The "Ordinary Course of Business" Test for Voidable Preferences.

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INTRODUCTION

Section 292 of the Companies Act 1993 ("the Act") prescribes the circumstances in which a voidable transaction may be set aside by a liquidator. It is a section which has been subject to much litigation since the passing of the Act. It is also one which has occupied many academic minds.

Much of this attention has been given to attempting to resolve the question of what is "in the ordinary course of business". This phrase forms the crux of section 292. Under section 292(2) a transaction by the company which would otherwise be void under the statutory regime (and thus able to be set aside by the liquidator), will not be set aside if it was in the ordinary course of business. Clearly, the meaning of the phrase is fundamental as it is likely to form the basis of any application to reverse a liquidator's decision to set aside.

So why has the "ordinary course of business" proved so problematic? The problem facing the profession, the judiciary and the business community is framed nicely by the words of Barker J:[1]

> The phrase immediately invites the query whether it refers to some vague general commercial criterion of the ordinary course of business; whether it is confined to the practice in a particular trade or industry or commerce in general; or whether the ordinary course of business is to be assessed from a subjective viewpoint, i.e. the ordinary course of business between two particular parties.

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[1] *Re NZ Spraybooth Ltd (in liq)* (1996) 7 NZCLC 261,075

This paper is primarily concerned with answering the question: how do we assess the "ordinary course of business"? Then, it will consider the more fundamental question of whether the test, so framed and applied, is useful to parties involved in liquidations?

SECTION 292 OF THE COMPANIES ACT 1993

Section 292 of the Act allows liquidators to void transactions such as payments made to a creditor if, at the time of the transaction, the company was insolvent and the transaction was not in the "ordinary course of business". The section marks a radical change from the previous legislation, under the 1955 Companies Act.

Previously, such a payment could only be set aside as a voidable transaction if there was an intention on the part of the company to prefer the particular creditor.[2] It was relatively easy for a creditor who had received a payment to assert that there was "no intention to prefer". Unless a liquidator could prove such an intention, the transaction was not voidable.

Under the 1993 Act, if the payment is made within six months of liquidation, it is presumed not to be in the ordinary course of business.[3] The 1993 Act has reversed the presumption from one of non-voidability to one where all transactions in the specified period are presumed void, unless they are shown to be otherwise.

In practice, the principal effect of inverting the presumption is that liquidators feel more comfortable serving notices setting aside transactions. This is clear from the marked increase in applications arising from liquidators' notices. This is reflected in the more than 20 "voidable preference" judgments noted in the weekly editions of "The Capital Letter" in 1998.

The current presumption places creditors in a novel position for this area of the law: they must now defend payments made to them during the last six months of a company's

[2] See s309 Companies Act 1955
[3] Companies Act 1993, s292(2) and (3)

existence. The usual basis of any defence to the voiding of a payment will be that it was part of the ordinary course of business. Hence, the definition of that phrase is pivotal.

JUDICIAL DEFINITIONS

Since the passing of the legislation, there have been several judicial approaches to the definition of the "ordinary course of business". There has been a degree of oscillation in judicial opinion between an objective and a subjective test and the issue does not appear to be resolved. The following cases highlight these changes.

Downs Distributing v Associated Blue Star

The usual starting point in an assessment of the meaning of "ordinary course of business" is the judgment of the High Court of Australia in *Downs Distributing*.[4] This expresses the test used in Australia from 1924, until it was removed from the Australian legislation in 1993. The reason for the change in Australia was, apparently:

> ...principally, because of the judicial uncertainty in interpreting what was meant by the phrase. It is undeniable that there has not only been uncertainty, but also confusion.[5]

Downs Distributing is cited extensively in New Zealand, for example see *Builders Hardware v Steel*.[6] For all the persuasive power of the Australian experience, however, it is interesting to note that Australia removed this test from its companies law as New Zealand was adopting it in our own.

