AICM
2003 State Conference
17 October 2003

UNDUE PREFERENCES -

LEGAL ISSUES

And

MINIMISING EXPOSURE

Presented by George Lopez
Melsom Robson Chartered Accountants
17 October 2003

MELSOM ROBSON
CHARTERED ACCOUNTANTS

Undue/Unfair Preferences - Legal Issues and Minimising Exposure

Undue/Unfair Preferences - Legal Issues and Minimising Exposure

1. Introduction

The laws of insolvency, be they corporate or personal, seek, with few exceptions to treat like creditors equally. The rationale behind the recovery of preferences reflects that concept of equality. Creditors that have gained unfair advantage over the others and have, accordingly, been "preferred", and the laws provide the means by which Liquidators or Trustees may recover this "preference".

Long before the recovery of preferences was introduced into statute, the prohibition of preferences had been read into common law and there are claims [1] that it had even been addressed in Roman civil law. Understandably then, the first bankruptcy legislation introduced into England in 1542 included the recovery of transactions which had "diminished the debtor's property in favour of someone else".

In Australia, prior to Federation, each State had its own bankruptcy and insolvency laws demonstrating, as can be expected, a variety of approaches.

The first Commonwealth legislation on bankruptcy was the Bankruptcy Act (Cth) 1924. This included a section on preferences, which are little changed from today's provisions. The first legislation adopted, substantially, a different approach to what had been known in England and Australia as "fraudulent preferences". The Australian approach was to treat transactions as preferences whether or not there was an intention to prefer any creditor or group of creditors. In fact, a major difference that remains to this day between English and Australian law is that, in England, only a fraudulent preference is voidable.

For many years, recovery of preferences under corporate legislation simply referred to the Bankruptcy Act, by stating that a transaction that, in bankruptcy, would be void against a trustee, was void as against a liquidator.

This provided a measure of consistency between the two jurisdictions and, in the main, legal precedents set in one jurisdiction could be comfortably applied in the other.

This changed in 1993, with the introduction of Part 5.7B into the then Corporations Law. The change incorporated its own definitions and created a divergence from the previous reliance on the Bankruptcy Act. While many would claim the differences are of minor significance only and that the philosophies are unchanged, the fact is, the wording has changed, and there have been some omissions and additions. The changes are sufficient to create quite significant differences between the two. With further legal precedent being set over time, the differences will only increase.

2. Summary of legislation

2.1 Bankruptcy Act - summary

Under the Bankruptcy Act, the issue of undue preferences is essentially covered under section 122 (see annexure "A"), with defences available under that section and section 123.

Unlike the Corporations Act, the Bankruptcy Act does not actually define preferences, but provides the circumstances in which a transaction is void against the trustee.

In essence, for a transaction to be void, it needs to satisfy the following criteria:-

- Property has been transferred;
- There must be a debtor/creditor relationship;
- The recipient must have received a preference, priority or advantage over other creditors;
- The transaction took place in the qualifying period; and
- At the time of the transfer, the debtor was insolvent

[1] May, The Law of Fraudulent and Voluntary Conveyances,

It should be noted that the transaction is voidable. In other words, it is not invalid unless the Trustee elects to set it aside.

The onus of proving these elements rests with the Trustee[2].

The Bankruptcy Act also provides protection for certain transactions. In essence protected transactions include:-

- Where the recipient acted in the ordinary course of business, in good faith and provided valuable consideration;
- Transactions wherein, persons make title through or under a creditor in good faith and provided consideration at least to the market value of the property;
- Transactions made or incurred under maintenance agreements or orders; or
- Transfers under a debt agreement

It should be noted that undue preferences are only recoverable where the debtor is bankrupt, subject to a Deed of Assignment under Part X, or in administration of deceased estates under Part XI.

2.2 Corporations Act - summary

The Corporations Act takes a more circuitous route in its treatment of what it calls "Unfair Preferences".

Unfair Preferences are defined in section 588FA which states that a transaction is a preference only if:-
The debtor company and the creditor are parties to the transaction; and
As a result, the creditor receives more than the creditor would have received had the transaction not occurred.
Even if the transaction occurred because of a court order or direction from an agency.

It should be noted that being an unfair preference by itself does not make a transaction void. It must also be an insolvent transaction. Section 588FC defines an insolvent transaction as, *inter alia*, an unfair preference:-
Occurring or given effect when the company is insolvent or
Whose occurrence or effect causes the insolvency of the company

Having established that a transaction is an insolvent transaction, section 588FE then defines transactions that are voidable as insolvent transactions that occurred:-

- Within six months ending on the relation-back day or
- After the relation-back day but before the winding up began;
- If a related party is involved, transactions occurring within four years of the relation-back day; or
- If the transaction was intended to defeat, delay, or interfere with the rights of creditors, transactions occurring within ten years of the relation-back day.

On the other hand, a creditor who wishes to claim protection has to show, in accordance with section 588FG(2) that:-

- The transaction was effected in good faith;
- The creditor did not and had no grounds to suspect, that the company was insolvent or would become insolvent as a result of the transaction; and
- Provide valuable consideration, or changed its position in reliance upon the transaction.

3. Personal Insolvency

3.1 Essential Elements

For a transaction to be void, it needs to satisfy the following criteria:-

- Property has been transferred;
- There must be a debtor/creditor relationship;
- The recipient must have received a preference, priority or advantage over other creditors;
- The transaction took place in the qualifying period; and

[2] Sandell v Porter (1966) 115 CLR 666

- At the time of the transfer, the debtor was insolvent

3.1.1 Transfer of property

To be voidable, the transaction must include a transfer of property by a person who is insolvent.

The Bankruptcy Act defines property as any property, whether real or personal of every description, whether in Australia or otherwise and includes any estate, interest or profit, present or future, vested or contingent, arising our of or incident to any such real or personal property[3].

Transfer of property includes the payment of money and a person who does something that results in another person becoming the owner of property that did not previously exist is taken to have transferred that property[4]. This can be used in the widest sense and may include a mere transfer by book entry, that is, by journal entries without any money actually passing across[5]. It should be noted, however, that book entries without the knowledge or agreement of the other party may not establish a transfer or payment[6].

On the other hand, payment by cheque, whether or not with authority, is still a payment[7].

Other than the obvious physical transfer of assets or cash, the following provide further examples of transfers:-

- A bank normally reserves the right to set off funds in one account against an overdraft or debt in another. However, where there is agreement, even if only implied, that two accounts should be kept separate, payment by the customer of funds from one to the other is a transfer and gives the bank a preference[8].
- Wool shorn from a sheep and delivered during the relation back period to a creditor, who retained the proceeds of sale is deemed to be a payment for he purposes of preference[9].
- On the other hand, while an agreement authorising an agent to retain the proceeds of sheep was not deemed to be a transfer, the subsequent retention of the proceeds was, and deemed a preference. In this case, the agreement was outside the six months, while the retention of proceeds was within six months[10].
- Granting of security is also a transfer for the purposes of this section. A Bill of Sale granted within six months was a transfer[11].
- The sale of assets to a creditor, with the proceeds set off against a debt owed is a transfer and thus voidable[12]. In this case a motor vehicle was sold to the creditor and the sale proceeds set off against the debt.
- A transaction wherein the supplier entered into an arrangement with the debtor to re-transfer title back to the supplier and to hold the property as bailee, was defeated. The revesting of title in the creditor was deemed to be a transfer[13].

3.1.2 Debtor/creditor relationship

For a transaction to be voidable, the relationship must be that of a debtor and creditor. A transfer of property to a party that is not a creditor cannot be a preference, but may be recoverable as a disposition under section 120.

A Creditor is a person who would be entitled to prove in the bankruptcy of the debtor. Accordingly, it is arguable that parties who do not have debts which may be provable cannot receive a preference. For example, claim for unliquidated damages in tort is not a provable debt and hence, cannot be a creditor[14]. Using similar argument, payment of court fines and penalties, which are not provable debts, cannot be recovered as preferences.

---

3 Bankruptcy Act sec 5(1)
4 Bankruptcy Act sec 122(8)(a),(b)
5 Re Hardman: ex parte Official Receiver; Leng, Rundle and Sloss (1938) 10 ABC 198
6 Manzi v Smith (1975) ALJR 376
7 Re N A Kratzmann Pty Ltd; Rees v Atherton's (Qld) Pty Ltd (1968) Qd R 480
8 Re Deague; Burns v Commercial Bank of Australia Ltd (1951) 15 ABC 197
9 Re Wade (1943) 13 ABC 116
10 Re Kelly; ex parte Young; Victorian Producers Co-op Co Ltd (1932) 4 ABC 258
11 Re Simpson; ex p Cook (1935) 8 ABC 234
12 Re Smith; ex p Trustee ; J Bird Pty Ltd and Tully (Respondent) (1933) 6 ABC 49
13 Radio Corp Pty Ltd v Bear (1961) 108 CLR 414
14 Re Sperling & Sperling ex parte LR Aitkin (1984) 3 FCR 124

Section 122(1) does not require that the transfer or payment be made to the creditor, merely "in favour of" a creditor. Thus a payment made to a board of publishers pursuant to its requirement debts owed to publisher members be satisfied prior to the board approving a transfer of the newsagency, was void as a preference[15]. Similarly, payment made to a bailiff who remits the funds to the creditor, is caught as a preference[16]. The creditor, however, is not obliged to remit the sum paid by the debtor, but only the funds received from the bailiff.

