

**‘Don’t take a slice of my pie’: Defending Your
Position as an Unsecured Creditor of a Company
in Liquidation**

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Table of Contents

| | | |
|------------|---|-----------|
| 1. | Introduction | 2 |
| 2. | Powers of the Court to set aside transactions | 3 |
| 3. | When is a transaction a ‘voidable transaction’? | 4 |
| 4. | When is a transaction an ‘insolvent transaction’? | 5 |
| 5. | Section 588FA: unfair preferences | 6 |
| 6. | Section 588FB: uncommercial transactions | 6 |
| 7. | Section 588FG: defences to voidable transactions | 7 |
| 7.1 | Defence for a party to the voidable transaction | 7 |
| 7.2 | Defence for a non-party | 8 |
| 8. | Basic principles relating to the defences to voidable transaction claims | 8 |
| 9. | Avoiding the company going into liquidation | 8 |
| 10. | Avoiding the debtor/unsecured creditor relationship | 9 |
| 10.1 | Obtain security | 9 |
| 10.2 | Cash on delivery | 14 |
| 10.3 | Retention of title | 14 |
| 10.4 | Get paid by a third party or under a bank guarantee or letter of credit | 15 |
| 10.5 | The trust idea | 15 |
| 11. | The running account | 17 |
| 12. | At what time will the Court assess whether or not a creditor had reasonable grounds to suspect insolvency? | 18 |
| 13. | Long-term late payment does not equal suspicion of insolvency | 20 |
| 14. | <i>Beveridge v Whitton</i> – the doctrine of ultimate effect as a stand alone defence | 22 |
| 14.1 | What is the doctrine of ultimate effect? | 22 |
| 14.2 | <i>Beveridge v Whitton</i> (as liquidator of HSBB Pty Ltd) | 22 |
| 15. | <i>Jonsson v Ferrier</i> – preference claims – availability of recoveries to secured creditors and set-off | 23 |
| 15.1 | The law | 23 |
| 15.2 | Can a preference claim be set-off by a creditor under s553C? | 24 |
| 15.3 | Re ACN 007 537 000 Pty Limited; Ex parte Parker | 25 |
| 15.4 | Jonsson v Tim Ferrier Pty Ltd | 27 |
| 16. | Conclusion | 28 |

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1. Introduction

The reason why we have provisions like uncommercial transaction and unfair preference provisions is that we want to see the money and assets of companies which are insolvent shared fairly. These provisions aim to stop people dealing with insolvent companies from getting unfair or uncommercial benefits which are not available to unsecured creditors generally.

In this paper we will first give an overview of the provisions dealing with preferences and uncommercial transactions before looking at some of the ways in which an unsecured creditor might go about avoiding in the first place or defending an unfair preference action including:

- avoiding the debtor company going into liquidation; and
- avoiding the debtor/unsecured creditor relationship.

The paper considers then:

- the running account;
- when a person might not have reasonable grounds to suspect insolvency;
- the doctrine of ultimate effect as a stand alone defence to a preference action; and
- whether or not a creditor can set off a preference claim against money owed to it by the debtor.

The *Corporations Act 2001* (“the Act”) gives liquidators a wide range of powers to ask a Court to set aside or vary transactions that have been entered into by insolvent companies that are subsequently wound up.

The ability of a liquidator to seek Court orders to set aside transactions entered into by an insolvent company is governed by Part 5.7B Division 2 of the Act. Amongst other things, a liquidator can seek to set aside what are known as ‘unfair preferences’ and ‘uncommercial’ transactions, and recover the proceeds for the benefit of the general body of unsecured creditors. The rationale behind this statutory regime is to ensure that unsecured creditors are not prejudiced by the disposition of assets or the assumption of liabilities by a company in the period leading up to it being wound up.

2. Powers of the Court to set aside transactions

Where the Court is satisfied that a transaction is a voidable transaction pursuant to s588FE of the Act (discussed in 3 below), it has wide powers to make orders for the benefit of the company's creditors. Amongst other things, s588FF of the Act provides that the Court may direct a person to pay money or transfer property to the company, discharge a debt incurred by the company in connection with the transaction, vary an agreement or declare it void or unenforceable (s588FF).

Section 588FF(1) provides that a Court may make a very broad range of orders which are set out in the Act as follows:

- (a) an order directing a person to pay to the company an amount equal to some or all of the money that the company has paid under the transaction;
- (b) an order directing a person to transfer to the company property that the company has transferred under the transaction;
- (c) an order requiring a person to pay to the company an amount that, in the court's opinion, fairly represents some or all of the benefits that the person has received because of the transaction;
- (d) an order requiring a person to transfer to the company property that, in the court's opinion, fairly represents the application of either or both of the following:
 - (i) money that the company has paid under the transaction;
 - (ii) proceeds of property that the company has transferred under the transaction;
- (e) an order releasing or discharging, wholly or partly, a debt incurred, or a security or guarantee given, by the company under or in connection with the transaction;
- (f) if the transaction is an unfair loan and such a debt, security or guarantee has been assigned – an order directing a person to indemnify the company in respect of some or all of its liability to the assignee;
- (g) an order providing for the extent to which, and the terms on which, a debt that arose under, or was released or discharged to any extent by or under, the transaction may be proved in a winding up of the company;
- (h) an order declaring an agreement constituting, forming part of, or relating to, the transaction, or specified provisions of such an agreement, to have been void at and after the time when the agreement was made, or at and after a specified later time;
- (i) an order varying such an agreement as specified in the order and, if the court thinks fit, declaring the agreement to have had effect, as so varied, at and after the time when the agreement was made, or at and after a specified later time;
- (j) an order declaring such an agreement, or specified provisions of such an agreement, to be unenforceable.

Section 588FF(3) provides that an application under s588FF(1) may only be made:

- (a) within 3 years after the relation-back day; or
- (b) within such longer period as the Court orders on an application under this paragraph made by the liquidator within those 3 years.

This means that a limitation period of 3 years applies to applications by the liquidator of a company to avoid a voidable transaction, unless the liquidator makes an application within that 3 year period for an order extending the time in which the proceedings are to be commenced, and obtains such an order.

Generally speaking, the relation-back day will be the date that an application to wind up the company was filed at Court, or if the company was previously in voluntary administration, the date that the administrator was appointed (see s9 definition of 'relation-back', Part 5.6 Division 1A and s513C).

3. When is a transaction a 'voidable transaction'?

Section 588FE defines voidable transactions, to the extent that an impugned transaction was entered into on or after 23 June 1993.

'Transaction' is broadly defined in s9 of the Act as a transaction to which the 'body corporate' is a party, for example (but without limitation):

- (a) a conveyance, transfer or other disposition by the body of property of the body;
- (b) a charge created by the body on property of the body;
- (c) a guarantee given by the body;
- (d) a payment made by the body;
- (e) an obligation incurred by the body;
- (f) a release or waiver by the body; and
- (g) a loan by the body.

Section 588FE(2) provides that, for a transaction to be a voidable transaction within the meaning of s588FE, it must :

- (a) be an 'insolvent transaction' of the company (discussed in 4 below); and
- (b) have been entered into, or there must have been an act done to give effect to it:
 - (i) during the 6 month period ending on the relation-back day; or
 - (ii) after that day but on or before the day when the winding up began.

Section s588FE(5) (set out below) extends time to 10 years ending on the relation-back date in circumstances where the insolvent transaction was for the purpose of defeating, delaying or interfering with the rights of creditors on the winding up of the company.

The transaction is voidable if:

- (a) it is an insolvent transaction of the company; and
- (b) the company became a party to the transaction for the purpose, or for the purposes including the purpose, of defeating, delaying, or interfering with, the rights of any or all of its creditors on the winding up of the company; and
- (c) the transactions was entered into, or an act done was for the purpose of giving effect to the transaction, during the 10 years ending on the relation-back day.

In a similar way, s588FE(4) (set out below) extends time by 4 years in relation to an insolvent transaction to which a related entity is a party:

The transaction is voidable if:

- (a) it is an insolvent transaction of the company; and
- (b) a related entity of the company is a party to it; and
- (c) it was entered into, or an act was done for the purpose of giving effect to it, during the 4 years ending on the relation-back day.

