

**A consideration of the elements a Liquidator is required to
prove when attempting to recover an unfair preference
under the Corporations Act 2001**

Introduction

This paper is intended to be a study of the elements a liquidator is required to establish when seeking to recover an unfair preference under Part 5.7B Division 2 of the Corporations Act 2001 ("**Act**").

Part 5.7B Division 2 of the Act ("**Part**") commenced on 23 June 1993 by virtue of the Corporate Law Reform Act 1992 ("**Reform Act**"). The commencement marked the legislature's effort, amongst other things, to modify and regulate the recovery of certain pre-liquidation transactions such as those upon which this paper focuses, that is, unfair preferences. It should be noted that the passage of the Reform Act through the Federal Parliament was not without criticism.¹

The elements a liquidator is required to establish when seeking to recover an unfair preference are set out in section 558FA of the Act. This section along with others in the Part work together in setting out what a voidable transaction is, when they occur and when they can be set aside.

Exactly what the elements are and how they should be interpreted has led the judicature down a path of discovery, the end of which is not yet in sight.

In addition, this paper will consider whether the legislative intention has been realised, simply stated 'the aim of the Division is to protect the interests of unsecured creditors which would otherwise be prejudiced by a company disposing of assets or incurring liabilities or entering into unrealistic loans shortly before winding up'.²

What is an unfair preference ?

¹ For example Costello, Mr P. H in debate who considered the Bill to be hastily presented and cumbersome in drafting, see Hansard, page 3029 10 November 1992.

² Singer, "Invalidation of Antecedent Transactions Under the Corporations Law Reform Act 1992"(1994) 2 Insol LJ, 36,37 cited in Keay, A and Murray M, Insolvency: Personal and Corporate Law and Practice (4th Ed.), Lawbook Company, Sydney, 2002, p294.

A good starting point is the section itself.

Section 588FA(1) of the Act, with the key elements identified by the writer highlighted, is set out below:

*588FA(1) [**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.

Put simply, a transaction is an unfair preference 'if the company and the creditor are parties to the transaction and the transaction results in the creditor receiving from the company, in relation to an unsecured debt owed to the creditor, a greater amount than it would have received in relation to the debt in a winding up of the company!'³

Therefore the elements that a liquidator has to establish are;

- i. There has to be a transaction
- ii. The company and the creditor have to be parties to the transaction
- iii. The transaction has to be an insolvent transaction
- iv. The transaction has to be in relation to an unsecured debt
- v. The creditor must have received more than they would have than if they had to prove in the liquidation
- vi. The transaction occurred within the relevant period.

³ Keay, A and Murray M, Op. Cit.,p299

In order for a liquidator to successfully recover an unfair preference he or she must prove all of the elements set out above⁴. The burden of proof remains with the liquidator.

Before considering the elements of an unfair preference it is important to understand what transactions are voidable and when transactions are considered to be insolvent transactions.

Putting the Part into perspective

Section 588FE of the Act sets out what transactions are voidable and the time periods in which the transaction must have occurred for it to be voidable and may be summarised as follows:

- it must have been entered into during the six months immediately before the relation back day or during the period between the relation back day and the commencement of the winding up (s 588FE(2));
- it must be an uncommercial transaction which took place during the two years immediately before the relation back day (s 588FE(3));
- it must have involved a related entity of the company and occurred during the four years immediately prior to the relation back day (s 588FE(4));
- it must have involved the situation where the company was a party to an unfair preference or uncommercial transaction in order to defeat, delay or interfere with the rights of any or all of its creditors and the transaction was entered into during the ten years immediately prior to the relation back day (s 588FE(5))⁵.

In addition to the above, sections 588FE(6) and 588FE(A) set out when transactions are voidable in circumstances where there is an unfair loan or an unreasonable director related transaction.

For a transaction to be voidable it must be an insolvent transaction. Section 588FC of the Act provides that a transaction of a company is an insolvent transaction if and only if it is an unfair preference given by the company (as defined in Section 588FA of the Act) or is an uncommercial transaction and certain events occur when the company was insolvent or the company became insolvent as a result of those events occurring.

⁴ *Totter dell v Nicol-Bergmeister* (1995) 13 ACLC 1521, 1527

⁵ Keay, A and Murray M, Op. Cit., p295

In short section 588FE of the Act sets out what types of transactions can be set aside and in what time periods.