A payment made in favour of a person in trust for the creditor (e.g. a solicitor) is deemed to be a payment in favour of a creditor[17].

Some examples of payments to creditors include:-

- A payout under a leasing agreement if a shortfall may have eventuated on the lease[18];
- A guarantor of the debtor's liability, is a creditor if he may prove in the debtor's bankruptcy[19];
- Money paid into court [20];
- Moneys held in trust are not payments to a creditor, but note that they still belong to the debtor. As soon as they are paid out of the trust account in favour of the creditor, they may be recoverable[21].;

On the other hand, here are some examples of payments deemed not to have been made to or in favour of a creditor:-

- Authorised payments under contract to nominated sub-contractors[22];
- Payments against future advances or supplies[23];
- Garnishee orders do not create any debt at law o equity, they merely give the garnishor a lien upon that debt[24];

3.1.3 Giving "preference, priority or advantage"

This is a vital component if a transaction is to be voided. If a creditor has not received a preference, priority or advantage over other creditors, then there simply is no voidable transaction, no matter that all the other elements may apply. The onus of proof rests on the Trustee seeking to void the transaction.

Under Australian Law, the debtor's intention to prefer is largely irrelevant, although his intention could be used, in the event of collusion with the creditor, to show lack of good faith on the creditor's part. Thus the Australian approach is that of a *de facto* preference as opposed to a *fraudulent preference*.

A test to determine the extent of the creditor's claim and the likely return if the transaction had not occurred would help determine whether the creditor had received a preference or advantage. This test has now been codified in the Corporations Act[25].

Any transaction that would, in effect, change the statutory priorities of creditors is voidable[26]. A mortgage creates a charge even if not registered and is a transfer[27].

However, in Sheahan v Carrier Air Conditioning[28] payments made by a Receiver to creditors was not a preference although those creditors received an advantage, the argument being that the payment was from the Receiver and not the company and the funds belonged to the secured creditor, not the company.

---

15 Re Price (1963) QWN 12
16 Rae v Samuel Taylor Pty Ltd (1963) 110 CLR 517
17 Bankruptcy Act sec 122(4)(a)
18 Re S&N (Nominees) Pty Ltd (in liq); Yeomans v Lease Finance Ltd (1986) 84 FLR 463
19 Re Blackpool Motor car Co Ltd (1901) 1 Ch 77
20 Commercial banking Co of Sydney Ltd v Colonial Financiers of Australia Pty Ltd (1972) 20 FLR 220
21 Re Wedgwood: ex parte Bank of New Zealand (1993) 116 ALR 153
22 CG Monkhouse Pty Ltd Re (1968) 88 WN (pt 2) (NSW) 238
23 Expo International Pty Ltd (in liq) v Torma (1985) 3 ACLC 748
24 Melsom & Anor v Vanpress Pty Ltd (1990) 8 ACLC 496
25 Corporations Act sec 588FA(1)(b)
26 Burns v Stapleton (1959) 102 CLR 97
27 Re Shoreline Homes Ltd (1982) NZLR 663;
28 Sheahan v Carrier Air Conditioning (1997) 15 ACLC 1116

This is contrasted in another matter wherein payment was made from a bankrupt's superannuation fund to his wife[29]. In this matter, even though the funds were not divisible property and hence, not available to creditors, the court determined that the wife had received payment in full while other creditors had not.

The fact that any disgorgement of funds will simply be used to pay liquidator's costs and not benefit creditors does not affect the fact that the funds should be refunded[30].

3.1.4 Insolvency

For a transaction to be voidable, it must be one that is made by an insolvent debtor. The onus is on the Trustee to prove the insolvency of the debtor at the date of the transaction.

The Bankruptcy Act defines solvency as the ability to pay one's debts as and when they become due and payable[31] and a person who is not solvent is "insolvent". This is an objective test and is a watered down version of a previous test which required the debtor to be able to pay "from his own money".

While the test is an objective one, in personal insolvency this is no easy task. Where companies are required to maintain proper records which may assist, the financial record-keeping of individuals may not be of the same standard. Accordingly, establishing a debtor's financial capacity to pay his debts at any point in time may be difficult.

It is not sufficient to show that the debtor was insolvent at the date of bankruptcy, nor is proof of temporary liquidity sufficient. Lack of liquidity is not equivalent to insolvency, nor is the presence of liquid assets proof of solvency[32].

Evidence of insolvency may include invoices unpaid long beyond accepted trading terms, dishonoured cheques, payments on account, bank statements and correspondence and demands from banks, creditors and the like.

3.1.5 Qualifying Period

It is generally considered that a Trustee may attack transactions occurring within six months from the date of bankruptcy. However that is not exactly the case. The Bankruptcy Act provides for specific periods, depending on the nature of the petition leading to the bankruptcy.[33].

In the case of creditor's petitions and debtor petitions where there are no other petitions outstanding, the relevant period is the period six months prior to the presentation of the petition, up to the date of bankruptcy. Depending on time between lodgement of the petition and the order, the actual period will exceed six months.

On the other hand, where the bankruptcy occurred because of a debtor's petition, and at the time of the petition, there were outstanding creditor's petition/s then the Trustee may go back to the date of **commencement of the bankruptcy**.

This adds a measure of uncertainty, as, under these circumstances, the date of commencement of bankruptcy is the time of the earliest act of bankruptcy on which any of the outstanding creditor petitions is based.[34]

It should be noted that the act of giving a preference is, in itself, an act of bankruptcy.

In the case of a Deed of Assignment under Part X, the date of the creditor's petition is deemed to be the date of the creditors' special resolution in favour of the Deed[35]. Accordingly, the Trustee may go back six months from the date of the special resolution.

---

[29] Worrell v Kerr-Jones (2002) FCA 1090
[30] Pegulan Floor Coverings Pty Ltd v Carter (1997) 15 ACLC 1293
[31] Bankruptcy Act sec 5(2),(3)
[32] Expo International Pty Ltd (Rec Apptd)(In Liq) & Anor v Chant & Ors (1979) CLC
[33] Bankruptcy Act sec 122(1)(b)
[34] Bankruptcy Act sec 115(2)
[35] Bankruptcy Act sec 231(2)(a)

It follows that the deemed date of the transaction becomes a vital component in determining whether a transaction falls within the relevant time period.

This raises an interesting question as to when a payment by cheque is made. It has been established that, where the creditor is not the banker, payment by cheque is deemed to have been made on the date the cheque was given to the creditor, not the date in which the proceeds were available to the creditor[36]. Using that argument, a cheque issued outside the relation-back period but presented within the period may escape avoidance.

The situation changes where the creditor is the bank. In that instance, the payment was deemed to have been made when the bank made the funds available to the company[37].

In the case of postdated cheques, however, it has been held that payment is made upon presentation and not when provided to the creditor[38]. In the case concerned, although the cheques were postdated, they could be presented on the date noted on the cheque, but after the debtor had notified the creditor that it was OK for payment.

Would the situation differ if the postdated cheques were presented upon a trigger event, such as delivery of goods, completion of construction stage, etc? In one such case, payment by way of post-dated cheques handed over at the time of delivery of the goods, were not preferences, but may have been if the periods of post-dating had been longer, presentation deferred past the post-date, or if cheques had bounced[39].

3.2 Defences

3.2.1 Standard defences

Even if a transaction fits all the elements of a voidable preference, a creditor may still be protected if it can be shown:-

- that the transaction was entered into in the ordinary course of business;
- That the recipient acted in good faith, AND
- That the recipient gave at least as valuable consideration as the market value of the property.

It should be noted that the creditor must prove ALL three elements and the onus of proof is on the person claiming the protection of this section[40].

Ordinary course of business

In bankruptcy, a recipient of a preference can have no defence if the payment or transfer was made outside the ordinary course of business.

As to what comprises the ordinary course of business, the courts will take into account the normal transactional relationship between the debtor and the creditor and the knowledge of impending bankruptcy, if any.

A payment in the ordinary course of business, is “what a man may do without bankruptcy in view”[41]. Thus, a payment made in response to a bankruptcy notice is likely to be outside the ordinary course of business[42].

There is significant legal precedent in this area and some examples of payments held to be outside the ordinary course of business include:-

- Payment under a cheque initially dishonoured is also likely to be outside the ordinary course of business[43].
- Similarly part payment of a judgement debt after the initial cheque was dishonoured was not in the ordinary course of business[44].