4. When is a transaction an 'insolvent transaction'?

A transaction will not be voidable unless it is an 'insolvent transaction'. Section 588FC of the Act provides as follows:

A transaction of a company is an insolvent transaction of the company if, and only if, it is an unfair preference given by the company, or an uncommercial transaction of the company, and:

- (a) any of the following happens at a time when the company is insolvent:
 - (i) the transaction is entered into; or
 - (ii) an act is done, or an omission is made, for the purpose of giving effect to the transaction; or
- (b) the company becomes insolvent because of, or because of matters including:
 - (i) entering into the transaction; or
 - (ii) a person doing an act, or making an omission, for the purpose of giving effect to the transaction.

The critical thing here is that at the time of one of these steps the debtor company must be insolvent or be caused to be insolvent by one or more of those things happening. If not the creditor cannot receive an unfair preference for the purposes of the Act. For this reason generally, the key issues in a voidable transaction case relate to the solvency or otherwise of the company. Solvency is defined in s95A of the Act as follows:

- (a) A person is solvent if, and only if, the person is able to pay all the person's debts as and when they become due and payable.
- (b) A person who is not solvent is insolvent.

In a Federal Court decision, *Duncan v Commissioner of Taxation: re Trader Systems International Pty Ltd (in liq)*¹, Justice Young extensively canvassed established principles relating to the determination of a company's solvency for the purposes of the Act including:

- the use of a cash flow rather than a balance sheet approach;
- the consideration of the company's financial position taken as a whole, having regard to commercial realities;

¹ (2006) FCA 885

- the commercial reality that creditors may afford some latitude in terms of time for payment does not warrant a conclusion that a debt is not payable at the time stipulated by the contract;
- a contract debt is payable at the time stipulated for payment in the contract, unless a person asserting otherwise can prove it;
- insolvency is not to be confused with the temporary lack of liquidity;
- it will be a question of fact whether borrowing from a third party amounts to a sufficient basis for concluding that a company is able to meet its debts as and when they fall due; and
- anticipated debts may be taken into account, to some extent, in assessing solvency.

As set out above, an insolvent transaction must be an 'unfair preference' given to the company or an 'uncommercial transaction'. The meaning of these terms is dealt with below.

5. Section 588FA: unfair preferences

An unfair preference is defined in s588FA(1) of the Act. This section provides that:

A transaction is an unfair preference given by a company to a creditor of the company if, and only if:

- (a) the company and the creditor are parties to the transaction (even if someone else is also a party); and
- (b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company;

even if the transaction is entered into, is given effect to, or is required to be given effect to, because of an order of an Australian Court or a direction by an agency.

So the critical things to note here are:

- the company and the creditor have to be parties to the transaction (although, as noted in 3 above, that word has a very broad meaning); and
- that the recipient of the benefit has to be a creditor –
if not there cannot be a preference.

6. Section 588FB: uncommercial transactions

Section 588FB(1) of the Act provides that a transaction of a company is an uncommercial transaction if:

...it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to:

- (a) the benefits (if any) to the company of entering into the transaction; and
- (b) the detriment to the company of entering into the transaction; and
- (c) the respective benefits to other parties to the transaction of entering into it; and

- (d) any other relevant matter.

Section 588FB(2) provides:

A transaction may be an uncommercial transaction of a company because of s(1):

- (a) whether or not a creditor of the company is a party to the transaction; and
(b) even if the transaction is given effect to, or is required to be given effect to, because of an order of an Australian court or a direction of an agency.

Section 588FE(3) (set out below) extends the time period within which voidable transactions which are uncommercial transactions can be set aside to 2 years ending on the relation-back day.

The transaction is voidable if:

- (a) it is an insolvent transaction, and also an uncommercial transaction, of the company; and
(b) it was entered into, or an act was done for the purpose of giving effect to it, during the 2 years ending on the relation-back day.

7. Section 588FG: defences to voidable transactions

Section 588FG sets out defences in favour of persons in relation to 'voidable transactions'.

7.1 Defence for a party to the voidable transaction

If the person against whom the liquidator is proceeding was a party to the voidable transaction, they may have recourse to the defence in s588FG(2). The section provides as follows:

A court is not to make under s588FF an order materially prejudicing a right or interest of a person if the transaction is not an unfair loan to the company and it is proved that:

- (a) the person became a party to the transaction in good faith; and
(b) at the time when the person became such a party:
(i) the person had no reasonable grounds for suspecting that the company was insolvent at that time or would become insolvent as mentioned in paragraph 588FC(b); and
(ii) a reasonable person in the person's circumstances would have had no such grounds for so suspecting; and
(c) the person has provided valuable consideration under the transaction or has changed his, her or its position in reliance on the transaction.

Accordingly, a party to a transaction can successfully defend an allegation that the transaction was voidable if the party can establish that:

- they became a party to the transaction in good faith;
- they had no reasonable grounds for suspecting the company was insolvent or would become insolvent, at the time they entered into the transaction;
- a reasonable person in those circumstances would not so suspect; and
- they provided valuable consideration for, or changed their position in reliance on, the transaction.



7.2 Defence for a non-party

In addition, s588FG(1) provides a defence for persons that were not a party to the voidable transaction, but received a benefit as a result of it. There are very few decided cases on this issue. Perhaps this is because, as a matter of practicality, it is unlikely that a liquidator will pursue a third party in relation to a voidable transaction when he or she is able to pursue a party to the transaction instead.

8. Basic principles relating to the defences to voidable transaction claims

The following are fundamental aspects of the defences:

- the onus of proving the defence rests with the person claiming the defence (*Levi v Guerlin*²);
- the requirement of good faith is to be given its natural meaning (*Re Ermayne Pty Ltd*³; *Sutherland v Eurolinx Pty Ltd*⁴) and is a subjective test (*Downey v Aira Pty Ltd*⁵);
- some factual basis for a 'suspicion' must be shown and the court's consideration is to be made without applying hindsight. An actual apprehension or mistrust will suffice, and clear proof of the negative propositions in paragraph 588FG(2) is required before the creditor can make out the defence: *Wily (as joint liquidators of Boutique Resorts Management Pty Ltd) v Commissioner of Taxation*⁶.

9. Avoiding the company going into liquidation

The first and critical thing to note about voidable transactions is that the provisions in the Act only arise if the company goes into liquidation – if a receiver or a voluntary administrator is appointed or the company enters into a Deed of Company Arrangement ("DOCA") or the company simply continues on under the control of its directors and never enters liquidation no one ever has power to ask the Court to give relief in reliance on the voidable transaction provisions of the Act.

So it sounds a bit trite but if you have received a substantial preference or entered into an uncommercial transaction you might want to think carefully before taking steps to force that company into liquidation by, for example, issuing a statutory demand or bringing a winding up application. Similarly if the company goes into voluntary administration you might want to carefully consider any DOCA which is proposed or indeed you might want to propose a DOCA yourself.

² (1997) 24 ACSR 159; 15 ACLC 913

³ (1999 30 ACSR 330

⁴ [2001] NSWSC 230

⁵ (1996) 14 ACLC 1068

⁶ [2002] NSWSC 909



10. Avoiding the debtor/unsecured creditor relationship

A transaction can only be a preference if the transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company. This means that for the liquidator to get to first base he or she has to show that a debtor/unsecured creditor relationship exists - perhaps the first thing that you can do if you are an unsecured creditor of a company which might be in financial trouble is to look at ways in which your future dealings might be structured to avoid the existence of a debtor/unsecured creditor relationship. Some of the things which you could do to avoid the creation of that relationship are:

- obtain security;
- change to a cash on delivery or cash in advance basis of dealing;
- supply on a retention of title or ROT basis;
- get paid by a third party or under a bank guarantee or letter of credit;
- get paid out of a trust established pre-insolvency.

10.1 Obtain security

If you obtain valid security before you advance funds you will not be an unsecured creditor. In that circumstance the only way in which you could receive a preference would be if you received payments which exceeded the value of your security. Only the amount over the value of your security could potentially be a preference as you were effectively an unsecured creditor for that excess amount of debt.

Security in personal property

Security in personal property can be broken up into two broad categories with respect to the type of asset charged. The first category is physical chattels, which includes movable property that takes a physical form, such as an automobile or piece of machinery. The other category is choses in action, which have no physical existence but are intangible bundles of legal or equitable proprietary rights, such as company shares or intellectual property rights. Both chattels and choses in action can be given as security by a company, but the law which governs these two categories is slightly different. Another distinction which can be made when talking of company charges over its movable property is the distinction between a fixed and floating charge.

