UNDUE PREFERENCES: SOME INNOCENTS "SCAPE NOT THE THUNDERBOLT"[1]

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In the aftermath of the corporate excesses of the 1980's, the dividends paid to unsecured creditors in a bankruptcy or liquidation are often negligible. In this climate trustees in bankruptcy and company liquidators are becoming more assertive in challenging antecedent transactions as undue preferences. Professor O'Donovan examines what relief is available to innocent creditors who are called upon to disgorge a preference and suggests that a more sophisticated regime for protecting hapless preferred creditors should be introduced

INTRODUCTION

One of the fundamental precepts of corporate insolvency law is that the available assets of the company are to be shared rateably among its creditors. This pari passu principle, founded on the maxim that equality is equity, is reflected in the general scheme of the winding up provisions of the Corporations Law, particularly section 565 which deals with undue preferences. Once the liquidator establishes the conditions necessary to avoid an undue preference,[2] the onus shifts to the creditor to show that he is entitled to invoke the protective provisions.[3] The creditor can retain the benefit of the preference if it was received in good faith, for valuable consideration and in the

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1. William Shakespeare *Anthony and Cleopatra* II, v.
2. See generally B H McPherson *The Law of Company Liquidation* 3rd edn (Sydney: Law Book Co, 1987) 314-320.
3. Ibid, 320-325. The preferred creditor carries the onus of proof of these matters on the balance of probabilities: *Re Mike Electric (Aust) Pty Ltd (in liq) And The Companies Act 1961* (1983) 7 ACLR 600; *Re Supreme Finance Corp Pty Ltd* (1984) 2 ACLC 529.

ordinary course of business.[4]

There is, however, no direct correlation between innocence and the operation of the protective provisions: a creditor can be required to disgorge a preference even if he had no dishonest or fraudulent intent.[5] If the creditor had reason to suspect that the company was insolvent and that the effect of the transaction was to confer an undue preference over other creditors, then the liquidator can recover the preference.[6] The subjective honesty or good faith of the preferred creditor is no defence.

Moreover, a creditor who acted in good faith may lose the benefit of the protective provisions where the court concludes that the transaction was outside the ordinary course of business.[7] The court does not consider what is in the ordinary course of the company's business or the creditor's business or what is in the ordinary course of a particular trade, industry or profession;[8] rather, it examines what is in the ordinary course of business generally.[9] Hence, a creditor may take the preference in good faith, honestly believing that the transaction was in the ordinary course of business, and yet be required to disgorge the preference.

The impugned transaction will be examined as at the date it occurred, not the date of the winding up order. Thus, it is immaterial that the preferred creditors did not, in fact, need the preference or that it was never utilised.[10] For example, if the preference takes the form of a mortgage debenture granted, by way of counter-indemnity, to guarantors of a particular account of the company, it does not matter that the account would have been in credit even if the mortgage debenture had not been granted.[11]

A preference can be attacked if it occurred within six months before the

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4. (Cth) Bankruptcy Act 1966 s 122(2)(a), incorporated in the Corporations Law by force of s 565.
5. *Re Sanderson; Ex parte Trustee in Bankruptcy; Lane's Motors Pty Ltd (Respondents)* (1930) 2 ABC 182; *Re Mazok; Ex parte Rees; E Sachs & Co (Respondent)* [1931] QSR 19.
6. See (Cth) Bankruptcy Act 1966 s 122(4)(c); McPherson, supra n 2, 321-322.
7. Compare *K & R Fabrications (Qld) Pty Ltd v M & B Rigging Pty Ltd* [1982] Qd R 585 (a payment made in response to a demand under s 460(2)(a) is not made in the ordinary course of business) with *Re Lee Furniture Pty Ltd (in liq)* (1983) 8 ACLR 251 (payment in response to a writ was in the ordinary course of business because the company was a reliable, but tardy, payer).
8. *Robertson v Grigg* (1932) 47 CLR 257, 267; *Burns v McFarlane* (1940) 64 CLR 108, 125. See also *Taylor v White* (1964) 110 CLR 129, 136-137 per Dixon CJ.
9. See generally *Downs Distributing Co v Associated Blue Star Stores Ltd* (1948) 76 CLR 463, 480; *Taylor v White* ibid, 136.
10. *Re J F Aylmer (Manildra) Pty Ltd; Burgess v Spooner* (1968) 12 FLR 337.
11. Ibid.