The view taken by the High Court of Australia in *Downs Distributing* is objective and one distanced from the individual industry in which the business is taking place. It holds that:

> ... the transaction must fall into place as part of the undistinguished common flow of business done ... it should form part of the ordinary course of business as carried on..."

Thus, the Court is asking whether the transaction in question is one which would have taken place between two solvent traders. It does not ask whether the payment is normal practice for

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[4] *Downs Distributing Co Pty Ltd v Associated Blue Star Stores Pty Ltd (in liq)* (1948) 76 CLR 463
[5] Keay, "An Exposition and Assessment of Unfair Preferences" (1994) 19 MULR 545,572
[6] *Builders Hardware Co Ltd v Steel* (HC, Christchurch, M386/94, 15 March 1995, Hansen J)

the particular debtor or creditor or even for the industry. In applying this test, judicial scrutiny turns to the terms for payment and whether it was made on or before the due date.

The *Downs Distributing* test has been accepted and applied in the New Zealand courts during the teething period for the application of section 292. It was affirmed and applied here in the Court of Appeal decision in *Countrywide Banking v Dean*.[7] The Court of Appeal considered the *Downs Distributing* test to be an "objective and general one" which is not concerned with the business of particular parties to the transactions.

Countrywide Banking v Dean in the Privy Council

However, this objective and general approach was modified by the Privy Council in its decision on appeal from the Court of Appeal's decision in *Countrywide Banking v Dean*.[8] Although dismissing the appeal, the Board preferred a less purely objective view, considering that:[9]

> Their Lordships do not accept ... that the test is general in the sense that it would be satisfied so long as it can be said that the transaction is one which might reasonably take place in some business setting. To abstract the particular business setting and inquire (in effect) merely whether it is possible to envisage a setting in which the transaction would be an ordinary one is not what the statute requires...
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> ... the transaction must be such that it would be viewed by an objective observer as having taken place in the ordinary course of business. While there is to be reference to business practices in the commercial world in general, the focus must still be the ordinary operational activities of businesses as going concerns, not responses to abnormal financial difficulties.

The Board looked favourably on the New Zealand High Court judgment of Fisher J in *Re Modern Terazzo Ltd (in liq)*.[10] Andrew Beck writes that the Privy Council adopted the "much more individual line" of *Modern Terazzo*. He welcomes the move, thinking it unrealistic to suggest that a proper determination can be made without examining the precise context in which the particular transaction was made.[11]

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[7] *Countrywide Banking Corporation Ltd v Dean* (1997) 8 NZCLC 261,325 (CA)
[8] *Countrywide Banking Corporation Ltd v Dean* [1998] 1 NZLR 385 (PC)
[9] Ibid, at p394/14-19 and 27-35
[10] (1997) 8 NZCLC 261,478
[11] Andrew Beck, "Casenote - *Countrywide Banking Corp v Dean*" (1998) 4 CSLB 47 at 48.

This is a persuasive argument and it was echoed in the earlier decision of Potter J in *Re Inspiration Homes (in liq)*.[12] Justice Potter made a pertinent observation that:[13]

> It would be unrealistic to suggest that there is a single course of business within the commercial community against which the conduct of each and every business, and each and every business transaction can be objectively measured. The "common flow of business done", the "ordinary and common flow of transactions and affairs of business", "calling no remark", as articulated by Rich J [in *Downs Distributing*] must be considered in the particular circumstances of each case.

Andrew Beck argues that this is exactly what was done in *Countrywide Banking v Dean* by the Privy Council. Moreover, he sees it as helpful and capable of application in a wide variety of contexts.[14] Lynne Taylor also views *Countrywide Banking v Dean* positively, stating that the test is laid down with sufficient precision as to be useful to liquidators, creditors and their advisors.[15]

However it is contentious whether the Privy Council's test has the precision required to promote ease of dealings and good business practice. The Privy Council refused to articulate any criteria or general statement of the law for the assessment of "the ordinary course of business". Their Lordships preferred not to adopt any particular formulation of the rule. Their argument was simple:[16]

> There are difficulties in drawing upon formulations in different words of statutory tests and treating them as applicable in all circumstances. Such difficulties are increased where those formulations originate in different legal or factual contexts. This is particularly so where the test is essentially one of fact in any event.