Fixed charges

Under the general law in Australia, a mortgage of a chattel operates as an assignment of the legal interest of the item charged, subject to the chargor's equity of redemption. There is no analogous Torrens style system when it comes to interests in chattels so all legal mortgages of chattels take the form of a conveyance, unlike with land where a mortgage of Torrens title operates as a charge. Mortgages may also be granted over chattels which are either potential, after-acquired or future property. These are categories of chattels which have yet to come under the ownership or possession of the mortgagor, but upon doing so, the title of that property is conveyed to the mortgagee. Instead of mortgaging the chattel at general law, it could be made merely subject to a

charge. A charge is not a conveyance, but instead indicates that the chargee can have recourse to the chattel so charged in order to satisfy the debt.

It is necessary to look at the intention of the parties when the security was created in order to determine whether it was done by way of mortgage or charge. While there is a distinction at general law between a mortgage and charge, it must be noted that for the purposes of the Act, both mortgages and charges of chattels are charges that are registrable with ASIC under the Act (which is different to the position with charges over land, which do not need to be so registered).

With respect to choses in action, although they are intangible, they are often capable of assignment under statute at law, or in equity. Because they are capable of assignment, they can be assigned or charged for the purpose of security for a loan, subject to the laws of maintenance and champerty. This latest proviso is important because a chose in action may have a right to sue attached to the property or actually be a bare right to sue, and the rules against maintenance and champerty are common law restrictions on the extent that one party can assign another the right to take legal action against a third party. Choses in action at law include debts, bills of exchange and insurance policies. Equitable choses in action are items such as shares or an interest in a partnership or deceased estate. Present choses are debts due under a contract, breach of which will give rise to a cause of action in contract. Future choses are contingent debts, payable upon the happening of certain events.

The most common choses in action offered to financiers as security for the obtaining of finance are rights under a specific contract, such as the right to receive payment of a sum of money, or general business debts. However, a decision of the Privy Council casts doubt over the extent to which a fixed charge may be taken over the book debts of a company⁷. If the company can use the proceeds from discharging of those debts without reference to the chargee, it will be held to be a floating charge (see below), regardless of the language used in the charge agreement.

At law, only a whole chose in action can be assigned, not a part of one, so any legal security over book debts will have to be over the whole debt. The priority of multiple securities held by different parties at general law is governed with reference to the time that notice was given to the debtor regarding the assignment of the chose. However, with respect to a company assigning its debts, registration requirements may also affect priorities which is discussed further on. Another important issue to note is that until the debtor is notified of the assignment, he or she may satisfy the debt by paying the assignor the sum owing, meaning that the assignee may only have recourse to recovering from the assignor and not the debtor.

Other choses often taken as security are intellectual property rights, the goodwill of a company's business (most often taken along with securing the business' tangible assets so the chargee would be able to sell the business as a going concern), and shares which are owned by the company.

Floating charges

A financier may wish to take an assignment or charge over all the book debts as opposed to a single debt. This will normally take the form of a floating charge, as the debtors owing on the books of a business, especially large corporations, will be changing all the time. A floating charge will allow the company charging its debts to deal with and discharge debts as the case arises,

⁷ *Agnew v Commissioner of Inland Revenue* (2001) 2 AC 710

without needing to first gain the consent of the chargee. Upon default of the loan by the chargor corporation, the floating charge crystallises and the chargee can then give notice to the debtors existing at that time and proceed to collect from them in due course. This will most often be done by way of appointment of a receiver, the terms of which will usually be set out in the security agreement.

In general, floating charges are an attractive form of security for a company to give over its assets because the terms of the security allow it to deal with the assets charged without first consulting the chargee. Only upon the happening of certain events, such as default, will the charge crystallize and that freedom be restricted. These events are either defined within the terms of the security instrument or implied by law. While the charge remains floating, the company retains the right to unilaterally grant fixed charges over the assets which are subject to the floating charge, except if there is a specific provision in the floating charge agreement prohibiting this. In reality, most floating charge agreements do prohibit these types of subsequent dealings. If the company does grant a subsequent charge over an asset contrary to the provisions of the floating charge interest, it is arguable that the party taking the subsequent charge takes the property subsequent to an equity which attaches to that asset, but only if that party has notice of that equity. Similarly, if the subsequent party takes the charge when it has notice of the restriction in the floating charge instrument, then that subsequent charge will be postponed to the original floating charge.

A floating charge created within six months prior to the filing of an application for a winding up order in insolvency is void, unless it secured the giving of a new benefit to the company or the company was solvent when the charge was created.

Types of business debts which are typically secured by personal property

A company is likely to give a fixed charge in respect of smaller loans, where it would be inappropriate to grant a fixed and floating charge over the entire assets when considering the amount of money involved. Often when buying a new asset, the company may give a charge over that asset in order to finance the purchase. A floating charge is appropriate for a company which must be able to deal with its assets on an everyday basis without first consulting the chargeholder. This will be the case where a large proportion of a company's assets are stock in trade or book debts.

Documents which evidence the transaction

Security over the personal property of a company is usually taken in the form of a deed of charge or a specific mortgage security, both in addition to the traditional loan contract. Further protection is often taken by the lender by retaining key documents of title. Special notice must also be taken of the requirements listed under any statute dealing with specific kinds of chattels which has been taken as security. There is such legislation governing motor vehicles, liquor licences, various intellectual property rights, and crops, stock and wool, among others.

Before execution of a security agreement with a company, it is prudent for the chargee to obtain a statutory declaration from an authorised officer of the company, confirming that the security arrangement was entered into by the company in accordance with the procedures set out for such a transaction in its constitution, that the company is not insolvent, and that this transaction is of benefit to the company. This is in part an attempt to provide some protection for the chargee against a claim from any liquidator or administrator later appointed that the charge was not properly executed, or not given for a proper purpose and is thus invalid. The existence of those provisions

in the security agreement will not necessarily afford the chargee that protection. For example, if the chargee knows that the chargor is in fact insolvent at the time the charge is given, such a representation in the security document from the chargor may not be sufficient to establish that the chargee in fact believed the chargor to be solvent.

The security documents generally set out the following information:

- description of the monies secured including all monies owing by the borrower along with all expenses and fees which may be charged by a financier;
- a covenant to repay by the borrower, either on demand or by a fixed date, including both principal and interest (this covenant is necessary in case realisation of the asset secured falls short of what is owing);
- warranties that the company has power to enter into and perform its obligations under the document and has undertaken the necessary corporate action in accordance with its constitution to properly execute the documents;
- undertakings or covenants such as prohibitions against creating another security over the same asset to be mortgaged or charged, selling the asset (unless it is subject to a floating charge) and to insure the property in question for its full amount, among other things;
- listing what occurrences will be events of default under the agreement upon which the lender can commence to enforce the security; and
- the power of the lender to appoint a receiver and what that receiver is entitled to do.

Recording or other perfection requirements

Charges against the property of a company, which is not land, incorporated within Australia must be registered with ASIC. If the charge is not registered within 45 days of its creation, as required by the Act, there are two potential consequences. The first is that if the company was to become insolvent or be placed into voluntary administration ("VA"), then the charge would not be valid against the liquidator or administrator. Second, the charge would not be valid against a later chargee who took security over the same property and registered it prior to the registration of the first charge. Section 262 of the Act lists the types of charges that must be registered.

In *National Australia Bank Limited v Davis & Waddell (Vic) Pty Ltd (in liquidation)*⁸ an extension of time was granted to the bank to register the charge. In that case, a charge was granted to the bank from May 2000. In August 2000, the bank discovered that security documents had not been registered and had been lost. Replacement security documentation was executed in December 2000. Notification of the charge was not lodged with ASIC until February 2001, 18 business days after the expiration of the 45 day statutory time limit. The company was subsequently wound up.

The bank sought an order under s266(4) of the Act, extending the period for lodging notice of the charge. That section entitles the court to make such an order if the failure to lodge the notice:

- was accidental or due to inadvertence or some other sufficient cause; or
- is not of a nature to prejudice the position of creditors or shareholders.