commencement of the winding up.[12] The general rule is that a compulsory winding up commences on the date of the filing of the winding up application,[13] even if the winding up order is not made until some months later at the hearing of the application. The liquidator's right to *avoid* the preference arises upon his appointment, although in some cases his right to recover the property included in the preferential transaction might only arise at a later date after a demand has been made upon the preferred creditor.[14]

The appropriate limitation period for proceedings by a liquidator under section 565 of the Corportions Law to recover a preference is *not* that which applies to a speciality debt.[15] Even though the liquidator's right to avoid the preference is conferred by statute, the action to recover the preference is a common law restitutionary claim,[16] not an action to recover a debt created by statute. Hence, a limitation period of six years from the date of the liquidator's appointment[17] is appropriate whether the liquidator proceeds by writ in an action or in the usual manner by summons.[18] Consequently, a creditor can be liable to disgorge a preference considerably more than six years after it was conferred.

The creditor's liability is not restricted to the amount of the preference. It extends to interest on the amount or value of the preference from the date on which the liquidator elects to avoid the preference or perhaps a reasonable time thereafter, so that the preferred creditor can comply with the liquidator's demand.[19] The creditor will also be liable for the liquidator's costs.[20]

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12. (Cth) Bankruptcy Act 1966 s 122.
13. Corporations Law s 465.
14. See *Trevor v Cockburn Hire Service* (1974) (1986) 4 ACLC 502; *Spedley Securities Ltd (in liq) v Western United Ltd* (1992) 7 ACSR 721.
15. Before the liquidator can institute an action in detinue to recover specific chattels, it is necessary to establish that he made a demand for the return of the chattels and that the preferred creditor failed to respond. See *Lloyd v Osborne* (1899) 20 LR (NSW) 190, 193; *Clayton v Le Roy* [1911] 2 KB 1031, 1048.
16. *Re Ward; Thomas v L G Abbott & Co Ltd* (1950) 16 ABC 214; *Re Narbey* (1961) 19 ABC 201.
17. *Re Lehrain; Official Receiver (Trustee) v Franklin Timber Pty Ltd* (1975) 24 FLR 407; *Hamilton v Commonwealth Bank of Australia* ("*Hamilton*") (Unreported, Sup Ct NSW, Hodgson J, 2 October 1992 No 3176 of 1990).
18. *Coates as liquidator of Campus Holidays Ltd (in liq) v Charles Porter & Sons Ltd* (1990) 8 ACLC 1264.
19. See *Re Mike Electric (Aust) Pty Ltd (in liq)* (1983) 71 FLR 117, 123; *Maurice Drycleaners Pty Ltd (in liq) v National Australia Bank Ltd* (1990) 8 ACLC 798, 800; *Hamilton v National Australia Bank Ltd* (1991) 5 ACSR 432; *Spedley Securities Ltd (in liq) v Western United Ltd (in liq)* (1992) 7 ACSR 721. Compare *Hamilton*, supra n 17 (interest should be paid from the date of commencement of the winding up).
20. See generally *Gray v Bridgestone Australia Ltd; Ewing v Fiandri Pty Ltd* (1986) 10 ACLR

In the case of an innocent creditor, this liability may come out of the blue. The preference may have been dissipated and yet the liquidator may require its repayment in full. As *Richardson v Commercial Banking Co of Sydney Ltd*[21] illustrates, the liquidator's right to recover an undue preference is not dependent upon his ability to trace the company's property. In that case the Official Receiver of a delinquent solicitor, named Price, attempted to recover an amount of £390 from his bank. It appeared that a manager of the bank cajoled Price's clerks into giving him the cheque of one of Price's clients in order to reduce the office account. There was clear evidence that the bank manager knew that the cheque was impressed with a trust in Price's hands and that the payment to the bank involved a defalcation.

Justices Dixon, Williams and Fullagar conceded that if the cheque or its proceeds had been preserved and had remained identifiable they never would have been available to Price's creditors: the client would have been able to recover the cheque or its full value from the bank through the equitable remedy of tracing. However, the client did not make any attempt to hold the bank accountable for the proceeds of the cheque. In these circumstances, the High Court held that the payment of the cheque to the bank was an undue preference even though it was made out of trust assets. Hence, the payment was void as against the Official Receiver.[22]

It was unnecessary to decide whether the client could trace the proceeds of the cheque into the hands of the Official Receiver. If the client were unable to trace the cheque or its proceeds, she would nevertheless be able to prove in Price's bankruptcy. She would then share the amount recovered by the Official Receiver (and Price's other assets) rateably with his other creditors. In this respect, the amount recovered as an undue preference more than compensated Price's estate for any dividend payable upon the client's proof of debt.

