



Recovering Unfair Preference Payments - Issues arising from the operation of PT 5.7B of the *Corporations Act 2001*

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INTRODUCTION

“...preferences...the primary weapon in the avoidance arsenal of the liquidator in recovering property for the creditors of the company. The avoidance of this type of transaction is designed, ostensibly, to prevent a creditor from jumping to the front of the queue of the general creditors, all of whom should be paid equally...”¹

For a liquidator to recover payments, made by a company to creditors, as unfair preference payments pursuant to section 588FA of the *Corporations Act 2001* (“the Act”), he or she must be able to establish, amongst other things, that the company and the creditor were parties to the “*transaction*”. In certain circumstances, a holding company or related company may make payments to creditors of the company and such payments can still be recovered by the liquidator as unfair preference payments. But those payments may not always be easy to recover – some further elements must also be satisfied which address the principles which have been laid down by the caselaw.

WHAT CONSTITUTES A “TRANSACTION” FOR THE PURPOSES OF SECTION 588FA OF THE ACT?

Section 588FA of the Act provides as follows:

“(1) 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 transactions (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 was set aside and the creditor were to prove for the debt in a winding up of the company;*

¹ Keay, Andrew and Murray, Michael (2002); ‘Insolvency: Personal and Corporate Law and Practice’, Law Book Company, Pyrmont, p.298



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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.”²

There are three essential elements which must be established in proving the transaction element of an unfair preference:

1. A debtor/creditor relationship between the liquidated company and the creditor must have existed at the time the payments were made.
2. The transaction must have occurred within the six month period preceding the relation-back day.
3. As a consequence of the transaction, the creditor must have received more from the liquidated company (in relation to an unsecured debt) than it would have received if the transaction was set aside and the creditor proved for its debt in the winding up of the company.

But what events or circumstances may be characterised as a “*transaction*”? Section 9 of the Act provides a comprehensive definition as follows:

“transaction”, in Part 5.7B in relation to a body corporate or Part 5.7 body, means a transaction to which the body is a party, for example (but without limitation):

- (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;*

² *Corporations Act 2001 (Cth)*



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

However, none of the above assists to interpret what is meant by the word "by" - interestingly the legislation does not focus on whether the payment is made "by" the company but rather it focuses on whether the company and the creditor are parties to a "transaction" (even if someone else is a party).

Whilst it may often be easier to establish the essential elements for an unfair preference transaction in cases where the company has made the payment/s directly to the creditor, it may sometimes be a little harder to prove that the company was a party to a "transaction" in circumstances where a holding company or related company has made the payments to a creditor of the company.

Re: Emanuel (No 14) Pty Ltd (In Liq); Macks v Blacklaw & Shadforth Pty Ltd

The leading case in this area is the decision of the Full Court of the Federal Court in *Re Emanuel (No 14) Pty Ltd (In Liq); Macks v Blacklaw & Shadforth Pty Ltd*³. In that case, company "A" (Emanuel) contracted with "B" (EFG) that in settlement of claims between them, B would make payments for A, and at A's direction, to "C" (Blacklaw). C was A's creditor and the payments made to C would constitute a partial discharge of the debt which A owed to C. The question which was in issue was whether (upon C's acceptance of payments by B) A and C were parties to a "transaction" which is deemed to be an unfair preference. The Court held, *inter alia*, that:

*"...in any event, in so far as it is suggested that A was not a party to the extinguishment of C's debt brought about by B's payment, as a matter of general law, A's authorisation of B's payment is necessary to discharge the debt...In this way A is a party to the extinguishment even if it could be said that A was not a party to the payment itself".*⁴

The important aspect of this decision is the wide meaning which is given to the term "transaction". A "transaction" may comprise a course of dealings (and may also refer to more than one payment) which eventually leads to the extinguishment of a company's debt to

³ (1997) 147 ALR 281

⁴ Ibid.