---

[36] Re Transconsult Australia Pty Ltd (in Liq) (1991) 9ACLC 1,052
[37] KDS Construction Services Pty Ltd v National Australia Bank Ltd (1987) 5 ACLC 168
[38] Jayric Pty Ltd (in liq) v Sherwood Overseas Co Pty Ltd (1996) 14 ACLC 656
[39] Mann & Anor v Sangria Pty Ltd (2001) 19 ACLC 696
[40] Bankruptcy Act sec 122(3)
[41] Robertson v Grigg (1932) 47 CLR 257.
[42] Re K&R Fabrications (Qld) Pty Ltd (in liq) (1980) 32 ALR 183
[43] re Cummins & Anor; ex parte Harris v ARC Engineering Pty Ltd (1986) 62 ALR 129

- When goods are repossessed and future deliveries only made on a COD basis [45];
- Payments on account that do not bear relationship to particular invoices [46];
- Repayment of a loan by a company to a director's mother-in-law[47];
- Delivery of finished product by a manufacturer (in this case caravans) to a retailer who had provided working capital[48]. The result may have been different had agreement been made at the time of financing that repayment would be in the form of finished goods.
- Substantial reduction in the bank overdraft over a relatively short period of time[49].
- Where the business has effectively ceased operating and the transaction effectively involves transfer of the only remaining assets, the transaction is not in the ordinary course of business[50].

Ordinary course of business means 'that a transaction must fall into place as part of an undistinguished common flow of business done, that it should form part of the ordinary business as carried on, calling for no remark and arising out of no special or particular situation"[51].

In that regard, the attachment of stickers demanding payment, and even threatening legal action are not necessarily outside the ordinary course of business[52].

Ordinary course of business should take into account practices in general business and commercial practices as well as practices peculiar to a particular business[53]. In Hamilton v BHP Steel[54], the court rejected the liquidator's argument that repayments out of time, threats to refuse supply and temporary closure of the account were outside the ordinary course of business. The court looked instead at the commercial reality of the building industry and the fact that trading had been spasmodic, promise made were kept, and there was no history of bounced cheques.

On the other hand, in another matter[55], the Court rejected the creditor's argument that the Court should take the circumstances of the building industry into account. In this matter, the debtor had advised the creditor that it did not have sufficient funds at that time, and the relationship had undergone a significant change.

Good faith

Good faith implies that the parties entering into a transaction are doing so in all honesty, with no knowledge of any impropriety or insolvency. It is arguable that good faith and ordinary course of business are concepts that are intertwined. Certainly the cases do provide some overlap in these areas and the relevance of one to the other has been recognised[56].

In section 122(4)(c) the Bankruptcy Act seeks to clarify the definition by stating that the essence of good faith is lacking if the creditor knew, or had reason to suspect,

- that the debtor was insolvent and could not pay his or her debts as they became due *from his or her own money*. (the reference to "his or her own money" is actually an extension of the definition of insolvency); and
- that the effect of the transaction would give the creditor a preference, priority or advantage over other creditors

However, the clarification does not limit the definition and it is possible that a transaction which may escape the clutches of ss(4) may, nevertheless, still fail because of other circumstances.

---

[44] Trevor v Cockburn Hire Service (1974) (1986) 4 ACLC 504
[45] Downs Distributing Co Pty Ltd v Associated Blue Star Stores Pty Ltd (1948) 76 CLR 463
[46] Re Mike Electric (Aust) Pty Ltd (in liq) (1983) 1 ACLC 758
[47] Taylor v White (1964) 110 CLR 129
[48] Re Supreme Finance Corporation Pty Ltd (1984) 2 ACLC 529
[49] Kyra Nominees Pty Ltd (in liq) v National Australia Bank Ltd (1986) 4 ACLC 400
[50] Re Dunnemann; ex parte Trustee (1935) 8 ABC 148
[51] Downs Distributing Co Pty Ltd v Associated Blue Star Stores Pty Ltd (1948) 76 CLR 463
[52] Katoa Pty Ltd (in liq) v Dartnell (1983) 74 FLR 202
[53] Harkness v Partnership Pacific Ltd (1997) 41 NSWLR 204
[54] Hamilton v BHP Steel (JLA) Ltd (1995) 13 ACLC 1548
[55] Olifent vEmwest Products Pty Ltd & Ors (1996) 14 ACLC 24
[56] Harkness v Partnership Pacific Ltd (1997) 41 NSWLR 204

While the onus of proving the defence of good faith falls on the creditor claiming protection[57], the onus of proving "bad faith" under section 122(4)(c) rests with the Trustee.

What is important is whether the creditor knew or had reason to suspect insolvency, not whether he had doubts as to the insolvency of the debtor[58]. It is not necessary that he actually suspects that the debtor is insolvent[59].

Some examples

- If a bank is aware that a client is experiencing financial difficulties, any action taken to reduce the overdraft cannot be said to be in good faith[60];
- In the Sydney Appliances case[61], the creditor claimed that all payments were made in good faith, that it did not suspect insolvency, nor would any reasonable person have done so.
  Having considered that the supplier
  - had received financial information on the company,
  - had extended credit terms because it was aware that the debtor required the support of its suppliers,
  - payment by post-dated and undated cheques for round-dollar amounts which were applied against older debts and
  - the inability of the debtor even to stick to the new credit terms,

  the judge concluded that the supplier should have had suspicion of the debtor's insolvency. Accordingly, the defence of good faith was not available.

<u>Valuable consideration</u>

The Bankruptcy Act requires that, in order to section protection under this section, the consideration given must at least equate to the market value of the property transferred. The Bankruptcy Act defines it as "market value at the time of the transfer"[62]. The definition does not help in formulating or calculating market value, but at least it provides guidance as to when that valuation is to be calculated.

The task here involves establishing as precisely as possible, the value of the consideration, if any was in fact provided. If the property transferred is other than cash, the task may provide some practical difficulties, especially if the property transferred is not readily marketable.

The value must be assessed on an objective basis and not dependent on any special value that the transferor may subjectively have placed on the property or consideration. The courts tend to look at this question in the context of a willing but not anxious buyer and seller.

In the majority of cases involving trade creditors however, this question is of little real concern. In those situations, where a book debt is discharged by payment of cash or cheque, the discharge of the debt is deemed to be valuable consideration for the purposes of this section, as the payment of a book debt discharges a debt of the same value.

In accordance with this concept, taxes are given specific reference, and a payment of tax or other payment under the jurisdiction of the Commissioner of Taxation, is taken to be made for valuable consideration[63]. Tax itself is defined as a "tax, however described, payable under a law of the Commonwealth or State and includes levies, charges and municipal rates"[64].

3.2.2 Other protection

---

57 Bankruptcy Act sec 122(3)

58 Re Weiss; ex parte White v John Vicars & Co Ltd (1970) ALR 654

59 Re Southern Cross Commodities Pty Ltd (in liq); Mount v Pfeifer (1984) 58 ALR 149

60 Rees v Bank of New South Wales (1964) 111 CLR 210; Kyra Nominees Pty Ltd (in liq) v National Australia Bank Ltd (1986) 4 ACLC 400

61 Sydney Appliances Pty Ltd v Eurolinx Pty Ltd (2001) 19 ACLC 633

62 Bankruptcy Act sec 122(8)(c)

63 Bankruptcy Act sec 122(4)(b)

64 Bankruptcy Act sec 122(7)

Third parties

A person (who may not be a creditor) but acquires title to debtor's property, either through or under a creditor may be protected, if, and only if, he acquires the title in good faith AND gave consideration at least as valuable as the market value of the property[65].

An acquirer of property under this section does not have to prove that the property was received in the ordinary course of business and it should be noted that this defence is similar to that required under the Corporations Act.

Maintenance agreement or order

Payments made in accordance with a maintenance order or agreement are specifically protected pursuant to sec 122(2)(c). The Bankruptcy Act as *maintenance agreement* as:

(a) a maintenance agreement (within the meaning of the *Family Law Act 1975*) that has been registered in, or approved by, a court in Australia or an external Territory; or
(b) a financial agreement within the meaning of that Act; or
(c) any other agreement with respect to the maintenance of a person that has been registered in, or approved by, a court in Australia or an external Territory.

Maintenance order is defined as:

(a) an order relating to the maintenance of a person, including an order relating to the payment of arrears of maintenance, that is made or registered under a law of the Commonwealth or of a State or Territory of the Commonwealth; or
(b) an assessment made under the *Child Support (Assessment) Act 1989*.

It is interesting to note that the Bankruptcy Act does not distinguish between orders that are contested and orders arrived at by consent.

Transfer under debt agreement

Debt agreements, which are a relatively recent introduction, are administered under Part IX of the Bankruptcy Act.

As debt agreements are predicated on the basis that they can only be implemented by special resolution, that is, accepted by 75% in value and a majority in number of creditors who choose to vote, the arrangement has been accepted by and has the sanction of, creditors.