⁸ (2003) 44 ACSR 296.

The Victorian Supreme Court, on appeal from a decision of a Master, held that the bank's failure to register the charge was accidental, and due to inadvertence. The fact that the company was in liquidation at the time of the bank's application was found not to be fatal to an application for registration out of time, but to be a factor which must be considered with all the other relevant factors. In this case, there were exceptional factors that justified the exercise of the Court's discretion to extend time, including that the company had relied on the bank for financial accommodation without which the company could not have conducted its business, and the delay in lodging the notice for registration was relatively short.

Secured lenders should ensure that staff are aware of the consequences of a failure to lodge a notice of charge within 45 days of its creation. Even though a secured lender may apply to the Court for an extension, it appears that there must be exceptional circumstances before the extension will be granted.

In order for a charge to be registrable at ASIC the stamp duty payable at the relevant office of state revenue must be paid. The amount to be paid is determined as a percentage of the amount secured. Timely payment of stamp duty is advisable in order to avoid the build-up of interest and other penalty charges which may apply, and to facilitate registration of the charge with ASIC.

Variations for special types of collateral (e.g. intangibles, aircraft and vehicles, accounts)

- *Ships*: Similar to land, a charge or mortgage properly executed over a ship need not be registered with ASIC (s262(1)(d) of the Act).
- *Intellectual Property*: Implications of the relevant legislation needs to be looked at by the chargee. Such legislation includes the *Circuit Layouts Act*, the *Copyright Act*, the *Designs Act*, the *Patents Act* and the *Trade Marks Act*.
- *Life insurance policies*: The *Life Insurance Act* must be considered.
- *Stock, crop and wool securities*: In each jurisdiction there is legislation dealing with each of these types of chattel which lists specific requirements which must be met for any security agreement to be valid within that jurisdiction. While registration with ASIC will overcome any possible deficiency due to non-registration in the jurisdiction, for Act purposes the security over such a chattel must at least be *registrable* under the terms of the relevant state legislation.
- *Accounts*: The Courts have held that a bank cannot accept a charge granted to it by an entity over money deposited by that entity. This is because money deposited in a bank is taken to be, at law, a debt owed by the bank to the entity holding the account. Banks may overcome this problem by employing what is known as their contractual rights of consolidation and set-off. The contractual right to consolidate enables a bank to consolidate all of a customer's accounts into one and the contractual right of set off permits the bank to apply the deposit to satisfy a debt it is owed by that same entity.
- *Shares*: A lender can take security over shares owned by a company in the form of a mortgage. A legal mortgage of shares involves transferring the shares to the lender and executing a security document stating that the shares are held as security for the loan. An equitable mortgage over shares can be created by the depositing of the share title certificates.



- **Contracts:** Lenders often lend on contractual rights and take security over them. Where a provision of a commercial contract prohibits an assignment of the contract, it is important to know whether a charge will contravene the non assignment provision such that the charge is, in whole or in part, unenforceable.

The question whether an equitable charge constitutes an assignment is unresolved. There are conflicting authorities, both judicial and academic, as to the nature of a charge.

In the most recent case to reach a finding on the question⁹ Sackville J held that a charge constitutes an assignment and that a clause of a contract which prohibits assignment without consent precludes a charge from charging a party's right to performance of the contract, and also its right to receive benefits accrued under the contract.

The latest Australian case on the subject of whether an equitable charge can amount to an assignment¹⁰ ultimately did not decide the question. Regrettably, the conflict apparent in the authorities was not explored in argument. Still unresolved is the issue of whether a charge confers simply a personal right to realisation of the debt owed at the point of both execution and enforcement/crystallisation of the charge, or whether a charge operates to assign a proprietary right upon enforcement by the chargee.

It appears that it is possible that in certain commercial situations the equitable interest in a charge may amount to an assignment, although when those situations arise has not been authoritatively determined. Whether creation of an interest by way of a charge constitutes an assignment will depend on the provisions of the charge and the prohibiting clause itself, in which the term 'assignment' is used. While the law is unsettled, it would be prudent for lenders to seek to obtain the consent of the counterparty before securing interests by way of charge over contractual rights contained in contracts with prohibitions on assignment.

10.2 Cash on delivery

If you supply goods or services, either at the same time as you receive payment for them or after you receive payment in advance, you are never a creditor of the company at the time you receive payment and you cannot therefore receive a preference when you receive that payment.

10.3 Retention of title

One method by which trade creditors protect themselves without resort to creating a security or charge is by inserting a ROT or 'Romalpa' clause in the sale contract. This indicates that the goods sold to the company continue to be owned by the seller until the goods are fully paid for by the company which bought them, or more commonly, that the company has paid all debts which it owes to the seller. This type of clause has been held by the Courts not to create a charge. The clause will have to be worded very specifically in order to protect the creditor in the way that it wishes, particularly in the case of goods that are used for manufacturing where the goods' character is altered by the manufacturing process. Even more problematic is when the supplied goods become attached to, or part of, other goods which are the property of the purchasing company. A correctly executed Romalpa clause can mean a creditor may claim a proprietary right

⁹ *Macintosh v Turner Corporation Ltd (in Liq) and Others* (1995) 13 ACLC 1314 per Sackville J

¹⁰ *Starelec (Qld) Pty Ltd & Vangale Pty Ltd (in liq) v Kumagai Gumi Co Ltd* [2002] QSC 137



to the goods sold to the company (or the proceeds of sale of these goods), in the event of the company's insolvency, rather than proving as an unsecured creditor in a VA or winding up process. As a properly worded ROT clause gives the creditor property rights over its goods or the proceeds of sale of those goods again no debtor/unsecured creditor relationship will exist and payments received by the supplier are payments by a trustee of trust funds not payments by a debtor to a creditor. ROT clauses can be very valuable.

10.4 Get paid by a third party or under a bank guarantee or letter of credit

A favoured means by which creditors have sought to avoid receiving preference payments in the past was to be paid by a third party or by obtaining a bank guarantee or letter of credit. This should work fine however as mentioned in 3 above there is a very wide definition of transaction which applies to unfair preferences and other voidable transactions. It is clear for example that if A owes B money and B owes C money and B directs A to by pass B and pay C directly that C could receive a preference from B.¹¹

Letters of credit have generally been considered safe until the decision in *New Cap Reinsurance Corp Ltd & Anor v Somerset Marine & Ors* [2003] NSWSC 540.

In that case New Cap Reinsurance Corp Ltd ("New Cap Re") and its liquidator sought recovery of monies paid to the defendant reinsurance companies on the basis that they were unfair preferences within the meaning of s588FA(1) of the Act. The defendants sought orders setting aside the originating process, arguing that the letter of credit agreement under which they indirectly received money from New Cap Re was not an agreement to which they were a party, and so the legislation did not apply to the transaction in question. The Court took the view that, in the context of the entire transaction, there was an arguable case that New Cap Re's discharge of its indebtedness to the defendants via its bank constituted a transaction for the Act's purposes. Accordingly, the defendants' application was dismissed on the basis that New Cap Re and its liquidator should not be denied the opportunity to have a court finally determine the matter. The Court of Appeal refused to give leave to appeal.

This case and *Emanuel* make it difficult to be confident that payments from third parties can never be challenged as a preference unless the third party is a volunteer or has not been party to any transaction in the very broad sense defined by s9 of the Act (set out in 3 above) which also involves the debtor and creditor.

10.5 The trust idea

Another option is to have the company which owes you money set up a trust to pay you and/or other unsecured creditors. So long as this trust is properly set up when the debtor company is solvent, so that the assets of the trust cease to be property of the debtor company and become property which it instead holds as a trustee subject to an express trust in favour of preferably named creditors (preferably in specified amounts), later payments from the trust should not be preferences.

There were some obiter comments in *Emanuel* about payments out of trust funds but I think those comments were really referring to a trust established when the debtor was already insolvent in

¹¹ *Macks and Emanuel (No 14) Pty Ltd v Blacklaw & Shadforth Pty Ltd* (1997) 15 ACLC 1099 ("Emanuel")



which the debtor retained control over the funds in the trust and in which the property was held in trust for the debtor rather than in trust for creditors and with the debtor having power to direct the trustee which creditors to pay, so I don't read that case as meaning to say that a trust can never be effective. In *Emanuel* the Court relevantly said:

There is no doubt that, if the money received by B had been required under the Deed:

- (a) to be paid first to E and then paid on to B as E's money; or
- (b) to be held by EFG on trust for E pending the latter's direction to pay B, then the financial benefit accruing to B would, relevantly, have been received from the company (E).