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a creditor and may involve dealings in which the company itself does not directly participate but the involvement of a third party. The Court went on to say:

“We confine our observations for present purposes simply to a course of dealing initiated by a debtor for the purpose of, and having the effect of, extinguishing a debt. It is not apparent to us why it should not be said that, where a debtor so acts and extinguishes a debt, the relevant “transaction” is the totality of the dealings through which the debtor procures the intended outcome, irrespective of whether one or more of the dealings in the sequence in question does not involve or require participation of the debtor but does require that of a third party. The transaction, in other words, is the totality of the dealings initiated by the debtor so as to achieve the intended purpose of extinguishing the debt.”⁵

In reaching its decision, the Court rejected the reasoning of the earlier Federal Court decision of *Nilant v Flexipack Packaging Services*⁶ (“Nilant”). The facts of Nilant were as follows: A sold its business to a third party, B, on terms such that part of the purchase price was to be paid to A’s creditor, C. The payment was made at a time when A was insolvent and its liquidator sought to recover the payments as an unfair preference. The Court found, *inter alia*, that whilst the contract was a “transaction” within the meaning of section 9, there was no evidence that the creditor, C, was a party to the transaction. Therefore, it could not be said that the company was a party to the payment by the purchaser to the creditor – the payment was not characterised as an unfair preference payment.⁷

The Full Court rejected the *Nilant* decision upon the basis that a company is a party to a “transaction” (within the meaning of ss 9 and 588FA) if it authorises or ratifies the transaction:

“...Emanuel sought to and did procure the partial extinguishment of Blacklaw’s debt through action it took...its direction...for a payment to be made to Blacklaw, and the payment so made with Emanuel’s authorisation (with the result it produced when Blacklaw accepted the payment as partial satisfaction of the debt) constituted the

⁵ Ibid. p.288

⁶ (1966) 21 ACSR 428

⁷ Ibid.



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relevant transaction. Clearly both Emanuel and Blacklaw were parties to that transaction even though neither was a party to all of its component elements".⁸

In considering what circumstances constitute the word "transaction", the Court also noted that it will result where the conduct or dealing engaged in by the debtor company has the consequence of effecting a change in the rights, liabilities or property of the company itself.⁹

The Court concluded that:

"...a course of dealing initiated by a debtor that is intended to, and does, extinguish a creditor's debt can in its totality be a transaction for the purposes of Pt 5.7B of the Corporations Law notwithstanding that the achievement of that end can only be realised through the participation of a third party in a particular dealing (or dealings) to which the debtor is not or may not be a party".¹⁰

So, a company can be a party to a "transaction":

1. If the company initiates, authorises or ratifies the transaction.
2. Such initiation, authorisation or ratification results in a course of dealing for the purpose of, and having the effect of, extinguishing a debt.
3. This can occur even if it is not a party to the payment itself but the involvement of a third party.
4. The transaction is the totality of the dealings initiated by the debtor so as to achieve the intended purpose of extinguishing the debt.

OTHER CASES

An examination of other unfair preference payment cases highlight that the Court must consider the ultimate effect of the entire transaction rather than the effect of an isolated payment in determining whether a creditor has received an unfair preference payment.¹¹

⁸ Op.cit. p.289

⁹ Ibid. p.281

¹⁰ Ibid. p.289

¹¹ See *Airservices Australia v Ferrier and Another* [1995-1996] 185 CLR 483; *V.R Dye & Co v Peninsula Hotels Pty Ltd* [1999] 3 VR 185



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Re: MGT Samorr Knitting Mills Pty Ltd (In Liq); Jonas (as Liquidator of MGT Samorr Knitting Mills Pty Ltd (Liq) v Rocklea Spinning Mills Pty Ltd ¹²

In this matter, MGT Samorr Knitting Mills Pty Ltd (“MGT”) sold its business to Penburn. One of the liabilities assumed by Penburn was MGT’s debt to its supplier, Rocklea Spinning Mills Pty Ltd (“Rocklea”). However, Rocklea was not informed of the sale and shortly thereafter, it served a statutory demand on MGT. Rocklea then agreed with MGT that its debt would be paid by Penburn and this was documented in a deed. A number of payments were made by Penburn and MGT to Rocklea pursuant to the deed.