4. Corporate Insolvency

Recovery of preferences under the Corporations Act is similar to, but not the same as, in bankruptcy. As stated earlier, the development of the recovery provisions in corporate law followed and relied on the Bankruptcy Act for many years and you should note that many of the legal precedents referred to thus far actually involve corporate matters.

The changes to the Corporations Act (then Corporations Law) have seen moves in slightly different direction.

It should be noted that unfair preferences may only be recovered if a company is in liquidation[66].

Funds recovered by a liquidator are recovered under statute and do not form assets of the company subject to security. Accordingly, they are not available to secured creditors and may be distributed to unsecured creditors[67].

A creditor against whom a claim is made is not entitled to set that claim off against amounts still owing to him[68].

---

[65] Bankruptcy Act sec 122(2)(b)
[66] Corporations Act sec 588FE(1)
[67] NA Kratzmann P/L v Tucker (no 2) (1968) 123 CLR 295; Tolcher v National Australia Bank (2003) 21 ACLC 587
[68] Re Amour ex parte Official Receivers v Commonwealth Trading Bank of Australia (1956) 18 ABC 69

The Corporations Act allows creditors who have refunded the preference, that is have "put the company in the same position as if the transaction had not been entered into" to prove in the winding up as if the transaction had not been entered into[69]. What would the position be if the creditor did not refund all the funds? For example, the creditor may have refund all the moneys it received and was obliged to, but because of legal costs of recovery, the company did not recover all the funds paid out. Arguably, the conditions in the section have not been met and the creditor may not prove in the company.

As to the matter of interest, the courts have varied views on this. In Mike Electric[70], interest was awarded from the date of liquidation until recovery of the preference. This view was supported in later cases[71]. However, there have been contrary views, suggesting that interest should only be claimable from the date of demand, or commencement of legal action[72].

4.1 Essential Elements

To summarise the provisions of the Corporations Act, the elements of a recoverable transaction are:

- there must be a transaction;
- in which a company and its creditor are part;
- which results in the creditor receiving a benefit;
- occurring when the company was insolvent;
- within the qualifying period

The onus of proving these elements is on the liquidator.

4.1.1 Transaction

While the term used is different, transactions are essentially what the Bankruptcy Act refers to as transfers. The Corporations Act defines a transaction to mean a transaction to which the company is a party, for example:

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

and includes such a transaction that has been completed or given effect to, or that has terminated.

It should be noted that the Corporations Act does not limit the definition to the types of transaction described above.

In determining what is a transaction, one interesting case[73] involved a creditor who was a franchisor. The creditor terminated the franchise. It then obtained the business goodwill, customers, plant and equipment of the franchisee, which it set off against he debt owing. There was no binding agreement, mere acquiescence. A transaction required an arrangement between the company and the creditor. However, if the franchisor had simply terminated the licence and received the benefits of doing so, there would have been no transaction to which the company was a party.

---

[69] Corporations Act sec 588FI
[70] Re Mike Electric (Aust) Pty Ltd (in liq) (1983) 1 ACLC 758
[71] Maurice Drycleaners Pty Ltd (in liq) & Anor v National Australia Bank Ltd (1990) 8 ACLC 798
[72] Katoa Pty Ltd v Premier Auto Spares Pty Ltd (1984) 2 ACLC 352; Spedley Securities Ltd (in Liq) v Western United Ltd (in liq) (1992) 10 ACLC 888
[73] Wily v Bartercard (2000) 18 ACLC 448; upheld on appeal in Bartercard Limited v Wily & Anor (2001) 19 ACLC 1461

In another case that receives attention elsewhere in this paper[74], a series of six discrete events were so bound together that they were characterised as the same transaction. The transactions were

- order;
- delivery;
- contemporaneous delivery of invoice;
- cheque delivery at or soon after receiving an invoice; and
- postdated cheques for the exact amount of the invoice presented on the post-date.

4.1.2 Debtor/Creditor relationship

Section 588FA, which defines unfair preferences specifically requires that the company and its creditor must be parties to the transaction, even if someone else is also a party.

Accordingly, we do not need to extensively cover this aspect here and the reader may refer to the comments and cases referred to earlier in this paper in the section on bankruptcy.

Note however, that while section 588FA requires that the debtor and creditor must be parties to the transaction, it does not require that they be parties to all of the transaction's components. In this case the company had entered into a rescue package with some of the funds being used to pay its creditors. What mattered was that the creditor received a benefit from the company which discharged the company's debt[75] even if a third party was required to effect the transaction.

It is worth noting that, if the transaction under section 588FA comprises a series of related transactions, to be caught under this section, the "creditor" has to have been a creditor at the commencement of the series of transactions. A person who becomes a creditor as a consequence of the transactions is not a creditor for the purpose of this section[76].

In the case of Minister for Transport v Francis and Woodings[77], the question of whether a series of deductions against prepayments was addressed. This case involved advances being made on a contract by a client, ahead of the work actually being done. Effectively, from the company's viewpoint, until the work was done, those payments in advance rendered the client a creditor. The client subsequently deducted those advances from future payments. The liquidators claimed that the deductions were unfair advances, but the Full Court, on appeal, found that the Minister was not a creditor as the advances were made on account of the contract and the intention was that they should be deducted from future payments. At the commencement of the series of transactions, the client was actually a debtor and not a creditor.

In another matter, an accountant was engaged to assist in the conduct of a creditors voluntary liquidation and for work to be undertaken after liquidation. A fee was struck for the pre and post liquidation work and funds paid across, to be retained in the accountant's trust account until the work was done. When the pre-liquidation work was completed, the accountant drew funds from the account. The court ruled that there was a series of related transactions, beginning with the engagement on condition that the funds be paid into the trust account. At the beginning of the series of transactions, the accountant was not a creditor and hence, sec 588FA was not applicable[78].

Similar decisions were reached where prior arrangements were made for delivery of goods with payment by postdated cheques. The delivery of goods and the payment were closely related in event and time and hence, could be characterised as part of a series of transactions. The Court did note, however, that had the presentation of the cheques been deferred or cheques bounced, that series may have been broken and the result different[79].

Interestingly, Sales Tax remittances are not recoverable as payments to a creditor. The rationale is that the remitter is merely gathering the tax on behalf of the Commissioner[80].

---

[74] Mann & Anor v Sangria Pty Ltd (2001) 19 ACLC 696
[75] Macks and Emanuel(no 14) v Blacklaw & Shadforth (1997) 15 ACLC 1099
[76] Mann & Anor v Sangria Pty Ltd (2001) 19 ACLC 696
[77] Minister for Transport v Francis and Woodings (as joint liquidators of Covcon Pty Ltd) (2000) 18 ACLC 617
[78] VR Dye & Co v Peninsula Hotels Pty Ltd (1999) 17 ACLC 954
[79] Mann & Anor v Sangria Pty Ltd (2001) 19 ACLC 696
[80] Sands & McDougall (Wholesale) Pty Ltd v FC of T (1997) 15 ACLC 115

Payments to the ATO as a consequence of a section 218 order are not transactions as the debtor company is not deemed to be a party to the transaction[81]. This view is consistent with precedents involving garnishee orders.

4.1.3 Benefit to creditor

While wording of the Bankruptcy Act requires that a creditor have received a preference, priority or advantage over other creditors, the Corporations Act does not require that element of proof. It only requires that the creditor have received more than it would have if the transaction were set aside and the creditor were to prove in the winding up. For all intents and purposes, however, the effect is likely to be very similar, at least, that appears to have been the legislators intention, claiming that the new section specified, from a corporate viewpoint, the intention of the Bankruptcy Act.

This view appears to be shared by the courts generally by Tadgell JA[82], who said, and I quote :

> *"I cannot discern in the elaborate provisions …………any distinction now relevant from their forerunners in the Commonwealth Bankruptcy legislation of 1924 and 1966. It remains a quintessential prerequisite of a transaction to be avoided by any of those statutory provisions that it should operate to give a preference to a creditor in respect of an existing debt."*

A transaction caught under this definition is still regarded as a preference even if it was made to give effect of an order of a court or direction of an agency[83].

To calculate the advantage, one simply needs to compare the potential receipt in the actual winding up, rather than to calculate a theoretical return based on winding up at the date of the transaction[84].

Such a calculation would take into account the creditor's rights to priority and the extent to which the debt may be secured or unsecured. A secured debt is taken to be unsecured to the extent of so much of it (if any) as is not reflected in the value of the security[85].

4.1.4 Insolvency

For a preference to be voidable, it must be an insolvent transaction[86]. Section 588FC defines an insolvent transaction as, *inter alia*, an unfair preference:-

- Occurring or given effect when the company is insolvent or
- Whose occurrence or effect causes the insolvency of the company

A company is insolvent if it is unable to pay all its debts as and when they fall due[87]. This definition is consistent with that in the Bankruptcy Act and reinforces the judgement in Sandell v Porter[88] and tries to place an objective test on the question of insolvency.

