preference, there is no difficulty in concluding that that was the effect of the payment where it constituted repayment of the whole or part of a specific debt. Where a payment is made to a trade creditor who continues to supply goods as part of an entire transaction on a running account, or where a payment is made into an overdrawn bank account and the banker continues to permit the account to be overdrawn for further advances, the question has arisen of whether the account should be dissected so as to isolate payments to determine whether the creditor has received a preference. Here again, the most favourable judicial statements for creditors are in the judgments of Barwick CJ in *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 666 and the joint judgment of the High Court in *Richardson v Commercial Banking Company of Sydney Ltd* (1952) 85 CLR 110.

In *Richardson*, the High Court said, at pp 132, 133:

> "In considering whether the real effect of a payment was to work a preference, its actual business character must be seen, and when it forms part of an entire transaction which if carried out to its intended conclusion will leave the creditor without any preference, priority or advantage over other creditors the payment cannot be isolated and construed as a preference.
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> ...
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> But without stating any principle with an application beyond the facts of this case, it is enough to decide that the payments into the office account possessed in point of fact a business purpose common to both parties which so connected them with the subsequent debits to the account as to make it impossible to pause at any payment into the account and treat it is having produced an immediate effect to be considered independently of what followed and so to be adjudged a preference."

To the lastmentioned passage Barwick CJ adds in *Queensland Bacon* at p 284:

> "These expressions were guarded and appear to cover two different types of situation; one in which the payment is part of a larger single transaction and the other where the payment, though in discharge of a specific and identifiable indebtedness, is none the less linked in some fashion with other items in what is described, for want of any more precise nomenclature, as a 'running account'. But though guarded they do indicate that the mere fact that the payment is in discharge of an existing or past indebtedness is not enough to require in all circumstances that the effect of the payment vis-à-vis other creditors and their claims is to be estimated in complete isolation."

Barwick CJ's approach was adopted by Gibbs J in *Re Weiss* [1970] ALR 654.

More recently, Wootten J in *MR Jones Shopfitting Co Pty Ltd v National Bank of Australasia Ltd* (1983) 1 ACLC 946, distilled six propositions of law from the decided cases. They are:

"1. For the purpose of deciding whether a payment is void within s 122 of the *Bankruptcy Act* it is the effect in fact of the making of the payment that is decisive.

2. Where the payment forms part of a wider transaction or where it is sufficiently connected with other items in a running account, it is the effect of the whole transaction, of all the connected items, that has to be regarded.

3. The mere fact that a payment is in discharge of an existing or past indebtedness does not necessarily mean that its effect has to be considered in isolation.

4. In deciding whether payments are so integrally connected with counter payments that the ultimate effect of the course of dealings has to be considered to determine whether the payments are preferences, it is necessary to look at their business purpose or business character.

5. It is not necessary that a payment should have been made under express arrangements for the continuation of the relationship reflected in the running account, eg. continuance of supply. It is enough if implicitly in the circumstances in which the payment is made is a mutual assumption by the parties that there will be a continuance of the relation of debtor and creditor in the running account.

6. The mere fact that a payment is made on a running account does not protect it from scrutiny and if a point comes where payments are made with a view to terminating the running account, or greatly reducing the level of credit granted on the account, the effect of these payments may be a preference. It follows that the liquidator can choose any point during the statutory period in his endeavour to show that from that point on there was a preferential payment. However, this does not mean that the connection between such a payment and dealings prior to the chosen date is to be ignored."

PROTECTED TRANSACTIONS

If the liquidator establishes each of the elements of sub-s 122(1), the onus shifts to the alleged preferred creditor to show that it was a payee (i) in good faith, (ii) for valuable consideration, and (iii) in the ordinary course of business.