However, considering the volume of litigation which has followed the law change, there is a need for a clear formulation of the requirements. The argument for simplicity has been noted, but not adopted, in later decisions, such as the Court of Appeal's decision in *Meltzer v Attorney General*.[17] There the Court of Appeal rejected any attempt to formulate criteria on

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[12] (1997) 8 NZCLC 261,413
[13] Ibid. at 261,417
[14] Supra. n 11
[15] Lynne Tayor, "Voidable Preferences and the Ordinary Course of Business Exception" (1998) 6 Insolvency Law Journal 143 at 151.
[16] Supra. n 8 at p 394/5-8)
[17] *Meltzer v Attorney General* (CA216/98, 3 May 1999, Doogue J)

which an alleged voidable preference could be assessed. The Court was very clear in its position:[18]

> To add glosses to what is there...would result in an unnecessary over-refinement of the law in an area where the practical day to day decisions have to be made in respect of a very wide range of circumstances and monetary sums.

There is weight in this argument but the practical effect of refraining from listing criteria appears to be that parties in a liquidation do not (or cannot) decide the matter amongst themselves but rather can only have recourse to the Courts, because the issue is so discretionary that the parties and their advisors are not in a position to decide themselves. A clearer guide for the parties (if one could in fact be formulated) would clearly be desirable to avoid the cost and expense of court proceedings. That goal may not be aided by an approach that avoids establishing criteria.

The approach of The Privy Council in *Countrywide Banking v Dean* would appear to have benefits in addressing the variety of practices which exist in the business world. By adopting a degree of subjective assessment. the possible harshness to creditors of the application of this rule is somewhat ameliorated. Creditors would not be penalised for adopting a procedure which followed their industry's norms rather than strict business conventions. However. Lynne Taylor's view of the degree of certainty it will create in the business community is questionable. It is inherent in the variety of practices adopted that there will be uncertainty. By refusing to adopt criteria which would guide parties, the Courts do little to address this uncertainty. Lacking this criteria, it is likely that parties will need to have recourse to the Courts to decide what is "ordinary".

It will take considerable time for a body of decisions to form which addresses the many types of transactions in the plethora of industries and business which are affected by the "voidable preferences" regime. It will be necessary to compile schedules of what is "in" and what is "out", then to attempt to find common factors which can be used with some faith for the purposes of prediction. Even then, if it is financially viable for a party, it is likely that there will be attempts to distinguish earlier decisions.

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[18] Ibid. at p 7

Re Anntastic Marketing

However, the judiciary have not all been content to leave the formulation of this test with the Privy Council *Countrywide Banking v Dean* approach. In *Re Anntastic Marketing* [19], Baragwanath J offered some assistance with the formulation of criteria. Justice Baragwanath said:[20]

> The matter is to be viewed from the standpoint of an objective observer having the knowledge possessed by the trader of any previous course of dealings by the company and any relevant practices within the industry.

and

> The use of such general language as "ordinary course" leaves to the Courts the task of providing the concept with specificity. Since commerce takes many forms and usually occurs without legal advice, the test must in practice be one that conforms with the ordinary person's sense of business morality. Traders and their advisors need a reasonable basis to discern when they can and cannot be confident that the transaction will stick as against the liquidator.

Usefully, His Honour offered some "pointers to liability" (the result of a compilation of recent cases, looking for common factors), so as to better assess whether a payment is not in the "ordinary course":

- The recipient is not shown to have honestly believed that the transaction involved no element of undue preference;
- The payment is atypically prompt or large compared with the established patterns;
- The conduct is suggestive of response to abnormal financial difficulties;
- The degree of pressure to which the creditor has had recourse indicates abnormal circumstances;
- The creditor has departed from its usual practice of recovering debt.