Rocklea argued that MGT was not a party to the transaction and that the payments made by Penburn were not made by MGT. They were, in fact, to discharge the liability of Penburn pursuant to the deed.

The Court found, *inter alia*, that the payments by Penburn were not unfair preference payments:

1. The transaction included the deed and the payments in question but it did not include the sale of business agreement.
2. Rocklea was a party to the agreement and it was the party to whom Penburn agreed to make the payments in discharging MGT’s debt.
3. Each of the payments were not made by MGT.
4. The Penburn payments were made to discharge its own debt, not the debt of MGT.

However, the payments which were made by MGT were unfair preference payments because MGT was a party to the transaction and that the two payments were made by MGT.

In cases where a holding company or related company has made payments to the creditor of the company, a comparison may be drawn such that the holding company can be described as a “treasurer” which effectively disburses funds on behalf of other entities within a trading group. The Victorian Supreme Court decision of *Walsh v*

¹² [2003] VSC 277



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*Salzer Constructions Pty Ltd*¹³ (“Salzer”) involved a situation where Thompson Land made payments on behalf of a related company, TPM, to Salzer who was a creditor of TPM. Byrne J found that the payments which were made by Thompson Land were made as “treasurer” for TPM¹⁴:

“...all concerned saw the payments to Salzer as payments made in response to its progress claims and payments in satisfaction of the liability to it of TPM, not that of Thompson Land...Moreover, Thompson Land was the holding company with a more impressive balance sheet...”

*I conclude, therefore, that on the evidence available to me, the proper analysis is that the payments made to Salzer from the Thompson Land cheque account were made by it, not in its capacity as debtor of Salzer, but as the provider of funds for TPM which was itself a debtor of Salzer and in respect of the progress claims payable by TPM to Salzer under the building contract...”*¹⁵

In the MGT case, the payments were made to the creditor to discharge its own indebtedness however in the Salzer case the payments were made by one company within a trading group to discharge indebtedness of another company within the group which was insolvent.

Each case will have particular facts (which may not be dissimilar to facts in the caselaw mentioned above). In all cases it will be necessary to make a detailed analysis of the principles arising from the caselaw to the relevant facts in the case before it.

Re: Clyde White and Philip Newman (as liquidators of Entertainment Services International Pty Ltd) v Deputy Commissioner of Taxation

A recent case which focused on this issue, as to whether payments made by a related company to a creditor of the liquidated company in discharging its liability to the creditor could be characterised as unfair preference payments, was the decision of *Clyde Peter White and Philip Newman (as Liquidators of Entertainment Services International Pty Ltd) and Anor v Deputy Commissioner of Taxation*¹⁶. This decision considered an interesting issue as to whether the liquidated company and the Deputy

¹³ [1998] VSC 111

¹⁴ Ibid. [34]

¹⁵ Ibid. [37-38]

¹⁶ unreported, County Court of Victoria, 17 December 2004, Campton J



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Commissioner of Taxation were parties to the “transaction” which constituted the making of the two payments by a related company to the DCT. The Deputy Commissioner of Taxation defended the claim on the sole basis that there was no “transaction” within the meaning of the Act.

Facts

The facts of this matter can be summarised as follows:

- ❏ The Liquidators of Entertainment Services International Pty Ltd (In Liquidation) (“Services”) were claiming the sum of \$96,598.00 (being two payments of \$50,000.00 and \$46,598.00 respectively) (“the payments”) as unfair preference payments.
- ❏ The payments were paid to the Deputy Commissioner of Taxation by a third party, Wittingslow Holdings (33) Pty Ltd (“Holdings”), which was a related party to Services.
- ❏ The DCT did not dispute any of the other elements the Liquidators had to prove (insolvency and effect of the preference).
- ❏ Services ceased trading in June 2002 at which time it owed the Deputy Commissioner of Taxation \$372,907.23. Holdings traded the same business of Services after that date.
- ❏ On 19 July 2002 the DCT issued a Creditor’s Statutory Demand against Services for payment of outstanding taxation liabilities
- ❏ On 9 August 2002 Services’ accountant wrote to the DCT seeking to arrange a meeting for the purposes of discussing an extension of time for Services to pay the outstanding debt before any winding up application was issued
- ❏ On 28 August 2002 a meeting was conducted between the sole director of Services, Services’ accountant and officers of the Deputy Commissioner of Taxation regarding the outstanding tax debt (“the August meeting”). At the August meeting, it was agreed that Services would lodge its June 2002 Business Activity Statement (“BAS”) with the DCT and pay the outstanding amount by 6 September 2002