ASIC v Plymin[89] is a recent case that provides guidance as to the factors to be considered. In this case

- The company continually delayed paying its creditors;
- It main divisions were unprofitable;
- It incurred large trading losses funded by delayed and non-payment of many debts, extensions of credit were not granted by its creditors;
- Other sources of finance were not obtained;
- Payment of round sums on account;
- Some suppliers had placed the company on COD;

---

[81] Commissioner of Taxation v Macquarie Health Corporation Ltd and Ors (1999) 17 ACLC 171; Driver, liquidator of Tilse Building Pty Ltd (in liquidation) v Commissioner of Taxation (2000) NSWCA 247
[82] VR Dye & Co v Peninsula Hotels Pty Ltd (1999) 17 ACLC 954
[83] Corporations Act sec 588FA(1)
[84] Walsh v Natra Pty Ltd (2000) VSCA 60 (28/4/2000)
[85] Corporations Act sec 588FA(2)
[86] Corporations Act sec 588FC
[87] Corporations Act sec 95A
[88] Sandell v Porter (1966) 115 CLR 666
[89] ASIC v Plymin & Ors (No 1) (2003) 21 ACLC 700

- There were threatened legal actions;
- Taxes had not been paid;
- Further bank funding was rejected;
- The company could not raise equity capital;
- The company was forced by its bank to hold all financial facilities, a separate account being opened for the purpose of paying wages.

Quite clearly, the company was unable to use any funds generated to pay creditors other than the bank

To further assist liquidators, the Corporations Act provides for further presumptions on insolvency. These presumptions, contained in section 588FE, are

- If a company is insolvent within twelve months of the relation back day, in the absence of evidence to the contrary, it is presumed to be insolvent from that point until the relation back day;
- If a company is proved to be insolvent for other recovery purpose by its liquidator, it is presumed to be insolvent for the purposes of an undue preference; and
- The company is presumed to be insolvent throughout any period that the company has failed to maintain proper financial records or has failed to retain its records for seven years, in contravention of section 286. Note that this presumption does not apply in respect of recovering unfair preferences unless the creditor receiving the preference is a related entity.

Theoretically, at least the task of proving insolvency should be easier in a corporate recovery action than would be the case in bankruptcy. At least companies have a legal requirement to maintain proper books and records and if they do not, then they are presumed to be insolvent from that point on in the absence of evidence to the contrary.

For a number of reasons, related to potential recovery action, Liquidators devote significant energy to the question of insolvency and establishing a date of insolvency could encompass, *inter alia*, the following:-

- Listing Outstanding Creditors, obtaining copies of statements and invoices
- Evidence of legal threats, demands
- Aged creditor analyses
- Examining bank statements for evidence of dishonoured cheques
- Balance Sheet test
- Examining Management Accounts
- Reviewing director reports and minutes of meetings
- Assessing quality of books and records

4.1.5 Qualifying period

As referred to earlier in this paper, how far back the liquidator can go to recover preferences depends on the specific situation, in summary:

- From six months before the relation back day up to the day winding begins in the case of unrelated parties;
- Four years up to and including the relation back day in the case of related parties and
- Ten years up to and including the relation back day where purpose of the transaction was to defeat creditors

It will be clear that the critical day is the relation back day. This is defined as[90]

- In the case of a court liquidation, not preceded by a Voluntary Administration or Deed of Company Arrangement, the day on which the application for the court order was made;
- In the case of Voluntary Liquidation, the day of the members' resolution; and
- Where the company is in Voluntary Administration or subject to a Deed of Company Arrangement at the time it entered into Liquidation, the date of appointment of the Voluntary Administrator.

Thus, a winding up preceded by either a VA or DOCA could significantly extend the period of recovery by the liquidator. This was done to ensure that the VA process is not abused as a means to defeating recovery through the effluxion of time.

It should be noted that a floating charge security created within six months of winding may be invalid, regardless of whether it is an unfair preference. The exceptions are

---

[90] Corporations Act sections 9, 513A, 513C

- if the creditor has made contemporaneous or subsequent new advances, undertaken liabilities or other obligations, or provided services in consequence of the security[91] or
- the debtor company was solvent immediately after the time of creation of the charge

4.2 Defences

The defence provisions against recovery encompass three elements detailed in section 588FG(2), which states:

A court is not to make under section 588FF an order materially prejudicing a right or interest of a person if the transaction is not an unfair loan to the company , or an unreasonable director-related transaction of 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 .

The onus of proof rests with the creditor claiming the protection of this section and it should be noted from the wording of the section that the creditor must prove all three elements of the defence.

It should also be noted that this is a substantial departure from the Bankruptcy Act requirement that the creditor also demonstrate that the transaction was in the "ordinary course of business". This is no longer a requirement for the defence in the corporate scene.

Where a non-creditor third party is involved section 588FG(1) applies:-

A court is not to make under section 588FF an order materially prejudicing a right or interest of a person other than a party to the transaction if it is proved that:

(a) the person received no benefit because of the transaction ; or

(b) in relation to each benefit that the person received because of the transaction :

(i) the person received the benefit in good faith; and

(ii) at the time when the person received the benefit:

(A) 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

(B) a reasonable person in the person's circumstances would have had no such grounds for so suspecting.

4.2.1 Good Faith

This is the first of three elements that must be proved if a creditor is to successfully defend an action for an unfair preference.

There is no precise definition of "Good Faith" and guidance may only obtained by reference to the many cases based on sec 122 of the Bankruptcy Act.

It has been argued that the concept of good faith is too subjective, encompassing the state of mind of the creditor at the time of the transaction. In the final analysis, it is left to the court to decide as to the state of the creditor's mind at the time[92].

The courts have tended to adjudge good faith on the basis of propriety, honesty and awareness of other creditors. If a creditor accepts payment knowing or having reason to suspect that other creditors will be left

[91] Corporations Act sec 588FJ
[92] Wily v Lopresti (no 2) (1998) 16 ACLC 85

unpaid while he receives payment, good faith cannot be present. Similarly, all that is required to show absence of good faith is knowledge of other creditors over whom the creditor might be receiving a preference[93].

It is generally difficult for a bank, the company's accountant, or a director to prove good faith than it would be for trade creditors, especially those who do not deal with the company or a regular or frequent basis. Accordingly, good faith will be difficult to establish where payments are made to persons with control of the company and should have been aware of its insolvency[94].

4.2.2 No Reason to suspect insolvency

This is the second element of defence. Arguably, this test is more objective than that for "good faith" given, among other things, the test of insolvency. The key issues here are not that the company was insolvent, but that the creditor had no reasonable grounds for suspecting insolvency or, in the alternative, a reasonable person in similar circumstances would have no grounds for suspecting insolvency.

It is the actual insolvency that must be suspected or known and not a suspicion that the debtor may be insolvent. It is also important that a distinction be made between an inability to pay debts as opposed to an unwillingness to do so.

It has been suggested that the facts upon which the defence of good faith and lack of reason to suspect insolvency are often very similar. In that regard, as with the defence of good faith, it is harder for a bank to prove lack of suspicion of insolvency than it would be for a trade creditor. In a case where a bank sought to reduce the company's overdraft by applying deposits to the account and dishonouring cheques, the bank was held to know of the company's difficulties[95].

In Levi v Guerlini & Ors[96], the fact that the creditor stopped giving the debtor 90 day terms and insisted on COD payments was evidence from which a reasonable person could infer that the company was in financial difficulties. Accordingly, the defence was not available to the creditor.

In Mann & Anor v Sangria[97], while the court found that the creditor had acted in good faith, the trading history, the creditor's decision to commence legal recovery action, the negotiation of an instalment arrangement, acceptance of post-dated cheques all provided reasonable grounds for suspecting insolvency.

In Sydney Appliances[98], the fact that the debtor was unable to meet 60 day terms, the use of post-dated and undated cheques, acknowledgement by the creditor that the debtor was having trouble financially and need the support of its creditors to survive and the fact that figures were provided which, had the creditor bothered to analyse, showed the company was in financial difficulty, all combined to deny the defence afforded by this section.

The courts recognise, however, that industry norms must also be taken into account. In that regard, the fact that it was normal practice in the industry to make payments up to two to three months late, an expectation by the creditor that payment would be late and hence, building an allowance into its pricing to cover that eventuality, an awareness by the creditor that deliveries were late and consequent extensions of payment dates and endorsement of such on the invoices, led to the conclusion that no reasonable person would have grounds for suspecting insolvency[99].

In another case, involving the building industry, similar allowances were made for the history of the relationship between the company and its sub-contractor and what was, in effect common practice within the industry. Accordingly, there was no reason to suspect that the company was insolvent, at least up to a certain point. However, the company did, on a particular date, admit an inability to pay its debts and at around the same time, it

[93] Re Toowong Trading Pty Ltd (in liq) (1988) 6 ACLC 436
[94] Re Mike Electric (Aust) Pty Ltd (in liq) (1983) 1ACLC 758
[95] Rees v Bank of New South Wales (1964) 111 CLR 210
[96] Levi v Guerlini & Ors (1997) 15 ACLC 913
[97] Mann & Anor v Sangria Pty Ltd (2001) 19 ACLC 696
[98] Sydney Appliances Pty Ltd v Eurolinx Pty Ltd (2001) 19 ACLC 633
[99] Shirlaw & Anor v Associated Alloys Pty Ltd (2000) 18 ACLC 763

lost its contractor's licence, a fact well known in the industry. From that point on, the creditor was unable to rely on its defence that it had no grounds to suspect insolvency.