Does it make an operative difference that, rather than adopting such expedients, the Deed provided for direct payment to B? In our view it does not and it would be surprising if it did.

If a company anticipates insolvency prior to insolvency occurring, it may be prudent for directors to safeguard monies paid by customers for pending purchases and money due to suppliers from becoming general assets of the company by setting up an express trust.

Where an express trust has not been formed and documented it may still be possible to argue that a 'Quistclose' trust exists. Money advanced to a company for a specific purpose can be protected from creditors by what has become known as a 'Quistclose' trust (*Barclays Bank Limited v Quistclose Investments Limited* [1970] AC 567). A similar principle has been accepted into Australian law.

Issues surrounding trusts for the benefit of creditors were considered in the English case *OT Computers v First National Tricity Finance* [2003] EWHC 1010 (Ch) per Pumfrey J. The directors of OT Computers (a business assembling computers on a just-in-time basis), realising they were facing insolvency, set up two trust accounts with their bank to hold monies paid by customers for goods not yet received, and monies due to 'urgent suppliers'. It gave its bank instructions that the accounts were not to be used to set off other accounts that were held by the bank in the company's name. A draft deed of trust was prepared by the company's solicitors. At the time the trust accounts were created, lists of customers and suppliers were drawn up but they were not accurate and not kept up-to-date as time passed. The customers and suppliers themselves knew nothing of the trusts.

An administration order was made in relation to the company and proceedings were commenced on its behalf seeking a determination as to who were the beneficiaries of the customer trust account and the supplier trust account. Justice Pumfrey decided that the accounts did not constitute 'Quistclose' trusts, since the money advanced to the company was not for a specific purpose. The case was one in which the company had declared itself a trustee of funds to which it was entitled, in favour of customers that had originally transferred those funds to the company.

For an express trust to be created, there must be certainty of words, certainty of subject matter and certainty of objects. As a general rule, if you send money to a company for goods that are not delivered, you are merely a creditor of the company, unless a trust has been created. The Court considered the status of each of the trust accounts separately. The money in the customer trust account was found to be protected, because the company's intention and the amounts of money involved were sufficiently certain as the names of customers and the amount contributed could be identified by their receipts, despite the inaccurate records kept by the company itself. Those monies could only be used to pay the nominated creditors.

The money in the supplier trust account was found not to be protected. On those requirements, the supplier trust failed. What made a supplier an 'urgent supplier' was not sufficiently clear. This meant that the identities of the trust beneficiaries were uncertain, and a trust was never properly constituted for the suppliers. As a result, the money held in the supplier trust account was beneficially owned by the company and available for distribution to all of the company's creditors.

This case shows that, at least in English law, a properly created trust can be used to safeguard funds – as long as the beneficiaries of the trust are clearly identified or identifiable. Failure to specify the beneficiaries properly may mean that the funds involved become part of the company's general assets. As the company was subject to an English administration and not yet in liquidation the Court did not consider whether the formation of such trusts or payments from them could be attacked as preferences.

11. The running account

Whenever an unsecured creditor receives a preference claim it is important to remember the so-called 'running account' 'defence'. This 'defence' is now contained in s588FA(3) of the Act. Essentially it means that, where parties have an ongoing commercial relationship rather than considering each individual transaction alone to see if it has afforded the creditor a preference, you look at the net position of all of the transactions which formed part of the relationship as if they were one transaction. So if, at the start of the relevant period, the unsecured creditor was owed, say, \$1,200 and payments and supply occurred over the period such that at the beginning of the liquidation the creditor was owed only \$1,100, there might be said to be a \$100 preference. This may be so even though during the period the level of indebtedness rose and fell. In simple terms, if the creditor has supplied goods or services to the company during the six month period which are greater in value than the payments it received from the company during that period, then treated it as a single transaction, the creditor has given more than it received and no preference has occurred within the meaning of s588FA(1)(b).

Payments must be made as part of a 'continuing business relationship' for the running account defence to be available. In *Airservices Australia v Ferrier*¹², the High Court (per Dawson, Gaudron and McHugh JJ) highlighted this requirement that the purpose of any payment must be in part to induce future supply if the running account defence is to be available:

If the sole purpose of the payment is to discharge an existing debt, the effect of the payment is to give the creditor a preference over other creditors unless the debtor is able to pay all of his or her debts as they fall due. But if the purpose of the payment is to induce the creditor to provide further goods or services as well as to discharge an existing indebtedness, the payment will not be a preference unless the payment exceeds the value of the goods or the services acquired.

By way of example of the operation of the running account defence, in *John Irving & Andre Strazdins as liquidators of Pondermaria Pty Ltd (in liq) v F Laucke Pty Ltd*¹³, the creditor received total payments of \$721,078.72 from the company in liquidation during the relevant six month period, being payments for chicken feed. As the running account defence was available, the

¹² (1996) 137 ALR 609

¹³ [2006] SADC 91



liquidator challenged only \$219,190.16 as being an unfair preference, that amount being the reduction in the indebtedness of the company in liquidation over the relevant period.

Even if the running account defence is available, and even if there has been no reduction in the level of indebtedness over the six-month period taken as a whole, an unfair preference claim may nevertheless be available to a liquidator. Although the legislation does not provide for it, case law suggests a liquidator is entitled to pick a date within the six months as the date of greatest indebtedness and to calculate the running account from that date – in *Rees v Bank of New South Wales*¹⁴, Barwick CJ commented:

In my opinion 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 and I see no reason why he should not choose, as he did here, the point of peak indebtedness of the account during the six month period.

12. At what time will the Court assess whether or not a creditor had reasonable grounds to suspect insolvency?

Under s588FG(2), whether or not a person had reasonable grounds to suspect insolvency will be assessed at the time when a person became a party to the relevant transaction. As mentioned above, the term 'transaction' is defined very broadly at s9 of the Act and includes "a payment made by the body" and "an obligation incurred by the body".

Precisely when a person became a party to that transaction may be a key question – it might be the case that a person enters into a contract with the company at a time when there is no reason to suspect insolvency, but subsequently receives payments under that contract, by which time there are reasonable grounds to suspect solvency. That raises the question of whether or not there are 'reasonable grounds to suspect' should be assessed at the time of entering into the contract or at the time of receiving payments.

'Transaction' has generally been given a broad meaning in the context of the voidable transaction provisions of the Act:

- *unfair preferences*: the Court has on a number of occasions upheld claims that a company can be taken to have been a party to a transaction under s588FA(1), even though the transaction involved a third party making a payment to a creditor¹⁵; and
- *uncommercial transactions*: in a recent decision, *Lifestyle Earls Court Pty Ltd (in liq) v Mentone Mansions Pty Ltd* [2006] VSC 2, Mandie J commented:

In each case the Court is obliged to look at the transactions between the parties in a manner which accords with the commercial realities. It is not a matter of isolating particular individual steps in the course of the business relationship so as to give one element a different characteristic from that which the totality of the relationship would evidence.

While in the context of s588FA(1) and 588FB, a broad construction of 'transaction' is very much in the interests of liquidators, as their interests may be very different in the context of s588FG(2). The earlier the transaction, the easier it will be for the creditor to show that there were no reasonable

¹⁴ (1964) 111 CLR 210

¹⁵ See, for example, *Emanuel (No) 14 Pty Ltd (in liq), Re; Macks v Blacklaw & Shadforth Pty Ltd* (1997) 24 ACSR 292

grounds to suspect insolvency – a person will generally not enter into a contract with a party that it suspects to be insolvent.

In *Mulherin v Bank of Western Australia Ltd*¹⁶, the respondent, Bank of Western Australia Ltd (“Bank West”), offered United (T & C) Bretts Wharf Pty Ltd (“UTC”) a \$2m bank guarantee facility for the apparent purpose of providing a deposit for a property purchase in Hong Kong. The guarantee was provided to a director of UTC but secured against existing charges to Bank West over UTC’s assets. In addition, UTC agreed to indemnify Bank West for the \$2m guarantee in the event it was called upon. The guarantee had been entered into on 23 December 1997 and was subsequently “rolled over” on 2 October 1998 and 1 December 1998, and on 29 January 1999 Bank West and UTC entered into a loan agreement postponing UTC’s obligation to pay the \$2m until 28 February 1999. The guarantee was called upon and Bank West subsequently recovered the \$2m under the guarantee and indemnity together with interest and other amounts.