PAYEE IN GOOD FAITH

The first element in the protection is that the preferred creditor was a payee in good faith. A creditor receives a payment in good faith if he did not know that the debtor was insolvent and that a preference has been given. So the requirement of good faith, in the absence of collusion, concerns the payee's knowledge of the actual circumstances in which the payment is made. The good faith is the payee's. This element therefore ties in with the deeming provision in sub-s 122(4)(c) which deems a creditor not to be a payee in good faith if, objectively speaking, the payment was made under such circumstances as to lead to the inference that the creditor knew or had reason to suspect that -

(i) the debtor was insolvent; and

(ii) the effect of the payment would be to give him a preference.

Generally speaking a creditor will establish good faith if the circumstances do not lead to those inferences.

So the initial enquiry under s 122(4)(c) is as to the circumstances under which the payment was made:

> "The character of the circumstances is what has to be decided: were they such as to lead to the specified inference? The inference is that the payee had cause to suspect the existence of two states of fact. As to the first, the word 'unable' must be given its full force. The second goes further: it is that the payer's affairs are in such a state that acceptance of the payment (assuming that it would be allowed to stand) would put the payee in a better position vis-à-vis the other creditors than he would be in if the payer were bankrupt or, in the case of a company, were in liquidation. If the proper inference from the circumstances is that there was a sufficient reason for the payee to form an actual suspicion - a real apprehension though with insufficient warrant for a positive conclusion - that the situation had both these features, he is debarred by sub-s (4) from being deemed a payee in good faith. Otherwise he is not."
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> *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266, per Kitto J, at p 303.

The first task is to establish what the payee knew about the financial position of the creditor at the time he accepted the payment. What the creditor knew is a matter of fact. In the case of a corporation, what it knew is what its officers and agents knew. If the relevant person knew that the debtor was insolvent and that the payment would be preferential, that will be the end of the matter.

More usually the payee does not know of the insolvency until after the payment is accepted. Then it becomes necessary to ask whether the payee had reason to suspect insolvency (and preference). The criterion of what the creditor had reason to suspect involves the application of an objective test. In

Queensland Bacon Pty Ltd v Rees (1966) 115 CLR 266, at p 303 Kitto J explained it this way:

> "A suspicion that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of actual apprehension or mistrust, amounting to 'a slight opinion, but without sufficient evidence'. ... Consequently, a reason to suspect that a fact exists is more than a reason to consider or look into the possibility of its existence. The notion which 'reason to suspect' expresses in sub-s (4) is, I think, of something which in all the circumstances would create in the mind of a reasonable person in the position of the payee an actual apprehension or fear that the situation of the payer is in actual fact that which the sub-section describes - a mistrust of the payer's ability to pay his debts as they become due and of the effect which acceptance of the payment would have as between the payee and the other creditors."

A recent application of this test will be found in the decision of McGarvie J in *Taylor v ANZ Banking Group Ltd* (1988) 13 ACLR 780.

The test is an objective one, but the conduct of the payee can be of considerable relevance:

> "What the payee or anyone else inferred at the time is not to be treated as decisive, though the Court may be assisted in reaching its own conclusion by seeking how business men in fact reacted to the circumstances."

As with actual knowledge, a corporation can have "reason to suspect" only through its officers and agents.

VALUABLE CONSIDERATION

The next element in the protective provision is that the creditor be a payee for valuable consideration. I do not pause to discuss the meaning of this term save to say that the cases show that it bears its ordinary common law meaning of benefit received or detriment suffered.

ORDINARY COURSE OF BUSINESS

So I turn to consider the final element in the protective provision, namely that the creditor be a payee in the ordinary course of business. It is in relation to the meaning of the term "in the ordinary course of business" that difficulties have arisen. In this regard I should refer to a passage in the judgment if Rich J in *Downs Distributing Co v Associated Blue Star Stores Ltd* (1948) 76 CLR 463. Rich J explained that this criterion:

> "... does not require that the transaction shall be in the course of any particular trade, vocation or business. It

> speaks of the course of business in general. But it does suppose that according to the ordinary and common flow of transactions in affairs of business there is a course, an ordinary course. It means that the transaction must fall into place as part of the undistinguished common flow of business done, that it should form part of the ordinary course of business as carried on, calling for no remark and arising out of no special or particular situation." (76 CLR, at p 476).