It has been suggested that the scheme of Division 2 could be simplified⁶. Another commentator considers that definitional provisions could easily be incorporated, as regards each type of transaction covered by the Division, in the relevant substantive section⁷. The writer supports these views and notes that during the debate of the Reform bill the approach taken to drafting was the subject of negative comment⁸.

The Elements

1. There has to be a transaction

It is important that a transaction can be readily identifiable and that the company and the creditor, it is alleged received the benefit, were parties to it. If the company and the creditors were not a party to the transaction there is no unfair preference⁹. Judicial consideration of the word transaction has caused some confusion as observed by Hoser P "the judicial and legislative responses to the concept have given it a confusing elasticity"¹⁰.

Section 9 of the Act provides some examples of what the legislature considers are transactions for the purposes of the Act, with the qualification, that the examples provided are not intended to be exhaustive. Of those examples some of the transactions most frequently pursued by liquidators are "a conveyance, transfer or other disposition by the body of property of the body" and "a payment by the body". The Supreme Court of Western Australia in Palmer v Commissioner of State Taxation (1976) WAR 37 considered what was meant by the word transaction:

"The word transaction is not a word of precise meaning. The parties agree that it is wide, vague and of uncertain import. In its dictionary meaning it is "an act, doing, negotiation or dealing". That definition is possibly too general, but it clearly seems to me that, without attempting

⁶ Hoser, P. (2005) 13 Insolv LJ 42, para 2, p 49

⁷ Keay, AR, Avoidance Provisions in Insolvency Law (LBC) p351

⁸ See note 1.

⁹ Driver, Liquidator of Tilse Building Pty Limited (in liquidation) v Commissioner of Taxation (2000) NSWCA 247

¹⁰ Hoser, P. Op. Cit, p 48

for a comprehensive definition, one can affirm that the word as used in the paragraph can cover a series of steps linked together to obtain a definite objective."

More recently the determination of what a transaction is for the purposes of Section 588FA of the Act has been the subject of somewhat inconsistent judicial interpretation and usually in the context of composite dealing arrangements.

In Nilant v Plexipack Packaging Services Pty Limited (1996) 21 ACSR 428, Nicholson J preferred to adopt a narrow construction of the meaning of the word transaction in circumstances where the business of the company in liquidation was sold and the sale agreement contained a direction from the company to the purchaser to pay part of the sale proceeds directly to one of the company's creditors. He held that the payment to the creditor by the purchaser and the consequent extinguishment of the indebtedness of the company to the creditor was not a transaction.

Whilst in Re: Emanuel (No. 14) Pty Limited (In Liquidation) (1997) 22 ACSR 641, the Full Court of the Federal Court, on appeal, preferred a broader approach to the meaning of the word transaction. Here as part of a settlement of a dispute between Emanuel and a company known as Elfic Limited, it was agreed that Elfic Limited would make payments at Emanuel's direction to a third party company in partial discharge of Emanuel's debt to that third party company. The Court acknowledged that a composite of dealings intended to extinguish a creditor's debt could in its totality be a transaction for the purposes of the Part. In reaching this view their Honours disapproved of the decision reached by Nicholson J in *Nilant* above.

More recently in Wily v Bartercard Limited (2001) 19ACLCLC 1461, which was upheld on appeal, Austin J, preferring the broader interpretation of the word, approved the conclusion reached in *Re: Emanuel* above and in addition stated that:

"An arrangement between two parties which produces legal consequences under either the law of contract or the law of equitable estoppel in the transaction for the purposes of Section 588FA".

In Mann v Sangria Pty Limited (2001) 19 ACLC 696, transactions such as orders, deliveries, contemporaneous delivery of invoices, cheque delivery at or soon after receiving an invoice and post-dated cheques for the exact amount of the invoice presented on

the post date were considered by the Court as being so bound together that they were characterised as a transaction for the purposes of the Act.

In Prentice -v- St George Bank Limited (2002) 20 ACLC 923, Austin J despite finding that there was no transaction commented that where a company so acts as to extinguish its debt, the totality of the dealings initiated by the company so as to achieve the intended purpose of extinguishing the debt is a transaction of the company for the purposes of section 588FA(1).

As such, we can see that a series of dealings which in one context might be regarded as separate transaction will together constitute one transaction if they are connected in such a way as to bring about a change in the company's rights. If a company participates in one or more of the dealings it would be considered a party to the transaction for the purposes of Part 5.7B Division 2 of the Act even though it does not participate in all of them.