UTC subsequently went into liquidation and the liquidator of UTC challenged the guarantee and indemnity as an uncommercial transaction and sought a payment of \$2m by Bank West to the liquidator. The issues considered by the Court included the following:

- Was the transaction uncommercial?
- Was it an insolvent transaction?
- Did Bank West have reasonable grounds to suspect that UTC was insolvent at the time of entering into the transaction?

Justice Muir, in the leading judgment, with whom President McMurdo agreed, concluded that the transaction was uncommercial. UTC derived little or no benefit from the bank guarantee, while Bank West received interest and fees. Moreover, given that the transaction apparently procured a benefit for a company director in breach of his fiduciary duties, a reasonable person in UTC’s circumstances would have been aware of the difficulties UTC might face in recovering its losses if the transaction was found to be unlawful. In short, Justice Muir concluded, “there is little about the subject transaction which accords with normal commercial practice”.

Justice Muir also determined that entry into the bank guarantee facility was one of the reasons why UTC became insolvent. As such, the transaction was voidable in accordance with s588FB of the Act.

Nonetheless, Justice Muir held that Bank West had entered into the transaction in good faith, without any reasonable grounds for suspecting UTC’s existing or impending insolvency. Under s9 of the Act, it seems that there are a number of possible times at which it could have been held that Bank West entered into the relevant transaction:

- the date the guarantee was given (i.e. December 1997);
- the time at which actions “giving effect” to the transaction occurred (i.e. when the guarantee was rolled over); or
- the date that UTC made a payment to Bank West under the guarantee and indemnity (1999).

¹⁶ [2006] QCA 175



Justice Muir held that the relevant 'transaction' was entered into in December 1997, and whether or not there were reasonable grounds to suspect that UTC was insolvent was assessed at that time. Bank West was afforded the protection of s588FG which precludes an order materially prejudicing the interests of a third person who receives the benefit from an otherwise voidable transaction in good faith.

Other than this case, there is relatively little case law that considers what the relevant 'transaction' is in the context of s588FG. In the context of s588FA(1)(a) however the Court has adopted a broad approach to what constitutes the transaction.

An unsecured creditor that enters into a transaction with a company which envisages payments being made by the company in the future (e.g. a guarantee and indemnity or an unsecured loan) should consider very carefully in the context of any subsequent unfair preference or uncommercial transaction claim precisely when the relevant transaction was entered into and, consequently, the time at which the reasonable grounds to suspect defence should be assessed.

13. Long-term late payment does not equal suspicion of insolvency

It is important to take into account the fact that simply because a debtor company pays late this does not necessarily mean that the creditor should or does suspect insolvency. This question was considered in *Seller & Anor v Offset Alpine Printing Pty Ltd*¹⁷ which was an appeal from a decision of the County Court of Victoria. The Applicants were the liquidators of Eric Clarke & Associates Pty Limited ("the Company"). The Company had an advertising and marketing business which specialised in producing catalogues and brochures. The Respondents, Offset Alpine and Trigma, were printing companies that had printed the Company's catalogues and brochures for several years.

In the County Court, the liquidators had sought orders to avoid 7 payments made by the Company to Offset Alpine and Trigma for printing services, on the basis that the payments were unfair preferences within the meaning of s588FA of the Act. Each of the payments were made within the 6 month period ending on the relation back day and (at least on appeal) there was no dispute that the Company was insolvent at all relevant times, or that the payments resulted in the printing companies receiving from the Company more than they would have received if the transactions were set aside and the Company were wound up.

Accordingly, the payments were:

- unfair preferences under s588FA;
- insolvent transactions under s588FC; and
- therefore, voidable transactions under s588FE.

This meant that each of the transactions could be set aside under s588FF unless the defence under s588FG applied. In effect, the Respondents had to establish that:

- they received the impugned payments in good faith;

¹⁷ [2003] VSCA 37

- they had no reasonable grounds for suspecting that the Company was insolvent at the time the payments were made; and
- a reasonable person in their respective circumstances would have no grounds for so suspecting.

The trial Judge found that these elements had been satisfied. The liquidators' application was dismissed and they appealed on the basis that the findings of the trial Judge were against the weight of the evidence. Whilst this case does not mark a change in the law, it represents a good example of how the relevant legal principles are applied and the importance of the evidence.

The Victorian Court of Appeal noted a number of features of the relationship between the Company and its printers. In particular, even though the printers' normal terms of trade were 30 days, it was not unusual for the Company's accounts to be outstanding for long periods of time, and the Company had a policy of not paying for printing until it had itself received payment for the catalogues and brochures.

In disallowing the appeal and upholding the printers' defences, the Court of Appeal noted that the liquidators relied on what could be said to be obvious signs of insolvency, being:

- the poor payment history of the Company;
- the age of the debts;
- the earlier assurances that the Company could pay;
- the statements that the Company was in fact having difficulty in making the payments; and
- the forceful demand of Trigra solicitors for a guarantee and provision of a statement of solvency.

Although these matters were relevant, the Court of Appeal held that the test to be applied in defending a voidable preference action was one based on the actual circumstances known to those who benefit from the insolvent transactions, which must be examined to see whether a person in those circumstances and with that particular knowledge could have had no reasonable belief as to the insolvency of the Company.

The Court of Appeal found that the trial Judge was entitled to conclude that the events of early 1998 did not show any significant difference from the history of slow payment which had been typical of the Company's conduct over several years. Similar conclusion were reached in relation to the payments made to Offset Alpine Printing.

It is important to remember that the defence to a preference action will succeed if you can show that you had no reason to suspect that the company was unable to pay its debts as and when they fell due – the solvency test looks at the 'ability' of a company to pay its debts not whether it has been or is in fact doing so. Some companies use their creditors, in effect, as their banker i.e. as a very cheap source of credit and are habitual late payers. This fact may not cause people trading with them, particularly if it is a pattern repeated over a very long time, to suspect insolvency.

14. ***Beveridge v Whitton* – the doctrine of ultimate effect as a stand alone defence**

14.1 What is the doctrine of ultimate effect?

The discussion of an 'ultimate effect doctrine' has arisen largely out of the line of authority in relation to running accounts such as *Richardson, Queensland Bacon Pty Ltd v Rees*, and was affirmed by the majority of the High Court in *Airservices Australia v Ferrier* (1996) 185 CLR 483.

In *Airservices* the majority of the High Court held (at 509):

Both parties understood that the provision of the further services was dependent on Compass making payments to reduce its growing debts ... once the doctrine of ultimate effect is applied, it follows that the payments to Air Services gave it no preference, priority or advantage over the general body of creditors. On the contrary, the general body of creditors benefited from the revenues that were generated as a result of the services provided by and at the expense of Air Services. ... To ignore the practical relationship between the payments and the subsequent supply of the services and the ultimate effect of the dealings between the parties would not advance the purpose for which s122 (of the Bankruptcy Act) was enacted.

14.2 ***Beveridge v Whitton* (as liquidator of HSB Bank Pty Ltd)¹⁸**

The New South Wales Court of Appeal decision in *Beveridge* took the concept of the ultimate effect doctrine outside of the running account context.

The facts of this case were that by the end of June 1994, the company was in financial difficulties owing the Tax Office over \$200,000 and had a substantial overdraft. At the suggestion of the company's bank *Beveridge* was engaged to undertake general management of the financial matters of the company including the preparation of outstanding financial reports. The company agreed that *Beveridge's* fees would be paid within 7 days of issue. The trial Judge found he was in virtual sole control of the company on the financial side.

The trial Judge found that the company was insolvent by at least 13 July 1995 and that *Beveridge* was aware of this. Further that the ultimate effect of *Beveridge* being engaged created no benefit to any other creditors. Therefore *Beveridge* obtained an unfair preference in relation to the fees paid to him by the company.