It is no defence that the preferred creditors have disposed of the property or acted to their own detriment,[23] for example, by releasing guarantors or surrendering securities in reliance on the validity of the preferential payment. The obligation to repay the preference may even cause the creditor to go into bankruptcy or liquidation.

The purpose of this article is to examine whether any relief is, or should be, available to the hapless creditor who innocently receives a preference.

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21. (1952) 85 CLR 110.
22. Ibid, 135-136.
23. See infra 99-100, 101-106.

NO RIGHT OF SET-OFF

It is clearly established that a preferred creditor may not invoke section 86 of the Bankruptcy Act 1966 to set off his liability to repay an undue preference against the company's liability for the original debt.[24] In *Re A Debtor*[25] Mr Justice Clauson explained this principle in the following terms:

> If a creditor of a company receives payment of the sum due to him in such circumstances that the payment amounts to a fraudulent preference, the position is that he has no right to receive his debt in full, but has a right only to be paid a dividend on his debt pari passu with the other creditors: the decision of the Court, in a winding up subsequently supervening, that the payment to him was a fraudulent preference, must necessarily amount to a decision that he had no right to receive his debt in full, but had a right only, in the circumstances, to claim pari passu with the other creditors. It would be an absurdity if the appellant were entitled to set off, against the claim of the liquidator for the money which he wrongly received in full, a claim to be paid under his judgment an equivalent amount as a debt. The most that the appellant can be entitled to is to rank pari passu with the other creditors.[26]

The right of set off is denied, not because of a lack of mutuality, but on policy grounds. This result seems fair even though the preferred creditor is not entitled to prove for his debts in the liquidation of the company until he has refunded the undue preference in full.[27] But where the preferred creditor is itself in liquidation it will be unable to repay the preference in full, so it cannot prove for its debt in the liquidation of the debtor company. This result is not as harsh as it appears. It must be remembered that the preferred creditor was paid in full and that this conferred an advantage on that creditor over other creditors of the company. If the preferred creditor goes into liquidation, the liquidator of the debtor company will be unable to receive the full amount of the preference, so the unsecured creditors of the debtor company will still be at a disadvantage. There is no injustice, therefore, in denying the preferred creditor the right to prove in the liquidation of the debtor company in respect of the dividend which it paid in its own liquidation on the amount of the preference.

The preferred creditor's own unsecured creditors might not, however, share this view. Their debts might have been incurred some months after the preferred creditor received and dissipated the preferential payment. Nevertheless, their dividend in the liquidation of the preferred creditor will be

24. *Re Clements* (1931) 7 ABC 255, 268; *Re Smith* (1933) 6 ABC 49; *Re Grezzana* (1932) 4 ABC 203; *Re Austro-Rest Furniture Ltd (in liq) (No 2)* (1986) 3 NZCLC 99837; *Re Buchanan Enterprises Pty Ltd and the Companies Act* (1982) 7 ACLR 407.
25. [1927] 1 Ch 410.
26. Ibid, 419-420.
27. *N A Kratzmann Pty Ltd v Tucker (No 2)* (1968) 123 CLR 295.

reduced by the amount disgorged as a preference, and their liquidator will not be able to prove for this amount in the liquidation of the preferred creditor.

ACTIONS TO THE CREDITOR'S DETRIMENT

1. Improvements to the property

Some relief may be available to the innocent creditor in certain cases through the rule in *Re Condon; Ex parte James*[28] ("*Re Condon*"). That rule enjoins officers of the court from doing anything which would be regarded as dishonourable or unconscionable for an ordinary person. *Re Nitsche; Ex parte The Official Receiver*[29] ("*Re Nitsche*") provides an illustration of the application of the rule in the context of undue preferences. In that case the respondent, Bray, agreed to sell land to the bankrupt for £1 200. The bankrupt paid a deposit of £150 and agreed to pay certain instalments from time to time. He planned to erect a picture theatre on the land but had insufficient funds to complete the project. He borrowed money from Bray to buy materials and to pay his workmen. When it became clear that the bankrupt was unable to obtain the necessary finance for the venture, he entered into an arrangement with Bray whereby Bray released him from his contract to buy the land and took over the unfinished work and the materials on the land. Bray then completed the theatre, expending thousands of pounds.