Houser, quite reasonably suggests, that the judicatures interpretation of acts done pursuant to a transaction are not necessarily acts done for the purpose of giving effect to it have led to a tendency to expand the concept of "transaction" in order to bring particular factual situations within the voidability net¹¹.

In view of the continued litigation around the interpretation of the term and the centrality of the term to the recovery action, a refinement of the drafting to improve clarity would seem prudent. In doing so, reducing litigation and associated costs, consequently further advancing the interests of unsecured creditors.

2. The company and the creditor have to be parties to the transaction

Section 588FA expressly requires that the company and the creditor must be parties to the transaction even if the company and the creditor are not parties to all of the transactions components¹².

Creditors have been held to include sureties, guarantors and contingent creditors¹³. In Mann v Sangria Pty Limited, it was found that a party who becomes a creditor as a

¹¹ Houser, P. Op Cit, p 51

¹² Macks & Emmanuel (No14) v Blackwell & Shad Forth (1997) ACLC 1009

¹³ Dovey v Morgan [1901] 2 KB 477

consequence of the transactions is not a creditor for the purpose of the section. As such, a creditor has to be a creditor at the commencement of the series of the transactions and not as a result of the series of transactions.

In VR Dye & Co —v- Peninsula Hotels Pty Limited (1999) 17 ACLC 954, an accountant who provided services before and after a creditor's voluntary liquidation and who received and deposited funds into his trust account until the work was done was not a creditor at the beginning of the series of transactions and hence not a creditor for the purposes of Section 588FA.

In Minister for Transport v Francis & Woodings (as Joint Liquidators of Covcon Pty Limited) (2000) 18 ACLC 617, advances were made on a contract by a client ahead of the work actually being performed and the client subsequently deducted those advances from future payments the Court found that the client was not a creditor as the advances were made at the commencement of the series of transactions and as such, there was no debtor/creditor relationship for the purposes of section 588FA.

In Williamson (as Liquidator of Merlino Construction Services Pty Limited) (In Liquidation) -v- Hawkwood Holdings Pty Limited ¹⁴, three companies which included one of the companies later pursued by the liquidator for the recovery of payments as unfair preference payments, entered into a series of contracts with another company for the construction of a car park in Kalgoorlie. Two of the three companies merged to form a single entity and paid the non-merging company for work undertaken by it on the car park. It was found that there was no relationship of debtor/creditor between the merged entity and the non-merging company. As such, there was no basis upon which the transactions could be characterised as an unfair preference.

3 The transaction has to be an insolvent transaction

For an unfair preference to be voidable, it must be an insolvent transaction within the definition provided in Section 588FC of the Act. Insolvency has been widely considered. In respect to insolvency Barwick CJ noted in Sandell v Porte (1966) 115 CLR 666, that:

¹⁴ Unreported decision of the Supreme Court of Western Australia, 31 May 2002

"It is the debtors inability, utilizing such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates insolvency".

The determination of whether a company is insolvent cannot be based solely on an investigation of a balance sheet¹⁵. Pursuant to Section 95A of the Act a person is solvent if, the person is able to pay all the person's debts as and when they become due and payable. The definition further provides that a person who is not solvent is insolvent. Essentially this section provides that a company is insolvent if it is unable to pay all its debts as and when they fall due.

More recently in Lewis & Anor -v- Doran & Ors [2004] NSWSC 608, Palmer J expressed that the current definition provided under Section 95A removed part of the old test provided in earlier decisions such as Sandell -v- Porter. He stated that Section 95A requires the Court to decide whether the company is able, as at the alleged date of insolvency, to pay all its debts as they become due and payable by reference to the commercial reality. He further went on to say that if the Court is satisfied as a matter of commercial reality that a company has a resource available to pay all of its debts as they become payable, then it will not matter that the resource was an unsecured borrowing or voluntary extension of credit from another company.

Another relatively recent decision provided a list of factors to be considered when determining insolvency¹⁶ such as, inter alia, the company continually delaying paying its creditors, not being able to obtain other sources of finance, threatened legal actions, non-payment of taxes and some suppliers placing the company on a cash on delivery basis. Proving insolvency can more often than not be a difficult task for a liquidator to achieve. In order to assist the *Corporations Law* was amended on 23 June 1993 to include certain statutory presumptions of insolvency under Section 588FE for the purposes of recovery proceedings. Such proceedings include applications commenced for the recovery of voidable transactions under Section 588FF.