In the Court of Appeal, *Beveridge* argued that, first, he entered a contract for services on terms that he receive speedy payment and he would not have provided them otherwise. Second, that the value of the services should be treated as the price charged for them. Third, the services were necessary if the company was to continue trading and were inherently valuable even if they did not result in a quantifiable addition to turnover or inventory.

The liquidator argued that, on the basis that the services provided by *Beveridge* did not result in any quantifiable addition to turnover or inventory, applying the ultimate effect doctrine, there was less money for the general body of creditors and the transactions constituted an unfair preference.

The Court of Appeal held that the 'doctrine of ultimate effect' did not depend on an evaluation of whether the overall result of the impugned transaction was to improve or worsen the company's

¹⁸ [200] NSWCA 6

position. Rather, the doctrine looks to the 'ultimate effect' of the particular transaction. As an example, the Court stated a company gives up \$1,000 in cash, but gains goods which are unquestionably worth \$1,000 or more, the ultimate effect has not been to decrease the net value of the assets.

The Court went on to find that it was not the case that a failure to show any quantify addition to turnover or inventory means that the services supplied are without value, or that a payment made for them necessarily decreases the company's net asset.

On the facts of the case there was no deliberate over-servicing and no overcharging. Therefore, as services had been provided to the company which equalled the value of the fees paid, there was no unfair preference. The Court of Appeal further noted that if the argument of the liquidator was sound, then no person assisting a company in financial difficulties could recover if that company goes into liquidation, so long as the person assisting was aware of the company's insolvency.

The case appears to expand the doctrine of ultimate effect outside of the running account context. Here a creditor providing services when suspicious of the company's insolvency was found not to have received a preference when paid 100 cents in the dollar even though those services did not increase the money available to the general body of creditors.

15. Jonsson v Ferrier – preference claims – availability of recoveries to secured creditors and set-off

15.1 The law

Section 553C (Insolvent Companies – Mutual Credit and Setoff) operates to require an unsecured creditor who seeks to prove in a winding up to set off mutual credits and mutual debts between itself and the insolvent company in liquidation and prove for the net amount owing to it in the liquidation. The provision provides:

- (a) Subject to ss(2), where there have been mutual credits, mutual debts or other mutual dealings between an insolvent company that is being wound up and a person who wants to have a debt or claim admitted against the company:
 - (i) an account is to be taken of what is due from the one party to the other in respect of those mutual debts; and
 - (ii) the sum due from the one party is to be set off against the sum due from the other party; and
 - (iii) only the balance of the account is to be admissible to proof against the company, or is payable to the company, as the case may be.
- (b) A person is not entitled under this section to claim the benefit of a set-off if, at the time of giving credit to the company, or at the time of receiving credit from the company, the person had notice of the fact that the company was insolvent.

The leading High Court decision on the question of set-off in an insolvency context is *Gye v McIntyre*¹⁹. That case related to setoff in the bankruptcy context under s86 of the Bankruptcy Act. The High Court held (at pages 618-619):

¹⁹ (1991) 171 CLR 609

Where there are genuine mutual debts, credits or other dealings, it would be unjust if the trustee in bankruptcy could insist upon having 100 cents in the dollar upon the whole of the debt owed to the bankrupt but at the same time insist that the bankrupt's debtor must be satisfied with the dividend of some few cents in the dollar on the whole of the debt owed by the bankrupt to him...On the other hand, 'substantial justice' requires that the operation of set-off in bankruptcy be confined within limits which protect the creditors of the bankrupt from being disadvantaged by set-off being allowed in circumstances where debts, credits or other dealings have not been genuinely mutual as a matter of substance, such as where beneficial ownership is not the same or where, after bankruptcy or notice of an act of bankruptcy, a debtor of the bankrupt has brought up liabilities of the bankrupt at a discount for the purpose of setting them off against his own indebtedness.

The fundamental policy behind the operation of set-off in the insolvency context is to 'do substantial justice between the parties, where a debt is really due from the bankrupt (or insolvent company) to the debtor to his estate. The prime purpose is to protect those persons who engage in mutual dealings with the bankrupt, and as a protective provision of a statute, it is to be interpreted in the widest scope': *Forster v Wilson*²⁰.

As a result, pursuant to s553C, where a party wishes to lodge a proof of debt in the liquidation of a company, any debts owed by the company to that person must be set-off against any amount owed by that person to the company by way of debt, claim or other dealing.

The key element here is mutuality. The High Court in *Gye v McInyre* held that mutuality in the insolvency context has three key aspects:

- the claims must arise between the same persons;
- the relevant interest is the equitable interest of the parties;
- the claims must be of a kind which ultimately sound in money.

In summary therefore, where a party seeks to prove in a winding up, provided the debts satisfy the requirements of mutuality, that party must set-off its debt against monies owing by the insolvent company prior to proving in the winding up in accordance with s553C.

15.2 Can a preference claim be set-off by a creditor under s553C?

It has been held that there is no set-off available between a debt owed to a creditor who received payment of the debt as a voidable preference and the sum to be repaid to the company because of the preference: *Calzaturificio Zenith Pty Ltd (in liq) v NSW Leather & Trading Co Pty Ltd*²¹; *Re Buchanan Enterprises Pty Ltd (No.2)*²². In addition, there is no set-off between a debt due to a person guilty of misfeasance in relation to a company in liquidation and the misfeasance's liability to pay moneys which have been ordered to be paid pursuant to misfeasance proceedings.

The policy behind this general rule is that when a preference is recovered from a creditor, it cannot be offset against the debt due to the creditor, otherwise the very object of the preference recovery

²⁰ (1843 12 M&W 191 at 204

²¹ [1970] VR 605

²² (1982) 7 ACL R407

would be defeated. The creditor will be required to repay the preference in full before ranking as a creditor: *Clements; ex parte the Trustee; Goldsborough Port & Co Ltd*²³.

Despite this general policy position, in a Federal Court decision Mansfield J held that a liquidator could set off an insolvent trading claim under ss588W and 588V of the Act against the holding company of a company in liquidation, against amounts the company owed to its holding company.

15.3 Re ACN 007 537 000 Pty Limited; Ex parte Parker²⁴

This case involved an application by the liquidator of a company for a declaration that he be able to set off the amount of a proof of debt of Amber Ceramics (the holding company of the company in liquidation) in circumstances where the liquidator believed that the holding company was liable for insolvent trading in respect of the insolvent company. The debt owed by the company to Amber Ceramics arose out of loans made by Amber Ceramics to its insolvent subsidiary.

The facts in the case were as follows:

- On 30 May 1995 Barossa Ceramics Pty Limited ("Barossa Ceramics") appointed Messrs Parker and Freer as joint and several administrators. Amber Ceramics (SA) Pty Limited ("Amber Ceramics") was the holding company of Barossa.
- On 27 June 1995, the creditors of Barossa Ceramics resolved that the company be wound up and Messrs Parker and Freer be appointed liquidators.
- On 2 June 1995 Westpac appointed receivers to Amber Ceramics.
- On 15 June 1995, Messrs Parker and Freer resigned as administrators of Amber Ceramics.
- Amber Ceramics lodged a formal proof of debt in the liquidation of Barossa Ceramics on 23 May 1996 for \$516,453.74 made up of a loan account of \$456,870.41 and sundry debts of \$59,583.33.
- On 9 October 1996 the liquidators of Amber Ceramics admitted that claim for \$460,977.53, but indicated at that time that they may have a claim against Amber Ceramics as the holding company to the extent of \$314,796.73 by reason of a claim against it pursuant to s588V of the *Corporations Law*.

The liquidators applied to the Court for directions as to whether he was entitled to set off pursuant to s553C, or otherwise, the sum due to Amber Ceramics as its claim against Barossa Ceramics in the winding up of Barossa Ceramics, the sum he would otherwise be entitled to recover from Amber Ceramics pursuant to s588W of the Law.

The Court held that the liquidator was entitled to set off the liability under s588W on the bases that:

- although the claim against Amber Ceramics did not result from dealings between the two companies, there were debts due from one company to the other and the expression 'mutual dealings' as employed in s553C was not meant to confine the broad purpose of statutory set off;

²³ (1931) 7 ABC 225

²⁴ (1997) ACSR 360

- it did not matter that the claim could only be brought by the liquidator. As a matter of substance the claim under s588W was the claim of Barossa Ceramics; and
- it did not matter that the claim could only be perfected as a consequence of the liquidation. The conduct constituting the contravention occurred before the commencement of the administration (being the relevant date).