4.2.3 Valuable Consideration

The Corporations Act differs from the Bankruptcy Act in that whereas the Bankruptcy Act requires that consideration provided should be at least as valuable as the "market value" of the property transferred, the Corporations Act does not.

A purchaser for valuable consideration must give consideration which has real and substantial value and not one which is trivial, nominal or colourable[100]. Consideration can be valuable without being adequate, but it must have substance. Plain good consideration is not enough, in the sense that the natural love that a man has for his wife and children is not enough.

The existence of a debt is sufficient consideration for its discharge[101].

Where a creditor agreed to carry out work it was not obliged to do, not to enforce immediate payment of its debt and to withdraw caveats over land, it was held to have given valuable consideration[102].

In a New Zealand case, the court said that forbearance to sue is not valuable consideration and further, it doubted whether forbearance to sue could ever amount to valuable consideration[103]. It was contrasted by a later Australian case which held that a forbearance, in effect, conversion of a debt payable on demand to one payable in seven years was consideration of "real and substantial value"[104].

Payment of a tax or other liability to the Commonwealth or Commissioner of Taxation under an Act of which the Commissioner has jurisdiction, is valuable consideration[105].

5. Running Accounts

A running account is a continuous account, the balance of which fluctuates from time to time, increasing as the creditor provides further goods and services, and decreasing as payments are made. A running account may be described as an active account running from day to day as opposed to an account in which further debits are not contemplated. A basic tenet of the running account is that further transactions, both payments and supply, may be anticipated. Although not always the case, running account balances generally do not come down to a zero balance, especially if purchases are made on a frequent basis and payments made monthly.

It is fair to state that most supplier accounts where purchases are made on a frequent basis will be running accounts, another example of which will be a bank account. Surprisingly, it was held that a telephone account was not a running account. In the case concerned[106], it was held that there was always a debtor and creditor relationship. Periodic accounts were submitted with the requirement that they be paid in full by a certain date, failing which, the account would be cancelled and service terminated. This treatment is unusual and it is likely that the specific terms of trade between the creditor and the debtor was the determining factor.

Running accounts have always produced difficulties in the area of preferences, primarily because of the difficulty of determining the advantage or preferential effect where there is a continuous business relationship. The fluctuating balances in the account provide a dilemma as to which transactions during the relation back period may be attacked, given that payments are made with the anticipation of future supplies.

If the normal course of trading continues, payments made on a running account will not be preferential. However, if the creditor attempts to reduce the debt contrary to normal dealings, the advantage gained may

---

[100] Barton v Official Receiver (1986) 4 ACLC 533
[101] Taylor v White (1964) 110 CLR 129
[102] Shirlaw v Malouf & Ors (1989) 7 ACLC 1043
[103] Meo & Anor v Official Assignee (1987) 3 NZCLC
[104] Re Fairline Furniture (Aust) Pty Ltd (in liq) (1988) 6 ACLC 364
[105] Corporations Act sec 588FG(3),(5)
[106] Overseas Telecommunications Corporation Ltd v Russell Kumar & Sons Pty Ltd (1993) 11 ACLC 281

appear to breach good faith, unless it can be demonstrated that reduction operates on a periodic basis. To add to complications, some payments may be made to reduce the balance, while others to ensure continuing credit. If only one payment is made each month, differentiating between each type of payment may be difficult, if not impossible. Each payment may be said to be a preference, however, the courts tend to look at the overall effect of the series rather than the effect of each transaction[107].

In CSR v Starkey[108] the single judge initially found that each payment by the debtor was a preference, with the result that CSR was held to have received preferences totalling $657,230. CSR appealed successfully, relying on the running account principle, with the result that its liability was reduced to $190,191. It argued that as the account was a running account, the extent of the preference was limited to the difference between the debt at a particular peak point during the relevant period and the debt at the commencement of the liquidation.

The definition of Unfair Preferences in the Corporations Act specifically provides for running accounts firstly by defining them and providing for their treatment. In effect, it represents a codification of the principles reflected in a number of landmark cases, principally Queensland Bacon Pty Ltd v Rees (1967) 115 CLR 266 and Petagna Nominees Pty Ltd & Anor v AE Ledger 1 ACSR 547. The section is reproduced here:

588FA(3)

Where:

(a) a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor of the company (including such a relationship to which other persons are parties); and

(b) in the course of the relationship, the level of the company 's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship;

then:

(c) subsection (1) applies in relation to all the transactions forming part of the relationship as if they together constituted a single transaction ; and

(d) the transaction referred to in paragraph (a) may only be taken to be an unfair preference given by the company to the creditor if, because of subsection (1) as applying because of paragraph (c) of this subsection, the single transaction referred to in the last-mentioned paragraph is taken to be such an unfair preference .

In summary, where a running account has been established, the group of transactions within the period in question are to be treated as a “single transaction”, with each individual transaction only being a preference to the extent that the “single transaction” is deemed to be a preference.

The burning question here is, which point during the relation back period does the liquidator use to determine the extent of the preference?

The popular view is that the liquidator may choose any point within the period to show that a preference existed and there is no reason that he cannot pick the point with the highest indebtedness. The preference will then be the difference between that peak indebtedness and the debt outstanding at the date of liquidation[109].

Where there is a running account, whether there is any preference depends on the ultimate effect on the balance of the account rather than on the immediate effect. The issue is whether there has been a permanent reduction in the account balance over the period of the running account[110].

6. Minimising exposure

Minimising exposure to refunds of voidable preferences requires a consideration of the elements of voidable transactions, together with the defences available and a knowledge of the reasoning behind the judgements in the various cases considered over the years.

---

[107] Richardson v Commercial Banking Co of Sydney Ltd (1952) 85 CLR 110

[108] CSR Ltd trading as The Readymix Group v Starkey (as liquidator) of Allan Fitzgerald Pty Ltd (in liq) (1994) 13 ACSR 321

[109] Rees v Bank of New South Wales (1964) 111 CLR 210

[110] Sydney Appliances Pty Ltd v Eurolinx Pty Ltd (2001) 19 ACLC 63

Before addressing the various suggestions, the first piece of advice must be – to seek advice.

Before commencing any processes to prevent loss, to recover debt or to respond to an enthusiastic and insistent liquidator, seek advice from a professional experienced in insolvency. Whether that professional is a legal professional or insolvency practitioner will depend on the advice being sought, but we cannot emphasise enough the importance of that first step.

6.1 Instil good practice

The first step in minimising exposure is to ensure that good credit management practice is adopted within your organisation. All aspects of credit management practices and procedures should be reviewed and where applicable improved and enhanced, from procedures to assess applications and provide credit, setting of limits, monitoring procedures and finally, recovery policies and processes.

Good practice will help to ensure that credit is not provided or at least limited, in the first instance, to those undeserving of it. Good practice will ensure that the clients are monitored consistently and regularly to ensure compliance with the terms of credit. Good practice will facilitate the recovery of debt earlier rather than later, thus reducing the loss from bad debt and in the case of funds recovered, from subsequent avoidance.

6.2 Personal guarantees

Wherever possible obtain personal guarantees from directors of companies before granting credit. In our experience, many organisation include personal guarantees within their credit application forms, but not often is the completion of the guarantee section insisted upon or checked for correct completion.

Are the guarantees witnessed? Can the witness be identified? Are the guarantors aware of the consequences of the guarantee? Is an indemnity a preferred option?

It should be noted that personal guarantees from a debtor operating a business as a sole proprietor or in partnership provides no extra protection. In that case, should further sureties be obtained?

When taking guarantees, consider taking securities from the guarantor. This may be in the form of mortgage security or caveats over real property. The earlier the security is taken, the less likely that it will fall within any relation-back period fro subsequent avoidance.

6.3 Guarantor loophole

In most circumstances, unless other catered for, where funds are received by a creditor, the guarantor or surety is relieved of any further obligation under the guarantee. There are two issues to be considered:

- It is arguable that once the company has, in ordinary trading, reduced its liability to a nil balance and the debt, effectively eliminated, the guarantee no longer applies and is not valid for any new provision of credit. Accordingly, creditor companies may be living under the false impression that they hold personal guarantees when, in fact, they do not.
- Even if there is a valid guarantee, in the event that the creditor is forced to refund moneys received as a preference, unless the terms of the guarantee are specifically worded to provide for that contingency, the guarantor may be protected from having to repay the creditor, the guarantee having been extinguished upon initial payment of the debt[111].