It is important not to mistake the thrust of words such as "undistinguished common flow" and "calling for no remark", and to think that that cannot be true of large transactions which have been the subject of media attention. Transactions may be large and may be the subject of public attention and remark, and yet be in the ordinary course of business. I do not think that Rich J intended to exclude such transactions. In my view large transactions, and transactions the subject of public attention, can occur in the ordinary course of business. In *Robertson v Grigg* (1932) 47 CLR 257 Gavan Duffy CJ and Starke J put it:

> "... the test under s 95 of the ordinary course of business is not whether the act is usual or common in the business of the debtor or of the creditor, but whether it is 'a fair transaction, and what a man might do without having any bankruptcy in view.'"

In *Burns v McFarlane* (1940) 64 CLR 108, Rich J himself and Dixon and McTiernan JJ joined in saying:

> "(The expression) ... does not require an investigation of the course pursued in any particular trade or vocation and it does not refer to what is normal or usual in the business of the debtor or that of the creditor." (64 CLR, at P 126).

Starke J repeated the test as stated by Gavan Duffy CJ and himself in *Robertson v Grigg*. In *Downs Distributing* itself Williams J put it:

> "It seems to me, therefore, that the expression refers to a transaction into which it would be usual for a creditor and debtor to enter as a matter of business in the circumstances of the particular case uninfluenced by any belief on the part of the creditor that the debtor might be insolvent." (76 CLR, at p 481).

That approach seems to me authoritatively established and correct. I do not think that Rich J meant anything else, in the attractive but reasonably vague passage I have cited. If he did, it is contrary to authority, including his own.

In my view, accordingly, the facts that a transaction was large, that it involved a company in the public eye, and that it attracted media attention, are in themselves irrelevant to the question of whether it took place in the ordinary course of business. I emphasise this because many liquidators have taken the view that such transactions are not in the ordinary course of business.

Does the expression direct attention to the mind of the creditor or to the mind of the debtor or to both? Suppose a debtor company intended, in making a payment, to prefer a creditor, say because the debtor wanted guarantees by its directors discharged, but the creditor in receiving payment knew nothing of this intention. Is the creditor a payee in the ordinary course of business?

In my view, the test directs attention to the mind of the creditor; indeed Williams J spoke in terms merely of the creditor. There is also some authority - not very strong I believe - that it is the mind of the debtor which is determinative. That was certainly said by Taylor J in *Taylor v White* (1964) 110 CLR 129, at pp 149-154. Chief Justice Dixon in my view did not say that, when he contrasted the test "transactions regularly taking place in a sustained course of activity or some usual process naturally passing without examination", with the facts of the case:

> "... a family transaction in which a son-in-law, with the help of his wife, decided to borrow money from his mother-in-law for his company and then attempted to effect its repayment in the fact of approaching disaster." (110 CLR, at p 136).

Kitto J (dissenting) rejected the suggestion. Menzies and Windeyer JJ were not very clear. In *Kyra Nominees Pty Ltd v National Australia Bank Ltd* the Full Court of the Supreme Court of Western Australia applied what it found to be a rule laid down in *Taylor v White*, along the lines of what Taylor J said. It is true that special leave to appeal to the High Court was refused. But that does not mean that that court approved *Kyra Nominees* in its reliance on *Taylor v White*. On the contrary, the Chief Justice, speaking for the court in refusing special leave, went out of his way to make it plain that errors did occur in what was said in *Taylor v White*. His Honour said that things said in *Taylor v White* did require reconsideration by the court, by that *Kyra Nominees* was not a suitable vehicle for that challenge because the findings of fact by the Supreme Court of Western Australia were not clear. That was far from an endorsement of *Taylor v White* or of *Kyra Nominees*.

For myself I would doubt that any special weight attaches to the mind of the debtor. I would have thought the reverse. The protective provision in sub-s 122(2) speaks of "Nothing in this section [affecting] the rights of a ... payee ... in good faith and for valuable consideration and in the ordinary course of business". What the payee has to show is that the payment was *received*, not that it was *made*, in the ordinary course of business.