The Court held the relevant question was whether the two claims are 'mutual credits, mutual debts or other mutual dealings' between the company and Amber Ceramics under s553C of the *Corporations Law* (as it then was).

The Court held that the debts as between Amber Ceramics and the company in liquidation were mutual and applied the principles in *Gye v McIntyre* in respect of mutuality of debts, finding that: 'the debts are between the same companies, the burden of them would lie in the same interests. They are commensurable, in that they both sound in money'.

The key issue was whether the debt owed by Amber Ceramics for insolvent trading was a debt due to the company or a debt due to the liquidator. Mansfield J held that 'under s588V of the Act, the debt is recoverable as a debt due to the company. The fact that the claim may be enforced by the liquidator is but a procedural device for enforcing what is clearly a claim of the company'.

Accordingly the Court held that the liquidator was entitled to set off the amount of his claim under s 588W of the Act against Amber Ceramics against the amount for which Amber Ceramics was otherwise entitled to prove for as an unsecured creditor in the winding up of it's subsidiary.

Clearly, there appears some basis for an argument that where requisite mutuality of debts can be established, there may be some grounds for setting off a debt of an insolvent company arising out of insolvent trading claims.

However, we note that there have been no subsequent decisions affirming the position in *Re Parker*.

The question arises whether the reasoning in *Re Parker* can be extended to apply to situations in which liquidators are successful in establishing a preference claim. This would appear to depend upon whether the preference claim is a debt of the company in order to satisfy the mutuality requirement for set-off in insolvency.

In *Pipelines Induction Heat (Australia) Pty Ltd & Duncan v Vinidex Tubemakers Pty Ltd*²⁵, a Master allowed an amendment to the pleading in an unfair preference claim permitting the defendant to plead set-off as a defence to the claim. This decision was appealed on the basis that the point was unarguable, but the appeal failed. The Full Court of the Supreme Court of South Australia held that the issue was arguable.

A subsequent decision suggested moneys recovered by a liquidator under s588FF becomes the property of the company in liquidation.

²⁵ [1999] SASC 157

15.4 Jonsson v Tim Ferrier Pty Ltd²⁶

In this case an application was brought to set aside a default judgement entered by a liquidator in relation to an unfair preference claim.

Jones J in the Supreme Court of Queensland set aside a judgment in default of appearance because the express words of s588FF of the Act require the Court to be satisfied that the payments to creditors are voidable before ordering repayment. The Court was of the opinion that the 1993 *Corporations Law* (as it then was) changed the way liquidators could deal with monies recovered as having given a creditor an unfair preference. Hence, under s588FF, moneys recovered by a liquidator because a transaction is voidable become the property of the company and may be subject to a charge over the company's assets.

The Court further held that the orders the Court can make are limited to those identified in s588FF. There was no provision in that section for an order that money identified as being paid in a voidable transaction should be paid to the liquidators. Such money recovered by the liquidators becomes the property of the company.

The liquidators obtained a default judgment from the Registrar in their favour in respect of real estate agents' commissions and payments for marketing services which had been paid to the defendants 5 months before the appointment of the liquidators. On an application to set aside the Registrar's entry of judgment, the Court agreed with the defendants' submissions and held that:

- until there was a determination that there was a voidable preference, there could be no liquidated demand and therefore the request for default judgment was not available;
- an affidavit attesting to the continuance of the debt without additional material to satisfy the Court that the transactions were voidable as an unfair preference within the meaning of 5.7B of the CL was insufficient; and
- the orders the Court can make are limited to those identified in s588FF. There was no provision in that section for an order that money identified as being paid in a voidable transaction should be paid to the liquidators. Such money recovered by the liquidators becomes the property of the company (and could be subject to any charge which a creditor has over the company's assets).

The question of whether money recovered on the settlement of a preference action and an insolvent trading action would become subject to a prior charge or whether it would become available only for distribution to unsecured creditors was again considered in *Tolcher v National Australia Bank Limited B ("Tolcher")*²⁷ per Palmer J on 14 March 2003.

The Plaintiff was the liquidator of Lloyd Scott Enterprises Pty Ltd ("LSE"). LSE had entered into a debenture with the Defendant Bank ("the Bank"). The debenture provided for a fixed and floating charge over all of the assets of LSE. The liquidator made two claims against Key Equipment Finance Australia Pty Ltd ("Key") as a shadow director of LSE. The first was to recover an unfair preference under s588FA and s588FF(1)(a), and the second was a claim under s588M(2) to recover compensation for loss resulting from insolvent trading.

²⁶ [2001] QSC 10

²⁷ [2003] NSWSC 207



The claims were the subject of a mediation which resulted in the execution of a deed. The question for determination was whether the property, recovered under the deed, was property of LSE and therefore subject to the bank's charge and recoverable by the bank, or property which was only available for distribution to LSE's unsecured creditors in the administration of the winding up.

In *Tolcher* Palmer J did not follow Jones J in *Jonsson v Ferrier* and it appears that he was not referred to *Re Parker* at all. His Honour instead affirmed the correctness of previous authorities; Santow J in *SJP Framework (Aust) Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2000) 34 ACSR 604 which in turn affirmed *N A Kratzmann Pty Ltd v Tucker (No 2)* (1968) 123 CLR 295. According to *Tolcher* if property is the subject of a fixed charge, it will not be available for distribution to a company's unsecured creditors during a winding up. However, monies paid as a preference, which are recovered by the liquidator will not be subject to a floating charge, and will be held by the liquidator as trustee for the unsecured creditors of the company.

Palmer J stated that the *Kratzmann* principles were equally applicable to recoveries for claims under s588M. If a liquidator institutes proceedings under s588M (2) and recovers money in judgement, the proceeds are not available in priority to a secured creditor until the unsecured debts have been paid in full, as provided by s588Y(1).

In Palmer J's view a reference to payment 'to the company' in s588M(2) does not indicate a legislative intention that property recovered by a liquidator under s588M(2) is to be regarded as property of the company so as to be available to a secured creditor contrary to the principle established in *Kratzmann*.

In Palmer J's view *Kratzmann* is still good law. According to *Tolcher* if property is the subject of a fixed charge, it will not be available for distribution to a company's unsecured creditors during a winding up. However, according to *Tolcher* monies recovered by way of preference by a trustee in bankruptcy or a liquidator will not be subject to a floating charge over all the assets of the company; the monies will be held by the liquidator as trustee for the unsecured creditors of the company. The same principles that apply under s588F also apply under s588M(2). According to *Tolcher* the words 'to the company' do not indicate that monies recovered under this section are available to a secured creditor contrary to the principles established in *Kratzmann*.

If the preference recoveries are as *Jonsson v Ferrier* (but not *Tolcher*) suggests property of the company this would improve the argument in favour of the mutuality necessary for a s553C set-off to be available in relation to preference claims. Like insolvent trading claims which are recovered as a debt to the company preference claims would be property of the company. Following the authority of *Ex Parte Parker and Jonsson v Ferrier* there is therefore an argument in favour of a s553C set-off now being available in answer to a preference claim although the decision in *Tolcher* does not assist that argument.

16. Conclusion

In this paper we have examined firstly the statutory framework for uncommercial transactions and unfair preferences and looked at some of the methods and defences by which an unsecured creditor can seek to defend its position where a liquidator alleges it has received an unfair

preference. The paper suggests that, like most things, the best way to defend a problem is to avoid it in the first place to:

- avoid the debtor company going into liquidation; or
- avoid the debtor/unsecured creditor relationship.

Failing that the paper suggests some defences to consider:

- (a) the running account 'defence';
- (b) when a person might not have reasonable grounds to suspect;
- (c) the doctrine of ultimate effect; and
- (d) set off.

NOTE: This document is intended only to provide a general review on matters of concern or interest to readers. The text of this document should not be relied upon as legal advice. Matters differ according to their facts. The law changes. You should seek legal advice on specific fact situations as they arise. Parts of this paper have been extracted from the Allens Arthur Robinson Annual Reviews of Insolvency and Restructuring Law 2002-2006 – see <http://www.aar.com.au/pubs/arir/index.htm>.