Section 588FE refers to particular circumstances in which it will be presumed a company is insolvent. An example of the extent of the application of the statutory presumption raised in

¹⁵ *Calzaturificio Zenith Pty Limited v New South Wales Leather and Trading Company Pty Limited* [1970] VR 605, 609

¹⁶ *ASIC v Plymin & Ors (No 1)* 2003 21 ACLC 700

Section 588E(3) is demonstrated in the Western Australian Full Court of the Supreme Court decision in Levi -v- Guerlini [2004] NSWSC 608, where a liquidator proved that the company had been insolvent as at 30 June 2003 and was thus presumed to be insolvent until the date of liquidation in March 2004.

The creditor in that matter was unable to rebut the statutory presumption of insolvency. In Kenna & Brown Pty Limited (In Liquidation) -v- Kenna [1999] NSWSC 533, the Court demonstrated how far it was prepared to apply the statutory presumption under section 588FE(4) of the Act, for a failure to keep proper records, in circumstances where the company failed to keep proper records notwithstanding the fact that the company's directors signed statements that the company's accounts were true and correct.

In practise, proof of insolvency is quite a difficult task for a liquidator to establish. The cases referred to above provide some important guidance for liquidators and establish that the question of a transaction being an insolvent one is an important factor that a liquidator is required to prove. It seems that there is no simple way of proving insolvency, as it is dependent upon the individual facts and circumstances presented to a liquidator when a company is wound up.

The evidentiary difficulties facing a liquidator will ultimately impact upon the liquidator's decision to commence recovery of an unfair preference, in turn impacting upon the rights of unsecured creditors.

4. The transaction has to be in relation to an unsecured debt

In addition, a liquidator needs to establish that the transaction was in relation to an unsecured debt. To date the court has had little problem interpreting s588FA(1)(b), again the facts of the case determinative.

In Re Walker Group Pty Limited (In Liquidation) (1994) ACLC 434, Ambrose J considered whether a payment made by the company to a creditor, the debt to which had been guaranteed by a director, could be recovered from the director as an unfair preference to a related entity. The Court found that the Liquidator was entitled to recover from the director the sum paid by the company to the creditor, which had the result of discharging the guarantee that the director would otherwise have provided to the creditor.

In Wily (as official liquidator of Space Made Proprietary Limited (in liquidation) v St George Partnership Banking Limited (formerly Barclays Bank Australia Limited) (1997) 150 ALR 329, a liquidator brought an action against the bank to recover payments on the basis that they constituted unfair preferences. Here the company had granted a floating charge to the bank to secure its overdraft account and prior to it going into liquidation it had made three payments to the bank to reduce the overdraft. The court held that the payments to the bank out of the assets of the company were payments forming part of a secured debt and therefore could not constitute an unfair preference. An appeal by the liquidator was subsequently dismissed.

5 The creditor must have received more than they would have than if they had to prove in the liquidation

The fifth element that needs to be established is that the creditor must have received more than it would have if the transaction were set aside and the creditor were to prove in the winding up.

In VR Dye & Co. v Peninsular Hotels Pty Ltd (1999) 17 ACLC 954, Tadgell JA held that: *"It remains a quintessential prerequisite of a transaction to be avoided that it should operate to give a preference to a creditor in respect of an existing debt"*.

In order to calculate the benefit it has been suggested that a comparison with the potential receipt in the actual winding up, rather than calculating a theoretical return on winding up should be made¹⁷.

If a creditor has not received a preference, priority or advantage over other creditors then there is simply is no voidable transaction, no matter that all the other elements may apply. Again, the onus of proof rests on the liquidator.

In Sheahan -v- Carrier Airconditioning (1997) 15 ACLC 1116, payments made by a receiver to creditors were unfair preferences although those creditors received an advantage, as the payment was from the receiver and not the company and the funds belonged to the secured creditor of the company.

¹⁷ Walsh v Natra Pty Ltd (2000) VSCA 60

More recently the courts have asked what the ultimate effect of the benefit received is and has become known as the "Ultimate Effect Doctrine". It has been found that in order to have the ultimate effect of giving a creditor a preference the payment must result in a decrease in the net value of the assets that are available to meet the competing demands of other creditors¹⁸.