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- ❏ Pursuant to the agreement made at the August meeting, Services lodged its BAS and the sum of \$96,598.00 was outstanding
- ❏ The payments in satisfaction of the BAS debt were made by Holdings to the DCT on 10 September 2002 (\$50,000.00) and 16 September 2002 (\$46,598.00)

Evidence

The evidence was given at the trial by Affidavits from Services' accountant, its Financial Controller, its bookkeeper and a representative from the accountants' office. Oral evidence was also given by the sole director of Services and Mr Newman, one of the liquidators.

Submissions

The Plaintiffs submitted, *inter alia*, that:

- ❏ the payments were characterised as a loan from Holdings to Services. However, even if there was no loan from Holdings to Services, the Court should still determine that there was a transaction to which Services was a party.
- ❏ the payments were initiated and authorised by Services for the purpose of discharging its debt to the DCT. As demonstrated by the evidence given at the trial, there was a course of dealings and a sequence of events - Services had authorised the payments by Holdings to the DCT.
- ❏ Upon that basis, Services was a party to the transaction constituted by the making of the payments by Holdings to the DCT – the transaction was the totality of the dealings which had been initiated by Services which were designed to achieve an intended purpose – the extinguishment of the debt owed by Services to the DCT.
- ❏ This is where the “treasurer” analogy (as discussed in Salzer) was applied – Holdings was akin to a “treasurer” of the Group by disbursing funds to other companies within the Group.



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However, the DCT argued, *inter alia*, that:

- ❏ The payments could not have been characterised as a loan from Holdings to Services (upon the basis of lack of evidence and the fact that Services had ceased to trade).
- ❏ There was no evidence before the Court that Services had procured the payments (given that it had ceased to trade before the payments were made) or that it was involved in any conduct or dealings
- ❏ The fact that the effect of the payments was to reduce the debt which was owed by Services to the DCT was not sufficient to constitute a transaction within the meaning of the Act

Decision

In making her decision, Her Honour Judge Campton found that:

- ❏ The payments were loans from Holdings to Services
- ❏ At the time the two payments were made, and at least from 1 July 2002 onwards, Holdings was making payments on behalf of Services

After considering all the evidence presented to the Court and the submission made by Counsel, Her Honour found that the payments were unfair preferences and she commented as follows:

*“As a result of the transaction there was a change in the liabilities of Services in that the debt to the Defendant was extinguished...the effect of the loan from Holdings to Services was that Holdings became an additional creditor...the Defendant received an unfair preference was a result of a transaction to which the Defendant and Services were parties.”*¹⁷

This case involved a discreet but important issue which had to be decided by the Court – whilst it was difficult to prove that the payments were loans from Holdings to Services (particularly given that there were limited financial books and records for both companies), the payments did not have to be characterised as loans but the company merely had to be a party to the “*transaction*” as prescribed by the Act.

¹⁷ Ibid. p.15



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Practitioners may find this case useful (together with the other cases referred to in the previous section) where the holding company or a related company made payments to the creditor on behalf of the company. It is critical in such cases to prove that the company “*authorises, ratifies or initiates*” the making of the payments to the creditor before a Court will find that the payments were unfair preference payments.

* The writer wishes to acknowledge Michael Galvin and the submissions which he prepared for the trial of *Entertainment Services International Pty Ltd (In Liquidation)*