Accordingly, it may be useful to review the form of guarantee used by the creditor company to protect against those contingencies.

[111] Re Timbatec Pty Ltd (1974) 24 FLR 30

6.4 3rd Party payments

One means to protect the creditor from liability for preferences may be to insist that the debt be paid by the surety rather than by the debtor. If it can be shown that the debtor was not a party to the payment, then the transaction may not be recoverable by a Trustee or liquidator.

Such an approach may require changes to the terms of the surety enabling the creditor to place initial demand for outstanding debt upon the surety rather than on the debtor company, effectively a change in status from guarantor to indemnifier.

6.5 Retention of Title

Retention of title is becoming a more popular form of protection for creditors and this should be examined as a possible strategy.

It is not applicable in all instances and in some cases are incapable of enforcement, for example, where goods are mixed with other goods, incorporated within other products, cannot be clearly identified as belonging to the seller or are merely items in which title cannot be retained, such as the provision of services.

6.6 Early intervention

Consistent monitoring and early intervention are vital components to minimise risk of exposure.

Procedures to ensure that credit limits are adhered to, terms of repayment are met by the due date, follow up procedures are promptly instigated, all act to ensure that exposure is kept to a minimum.

Strict debt collection procedures followed consistently will help to ensure that the defences of good faith and (in the case of bankruptcy) ordinary course of business are available to the creditor.

In addition, the earlier and more frequently debt is collected, the less likelihood that the debtor will become bankrupt or go into liquidation within six months and hence, the time constraints work in your favour.

6.7 COD/post-dated cheques

If you are aware that the debtor is under financial strain but you wish to continue supporting the debtor for any reason (including protecting your current exposure), it may pay to instil, in your normal procedures, a system whereby payments are made by COD or a series of post-dated cheques be provided, for presentation upon, or shortly after provision of the goods or services.

Contemporaneous activities may assist with the defences of good faith, ordinary course of business and valuable consideration by adopting the principles in Mann & Anor v Sangria[112].

In addition, continued support may help to keep the debtor going for longer, may assist the business to recover and survive and if the liquidation or bankruptcy is the final outcome, may place any funds received for old debt beyond the relation back period for recovery.

6.8 Garnishees

When legal action has to be contemplated, consider the use of garnishee orders. It is established law that the debtor is not a party to garnishee orders and hence, removes a key element from the armoury of the insolvency practitioner[113].

---

[112] Mann & Anor v Sangria Pty Ltd (2001) 19 ACLC 696

[113] Melsom & Anor v Vanpress Pty Ltd (1990) 8 ACLC 496; Commissioner of Taxation v Macquarie Health Corporation Ltd and Ors (1999) 17 ACLC 171; Driver, liquidator of Tilse Building Pty Ltd (in liquidation) v Commissioner of Taxation (2000) NSWCA 247

6.9 Security

If the account is likely to be significant, consider obtaining security over the debtor's business assets in the case of a company and business and personal assets in the case of a sole trader or partnership. There may be difficulties if a bank also has security, but if your supply is vital to the business survival it may be possible to obtain letters of priority.

6.10 DOCA/Part X

If you are of the opinion that funds received by you may be recoverable as preferences, you may wish to consider supporting any proposals under Part X of the Bankruptcy Act, or Deeds of Company Arrangement.

Such arrangements often provide better returns than would liquidation or bankruptcy. Further, recovery of preferences is not available under these alternate administrations.

Before deciding on such courses of action, however, the creditor should consider the possible recoveries from voidable transactions, the anticipated costs of such recoveries, its own costs and overall returns under the various options.

6.11 Prove elements

We often have creditors approach our firm for advice when they have received a letter from a Liquidator or Trustee demanding payment of an alleged preference and threatening legal action.

It surprises us that before sending out these letters of demand, the practitioners have often not bothered to ensure that all the elements for voiding a transaction have been met and further, have not considered the probability of successful defence.

Our firm probably sends our fewer demands than most because, as part of our procedure, we would consider those issues before making any demands. Even then, we sometimes find that the creditor's response may force a re-think of our position.

Accordingly, we would suggest that when creditors receive such demands, as a matter of procedure, they should request the author of the letter prove the elements first. In the meantime, the creditors should examine the defence provisions available to them. This may save a lot of time and cost for both parties.

From the practitioner's viewpoint, it would pay to ensure that the elements have been met and the likelihood of successful defence considered before sending out letters of demand. Again, it would save time and cost if the initial letter of demand were to detail the elements of preference and if, known, point out specific reasons why they consider that the defence would not be available to the creditor.

Some practitioners (very few, we hope) adopt the reprehensible practice of simply sending letters of demand to every creditor who has received payment within the relation back period. While they may have sometimes experience success in obtaining funds, it is generally because of the ignorance of the creditors concerned and the issue of such letters, in those cases, amounts to a form of intimidation and bullying. Sometimes the funds received in response to such letters are not voidable preferences and we believe that it is unethical for a practitioner to accept funds under such circumstances.

Any practitioners who disagree are advised to refer to the rule in ex parte James[114].

In essence this rule requires that Trustees in bankruptcy are always treated as officers of the court and must act in an honourable, just and highminded (note: not high handed) way. The principle embodied in this rule is not confined merely Trustees but to all insolvency practitioners and has been applied to a myriad of cases since.

This rule was commented on by a report of the Australian Law Reform Commission in 1987 and I quote:

> "*Application of the rule …. can result in the exclusion from the estate of property which otherwise would have been available for distribution to creditors. Generally, equity requires*

[114] Re ex parte James; In re Condon (1874) LR 9 Ch App 609

repayment of money repaid as a result of a mistake of fact but not a mistake of law. However, in insolvency law, the position is different. Under the rule the court will not permit the trustee in bankruptcy to retain money paid under a mistake of law if the estate would be unjustly enriched. The rule applies to a liquidator in a court winding up: such a liquidator is also an officer of the court."

Annexures

- Quick Comparison between Bankruptcy Act and Corporations Law
    - Elements of Insolvent Transactions
    - Defence Provisions

- Relevant Sections of the Bankruptcy Act
    - Section 122
    - Section 123

- Relevant Sections of the Corporation Act
    - Section 588FA Unfair Preferences
    - Section 588FC Insolvent Transactions
    - Section 588FE Voidable Transactions
    - Section 588FG Transactions not voidable

Quick Comparison between Bankruptcy Act and Corporations Law

Elements of Insolvent Transactions

Bankruptcy Act	**Corporations Act**
Property has been transferred	Must be a transaction
There must be a debtor/creditor relationship	Debtor and creditor are parties to the transaction
The recipient must have received a preference, priority or advantage over other creditors	Creditor receives benefit greater than if transaction does not occur
The transaction took place in the qualifying period	Relation back period depends on circumstance:- • 6 months normally • 4 years for related entities; • 10 years for fraudulent preference
At the time of the transfer, the debtor was insolvent	Must be insolvent transaction, ie the company was insolvent at he time or became insolvent as a result of the transaction

Defence Provisions

Bankruptcy Act	**Corporations Act**
Where the recipient acted in the ordinary course of business, and	The transaction was effected in good faith and
in good faith and	
provided valuable consideration at least to the market value	Provide valuable consideration, or changed its position in reliance upon the transaction and
	The creditor did not and had no grounds to suspect, that the company was insolvent or would become insolvent as a result of the transaction
Other defences	
Third Party Transactions wherein, persons make title through or under a creditor in good faith and provided consideration at least to the market value of the property	Third Party (a) the person received no benefit because of the transaction ; or (b) in relation to each benefit that the person received because of the transaction : (i) the person received the benefit in good faith; and (ii) at the time when the person received the benefit: (A) 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 (B) a reasonable person in the person's circumstances would have had no such grounds for so suspecting.
Transactions made or incurred under maintenance agreements or orders	
Transfers under a debt agreement	Payments made by external administrator

Relevant Sections of the Bankruptcy Act

Sec 122

BANKRUPTCY ACT 1966 - SECT 122 - Avoidance of preferences

(1) A transfer of property by a person who is insolvent (the *debtor*) in favour of a creditor is void against the trustee in the debtor's bankruptcy if the transfer:

(a) had the effect of giving the creditor a preference, priority or advantage over other creditors; and

(b) was made in the period that relates to the debtor, as indicated in the following table.

Periods during which transfers of property may be void	Description of petition leading to debtor's bankruptcy	Period during which the transfer was made
1	Creditor's petition	Period beginning 6 months before the presentation of the petition and ending immediately before the date of the bankruptcy of the debtor
2	Debtor's petition presented when at least one creditor's petition was pending against a petitioning debtor or a member of a partnership against which the debtor's petition was presented	Period beginning on the commencement of the debtor's bankruptcy and ending immediately before the date of the bankruptcy of the debtor
3	Debtor's petition presented in any other circumstances	Period beginning 6 months before the presentation of the petition and ending immediately before the date of the bankruptcy of the debtor

(1A) Subsection (1) applies in relation to a transfer of property by the debtor in favour of a creditor:

(a) whether or not the liability of the debtor to the creditor is his or her separate liability or is a liability with another person or other persons jointly; and

(b) whether or not the property transferred is the debtor's own property or is the property of the debtor and one or more other persons.