The ultimate effect doctrine appears to have been generally accepted as Heydon JA (as His Honour then was), with whom Mason P and Powell JA agreed, in Beveridge v Whitton [2001] NSWCA 6, held that the doctrine of ultimate effect did not depend on an evaluation of whether the overall result of the transaction was to improve or worsen the company's position, rather the doctrine looks to the ultimate effect of the particular transaction.

When considering unfair preference payments the judiciary appears to have established that an important factor is the business relationship between the parties and the practical effect of the payment. The focus on the ultimate effect of all the payments and the goods or services supplied during the relevant period are an important issue. If the ultimate effect is to reduce the amount owing to the creditor, at the end of the period, to less than the maximum amount owed to it during that period, that the payments will constitute a preference for the purposes of Section 588FA(3).

6 The transaction must have occurred within the relevant period

The final and one of the most critical elements that a liquidator needs to establish is that the transaction occurred within the relevant period. A liquidator must establish that the transaction occurred within the periods prescribed under Section 588FE of the Act¹⁹. In the majority of cases, the liquidator will need to establish that the company was insolvent at the time of the alleged preference and that it occurred within six months before the relation- back day or between that day and the commencement of the winding up²⁰.

¹⁸ Air Services v Ferrier (1996) 185 CLR

¹⁹ As cited on pages 2 and 3 of this paper

²⁰ Section 588FE(2)

If the creditor who was a party to the transaction was a related entity of the company the time zone is extended to a four-year period before the relation-back day²¹. The genesis of the extended period appears to be the Harmer Report²², which recommended that related creditors should not be treated equally because they were more likely to be aware of the company's financial affairs. By adopting this approach the legislature provided a liquidator with greater opportunities to recover assets that have been disposed of to persons who are related²³.

Exactly how far back the liquidator can go to recover an unfair preference depends on the given circumstances. In short, the liquidator can go back six months before the relation-back day and up to the day the winding up begins in respect of unrelated parties, the liquidator can go back four years up to and including the relation-back day in respect of related parties and ten years up to and including the relation-back day where the purpose of the transaction was to defeat creditors²⁴.

The Relation-back day is therefore critical and is defined in Sections 9, 513A and 513C of the Act as follows:

- in the case of a Court liquidation that is not proceeded by a voluntary administration or deed of company arrangement, the day on which the application for the winding up order was made;
- in the case of the voluntary liquidation, the day of the members' resolution;
- 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.

The timing element is sufficiently codified in Section 588FE of the Act and does not require any further comment for the purpose of this paper other than to say that it requires a relevant event to have taken place during a specific period which differs according to the nature of the transaction. It is an important element to establish, as it is determinative of whether a transaction falls within the relevant period for an unfair preference to be available to a liquidator.

²¹ Section 588FE(4)

²² at para 636

²³ Explanatory Memorandum, Corporate Law Reform Bill 1992 (Cth), para 358

²⁴ Section 588FE(5)

What does this mean for unsecured creditors?

In reality, the rigour of section 588FA(1) means that the legislature's aim of protecting the interests of unsecured creditors are likely to be achieved to only a limited extent. Cumbersome drafting coupled with divergent treatment of provisions by the court means that success is never guaranteed.

A prudent liquidator would not embark on a course to recover an unfair preference unless the sum to be recovered far exceeded the cost of any attendant litigation. Even then, funds for potential litigation need to be available or accessed, at a fee from a lender. Additionally, the evidential burden, whilst fundamental to justice, could also operate as a disincentive to recovery.

There seems to be an opportunity for the Legislature to intervene and provide greater direction and clarity to further the original intention. However, given the current climate, it is unlikely that the Legislature would have an appetite for such reform.

Conclusion

From the discussion of the elements a liquidator must prove in order to recover an unfair preference and an examination of the cases on the statutory provisions detailing the recovery, it is clear that a complex task awaits the willing liquidator. They must determine which ransactions are voidable as an unfair preference, in what circumstances and in the time frames within which they must have occurred. Each of the elements that a liquidator has to establish in proving and ultimately recovering an unfair preference has led to varied interpretations by the judiciary.

The onus of proving these elements lies with the liquidator and if the liquidator fails to establish any one of them an unfair preference action under the Act will not be available. It is therefore important that a liquidator is satisfied that all of the elements are available and that an unfair preference claim is maintainable before commencing proceedings for the recovery of such as the consequences will impact on what if any funds become available for distribution to creditors.

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