The trustee in bankruptcy argued that Bray had received a preference as a result of the arrangement. Mr Justice Moule agreed, but he was not prepared to declare the entire arrangement void. His Honour had difficulty calculating the value of the land and materials at the date on which Bray recovered possession of the property but ultimately decided that the only real advantage which Bray gained was the value of the unused bricks on the site, namely, £35. His Honour even took into account the fact that certain buildings on the land when the bankrupt first entered into possession were dismantled and sold by the bankrupt. This reduced the amount of the preference conferred on Bray.

This decision represents a valiant attempt to prevent a trustee in bankruptcy from taking advantage of his strict legal rights where this would be unconscionable in the circumstances. It is interesting to note that the circumstances would not have given rise to an equitable proprietary estoppel

28. (1874) 9 Ch App 609.
29. (1930) 2 ABC 36.

because the creditor was not encouraged or induced to spend money improving land which belonged to the bankrupt. In fact, the land belonged to the creditor because the transfer to him was valid until it was avoided by the trustee in bankruptcy.

A similar result to that in *Re Nitsche*[30] could be achieved in a compulsory liquidation. A liquidator appointed in a compulsory winding up is an officer of the court and is, therefore, subject to the rule in *Re Condon*.[31] Under this rule the liquidator would not be permitted to take advantage of his strict legal rights if this would unjustly enrich the company's estate at the expense of the preferred creditor.[32] While this principle may be used to accommodate the preferred creditor's claim in a compulsory liquidation, it is doubtful whether the same principle applies in a voluntary winding up where the liquidator is merely an agent of the company. In any event, more comprehensive relief beyond the vagaries of the rule in *Re Condon*[33] should be available to innocent creditors who act to their detriment in reliance upon the validity of the transaction.

2. The defence of change of position

(a) In actions for money had and received

An action for money had and received is the most common way of recovering a perference.[34] Historically, the common law courts allowed this action "because it [was the plaintiff's] ... money, and [the plaintiff had] ... a right to it"[35] or because "the money was received without any reason, occasion, or consideration, and consequently it was originally received to the plaintiff's use."[36] In modern parlance, restitution was ordered because the original transaction was ineffective and the plaintiff was, therefore, entitled

30. Ibid.
31. Supra n 28.
32. Supra n 2, 266.
33. Supra n 28.
34. *Re Ward; Thomas v L G Abbott & Co Ltd* (1950) 16 ABC 214; *Banque Belge pour L'Etranger v Hambrouck* [1921] 1 KB 321, 333; *Trustee Rousou (a bankrupt) v Rousou* [1955] 1 WLR 545; *Penson v Moon* (1866) 15 LT 444; *Hamilton v Commonwealth Bank of Australia* (unreported) Supreme Court of NSW, 2 October 1992 no 3176 of 1990; *Coates, as liquidator of Campus Holidays Ltd (in liq) v Charles Porter & Sons Pty Ltd* (1990) 8 ACLC 1264.
35. *Howard v Wood* (1679) 2 Show 21, 22.
36. *Martin v Sitwell* (1690) 1 Show KB 156 Holt CJ, 157. See S J Stoljar *The Law of Quasi-Contract* (Sydney: Law Book Co, 1964) 11-12.

to recover his property or its value.

In *Lipkin Gorman v Karpnale Ltd*[37] the House of Lords finally recognised the defence of change of position in an action for money had and received, endorsing in principle remarks made by Lord Mansfield over two centuries earlier in *Moses v Macferlan.*[38] Lord Goff of Chieveley, with whom the other Law Lords concurred, declared: "[W]here an innocent defendant's position is so changed that he will suffer an injustice if called upon to repay or to repay in full, the injustice of requiring him so to repay outweighs the injustice of denying the plaintiff restitution."[39] The Supreme Court of Victoria[40] has also recognised this defence and there are indications that the High Court of Australia may soon follow suit.[41]

The rationale for this defence under the general law is inextricably bound up with the plaintiff's claim that the defendant has been unjustly enriched. It would not be available as a defence where the proceedings to recover the preference are framed in detinue or conversion. However, statutory relief might be available to an innocent creditor in some jurisdictions if he is pursued as a constructive trustee.[42]

(b) Relief in detinue and conversion cases

When a liquidator elects to avoid the preference, he has an immediate right to possession of the property in question. Section 474(1) of the Corporations Law confirms this right by providing:

> Where a winding order has been made... the liquidator ... shall take into his or her custody or under his or her control all the property to which the company is or appears to be entitled.