(2) Nothing in this section affects:

(a) the rights of a purchaser, payee or encumbrancer in the ordinary course of business who acted in good faith and who gave consideration at least as valuable as the market value of the property; or

(b) the rights of a person who is making title through or under a creditor of the debtor in good faith and who gave consideration at least as valuable as the market value of the property; or

(c) a conveyance, transfer, charge, payment or obligation of the debtor executed, made or incurred under or in pursuance of a maintenance agreement or maintenance order; or

(d) a transfer of property under a debt agreement.

(3) The burden of proving the matters referred to in subsection (2) lies upon the person claiming to have the benefit of that subsection.

(4) For the purposes of this section:

(a) a transfer of property is taken to have been made in favour of a creditor if it is made in favour of a person in trust for the creditor; and

(b) a payment of tax, or of any other amount payable to the Commonwealth, or to the Commissioner of Taxation, under or because of an Act of which the Commissioner has the general administration, is taken to be made for consideration equal in value to the payment and in the ordinary course of business; and

(c) a creditor shall be deemed not to be a purchaser, payee or encumbrancer in good faith if the transfer of property was made under such circumstances as to lead to the inference that the creditor knew, or had reason to suspect:

(i) that the debtor was unable to pay his or her debts as they became due from his or her own money; and
(ii) that the effect of the transfer would be to give him or her a preference, priority or advantage over other creditors.

(4A) A reference in this section (other than subsection (5)) to a creditor of the debtor shall be read as including a reference to a person who would be a creditor of the debtor in relation to a contract, agreement, transaction or other dealing if the contract, agreement, transaction or other dealing were not, in whole or in part, void or unenforceable, or had not been voided in whole or in part, by or under a law of the Commonwealth or of a State or Territory of the Commonwealth.

(5) If a transfer of property is set aside by the trustee in a bankruptcy as a result of this section, the creditor to whom the property was transferred may prove in the bankruptcy as if the transfer had not been made.

(7) In this section:

tax means tax (however described) payable under a law of the Commonwealth or of a State or Territory, and includes, for example, a levy, a charge, and municipal or other rates.

(8) For the purposes of this section:

(a) *transfer of property* includes a payment of money; and
(b) a person who does something that results in another person becoming the owner of property that did not previously exist is taken to have transferred the property to the other person; and
(c) the *market value* of property transferred is its market value at the time of the transfer.

Sec 123

BANKRUPTCY ACT 1966 - SECT 123 - Protection of certain transfers of property against relation back etc.

(1) Subject to sections 118 to 122 (inclusive), nothing in this Act invalidates, in any case where a debtor becomes a bankrupt:

(a) a payment by the debtor to any of his or her creditors;
(b) a conveyance, transfer or assignment by the debtor for market value;
(c) a contract, dealing or other transaction by or with the debtor for market value; or
(d) any transaction to the extent of a present advance made by an existing creditor;
if:
(e) the transaction took place before the day on which the debtor became a bankrupt;
(f) the person, other than the debtor, with whom it took place, did not, at the time of the transaction, have notice of the presentation of a petition against the debtor; and
(g) the transaction was in good faith and in the ordinary course of business.

(2) The burden of proving the matters referred to in paragraphs (1)(e), (f) and (g) in relation to a transaction lies upon the person who relies on the validity of the transaction.

(3) For the purposes of subsection (1), a transaction shall not be deemed not to have been in good faith and in the ordinary course of business by reason only that, at the time of the transaction, the person, other than the debtor, with whom it took place had notice of the commission of an act of bankruptcy by the debtor.

(4) Nothing in this Act invalidates a payment by a debtor, on or before the date on which he or she became a bankrupt, of, or in respect of, a penalty or fine imposed on him or her by a court in respect of an offence against a law, whether a law of the Commonwealth or not.

(6) Subject to section 121, nothing in this Act invalidates, in any case where a debtor becomes a bankrupt, a conveyance, transfer, charge, disposition, assignment, payment or obligation executed, made or incurred by the debtor, before the day on which the debtor became a bankrupt, under or in pursuance of a maintenance agreement or maintenance order.

(7) In this section:

payment includes the drawing, making or indorsing of a bill of exchange, cheque or promissory note.
transaction includes payment, delivery, conveyance, transfer, assignment, contract or dealing.

Relevant Sections of the Corporations Act

Sec 588FA UNFAIR PREFERENCES

588FA(1) [What is unfair preference]
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.

588FA(2) [When secured debt to be unsecured debt]
For the purposes of subsection (1), a secured debt is taken to be unsecured to the extent of so much of it (if any) as is not reflected in the value of the security.

588FA(3) [Transaction part of continuing business relationship]
Where:
(a) a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor of the company (including such a relationship to which other persons are parties); and
(b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship;
then:
(c) subsection (1) applies in relation to all the transactions forming part of the relationship as if they together constituted a single transaction; and
(d) the transaction referred to in paragraph (a) may only be taken to be an unfair preference given by the company to the creditor if, because of subsection (1) as applying because of paragraph (c) of this subsection, the single transaction referred to in the last-mentioned paragraph is taken to be such an unfair preference.

Sec 588FC INSOLVENT TRANSACTIONS

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.

Sec 588FE VOIDABLE TRANSACTIONS

If a company is being wound up:
(a) a transaction of the company may be voidable because of any one or more of subsections (2) to (6) if the transaction was entered into on or after 23 June 1993; and
(b) a transaction of the company may be voidable because of subsection (6A) if the transaction was entered into on or after the commencement of the Corporations Amendment (Repayment of Directors' Bonuses) Act 2003
.

588FE(2) [Insolvent transaction]
The transaction is voidable if:

(a) it is an insolvent transaction of the company ; and
(b) it was entered into, or an act was done for the purpose of giving effect to it:
(i) during the 6 months ending on the relation-back day; or
(ii) after that day but on or before the day when the winding up began.

588FE(3) [Insolvent and uncommercial transaction]
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 .

588FE(4) [Insolvent transaction to which related entity 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 .

588FE(5) [Insolvent transaction for purpose of defeating creditors]
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 purposes including the purpose, of defeating, delaying, or interfering with, the rights of any or all of its creditors on a winding up of the company ; and
(c) the transaction 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 .

588FE(6) [Unfair loan]
The transaction is voidable if it is an unfair loan to the company made at any time on or before the day when the winding up began.

588FE(6A) [Unreasonable director-related transaction]
The transaction is voidable if:
(a) it is an unreasonable director-related transaction of the company ; and
(b) it was entered into, or an act was done for the purposes of giving effect to it:
(i) during the 4 years ending on the relation-back day; or
(ii) after that day but on or before the day when the winding up began.
History

588FE(7) [Interpretation]
A reference in this section to doing an act includes a reference to making an omission.

SeC 588FG TRANSACTIONS NOT VOIDABLE

588FG(1) [Person received no benefit or benefit in good faith]
A court is not to make under section 588FF an order materially prejudicing a right or interest of a person other than a party to the transaction if it is proved that:
(a) the person received no benefit because of the transaction ; or
(b) in relation to each benefit that the person received because of the transaction :
(i) the person received the benefit in good faith; and
(ii) at the time when the person received the benefit:
(A) 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
(B) a reasonable person in the person's circumstances would have had no such grounds for so suspecting.

588FG(2) [Good faith and no reasonable grounds to suspect insolvency]
A court is not to make under section 588FF an order materially prejudicing a right or interest of a person if the transaction is not an unfair loan to the company , or an unreasonable director-related transaction of 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 .

588FG(3) [Discharge of tax is valuable consideration]
For the purposes of paragraph (2)(c), if an amount has been paid or applied towards discharging to a particular extent a liability to pay tax, the discharge is valuable consideration provided:
(a) by the person to whom the tax is payable; and
(b) under any transaction that consists of, or involves, the payment or application.

588FG(4) ["tax"]
In subsection (3):
tax means tax (however described) payable under a law of the Commonwealth or of a State or Territory, and includes, for example, a levy, a charge, and municipal or other rates.

588FG(5) [Valuable consideration provided by Commonwealth]
For the purposes of paragraph (2)(c), if an amount has been paid or applied towards discharging to a particular extent a liability to the Commonwealth, or to the Commissioner of Taxation, that arose under or because of an Act of which the Commissioner has the general administration , the discharge is valuable consideration provided by the Commonwealth, or by the Commissioner, as the case requires, under any transaction that consists of, or involves, the payment or application.

588FG(6) [Purpose and application]
Subsections (3) and (5):
(a) are to avoid doubt and are not intended to limit the cases where a person may be taken to have provided valuable consideration under a transaction ; and
(b) apply to an amount even if it was paid or applied before the commencement of this Act .