In *Anntastic*, Baragwanath J employed as a test whether the trader:[21]

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[19] *Re Anntastic Marketing Ltd (In Liq)* (HC, Auckland, M468/97, 9 September 1998, Baragwanath J)
[20] Ibid. at p 8, 10
[21] Ibid. at p 11

> .... subjectively was, or objectively ought in the particular circumstances to have been, alerted to real risk that the transaction was abnormal *for reasons of financial weakness*. Other forms of want of ordinariness do not bear on the mischief at which the provision is directed (original emphasis).

While Baragwanth J's analysis gives some clarity and definition to the "requirements" for a voidable preference which is avoided in other judgments, the question remains whether this is an equitable way to decide whether a payment should be clawed back? Justice Baragwanath is anxious that procedures should be equitable. He states that the rationale for voidable preferences is that all creditors of an insolvent company should be dealt with equally.

So, let us consider whether, for example, this approach penalises those recipients who have received payment as a result of diligent credit control. Considering the examples below, it would seem so:

- For instance, say a debtor usually pays promptly, but then does not for, say, two months. After intervention by the creditor's credit controller, payment is made of all outstanding amounts (a reasonably "ordinary" set of events, one would have thought). When the debtor goes into liquidation a couple of months later, the liquidator serves a notice, and the payment is voided. The liquidator could say that the creditor was "aware of financial weakness".
- Compare that to a debtor who is almost always in the 60-90 day category, and has always paid in sporadic "lump" sums. In the particular industry, that is not uncommon. The last payment was within a month or two of liquidation. The liquidator serves a notice, but the payment is not voided, because it is in the "ordinary course". Although the creditor has never been paid regularly, it cannot be said that it subjectively was, or objectively ought to have been alerted to the abnormality of the payment, for reasons of financial weakness.

Justice Baragwanath's approach may in fact work against the interests of a diligent creditor. For while Baragwanath J states that he is motivated by a wish to create equity, it is an equity between the creditors following a company being put into liquidation. He feels it is unfair for one creditor to steal a march over other creditors by jumping the queue. He refers to the need to remember the "faceless unfortunates", represented by the liquidator, when dealing with

claimants who received payment from an insolvent company and face the prospect of having to repay the money received. In Baragwanath J's view, the "ordinary course" exception is a "privilege".

But is it fair to claw back payments from an honest recipient who has done no more than exercise diligent credit control? Should such creditors be penalised in order to benefit those who allow debts to bounce along with erratic payment?

The approach adopted by Baragwanath J may ensure "equity" between creditors in a liquidation by creating an inequitable situation for diligent creditors. Arguably it may also represent a tendency towards the former subjective test.

PROBLEMS REMAIN

It is clear from a consideration of the authorities that problems remain with the application of s292 of the Companies Act and the "ordinary course of business" test. For all the time and energy spent on defining this pivotal term, and attempting to apply it in practice, there is as yet no result which is satisfactory to all.

The approach favoured by the Privy Council in *Countrywide Banking v Dean*, recently endorsed by the Court of Appeal in *Meltzer v Attorney General*, (which did not refer to *Anntastic*) leaves a good degree of uncertainty. It does not tell us whether a particular transaction is "in" or "out". The definitions seem to work on the principle of "we will recognise it when we see it". This approach provides little assistance for lawyers and their clients.

The approach of Baragwanath J in *Anntastic Marketing* creates a situation which can penalise diligent creditors merely for being diligent and effective in their credit control.

Thus it appears that for all the litigation that has discussed this point in the last five years, we have not heard the last of it. Section 292 is likely to remain problematic for some time yet, whichever side of the liquidator/recipient line you are on.

WHERE TO FROM HERE?

The conclusion must be that the "ordinary course of business" exception introduced into the New Zealand companies legislation has not succeeded. It has led to uncertainty such that companies, liquidators and their respective advisors cannot readily determine when a transaction comes within the exception.

It is not suggested that we go back to the prior "intention to prefer" test. Perhaps the solution is to follow the trend of harmonisation of Australian and New Zealand law and align our voidable preference regime with Australia's. Clearly discussion is desirable.