This right to immediate possession gives the liquidator sufficient stand-

37. [1991] 2 AC 545.
38. (1760) 2 Burr 1005.
39. [1991] 2 AC 548, 579.
40. *Bank of New South Wales v Murphett* [1983] 1 VR 489. It has also been recognised by statute in Western Australia and Queensland: (WA) Law Reform (Property, Perpetuity and Succession) Act 1962 s 24; (WA) Trustee Act 1962 s 65(8); (Qld) Trusts Act 1973 s 109(3) (note the reference to trust property).
41. See *Australia and New Zealand Banking Group Ltd v Westpac Banking Corporation* (1988) 78 ALR 157, 162, 168.
42. An undue preference can be recovered from a preferred creditor as a constructive trustee where he knowingly received property of the company from the directors in breach of their fiduciary obligation or knowingly induced or knowingly assisted in the breach of fiduciary obligations by the directors. See generally J O'Donovan "Procedural Aspects of Recovering Preferences" (1993) 2 Jour of Insol Law 1 (forthcoming).

ing to institute proceedings in detinue[43] or conversion[44] to recover specific chattels or their value or damages,[45] as the case may be. In *Re Jubilee Furniture (in liq) and The Companies Act*[46] ("*Re Jubilee Furniture*") the court awarded the liquidator damages where the preference took the form of a repossession of undamaged goods by a supplier who had not been paid. The fact that the liquidator is not the owner of the property is no bar as this type of action is not dependent upon the plaintiff's ownership.[47]

An interesting question arises as to the date on which the value of the property is determined for these purposes. The selection of this date can affect the amount recovered from the preferred creditor and confer a bonus upon the company at the expense of the creditor. In some cases the liquidator's assessment of the market value of the property is accepted by the respondent and the court.[48] But where the goods or other property have increased or fallen in value since the date of the transfer to the preferred creditor, the amount awarded in restitution will be a contentious issue. The court may, in fact, refer the issue to a Master or other court officer to determine.[49] What guidance is there in the authorities?

A preferential transaction is valid until it is avoided.[50] This suggests that the court should determine the value of the property to be recovered at the time of the declaration that the preference is void even if this approach reduces the liquidator's recovery. Perhaps this explains the decision in *Re Jubilee Furniture*[51] where Mr Justice Rath awarded damages against a creditor who repossessed goods, concluding: "I think that, *having regard to*

43. See *Bolwell Fibreglass Pty Ltd v Foley* [1984] VR 97, 99; *Cullen Allen & Co v Barclay* (1881) 10 LR Ir 224; *Ballett v Mingay* [1943] 1 KB 281 (detinue lies even if the possession was rightfully obtained by the defendant).
44. *Ratcliff v Davies* (1610) Cro Jac 244; 80 ER 733 (a right to immediate possession at the time of the conversion is necessary for standing in an action for damages for conversion).
45. See *Re Supreme Finance Corporation Pty Ltd* (1984) 2 ACLC 529, 537; *Re Jubilee Furniture Pty Ltd (in liq) and the Companies Act* (1981) 5 ACLR 762. For a case where the court ordered the respondent to deliver the specific goods in his possession *and* to pay the value of the outstanding goods, see *Re Sotiros; Ex parte Hungerford and Spooner* (1931) 4 ABC 125.
46. (1981) 5 ACLR 762.
47. See *City Motors (1933) Properties Ltd v Southern Aerial Service* (1961) 106 CLR 477; R P Balkin and J L R Davis *Law of Torts* (Sydney: Butterworths, 1991) 64.
48. See eg Re Buchanan Enterprises Pty Ltd and the Companies Act (1982) 7 ACLR 407.
49. See *Re Lemon; Official Assignee, Ex parte Colonial Finance, Mortgage, Investment & Guarantee Corporation Ltd, Respondents* (1894) 5 BC (NSW) 18.
50. A preference is voidable, not void, despite the terms of s 565 of the *Corporations Law: Re Hart* [1912] 3 KB 6; *N A Kratzmann Pty Ltd v Tucker (No 1)* (1966) 123 CLR 257, 277, 288; *N A Kratzmann Pty Ltd v Tucker (No 2)* (1968) 123 CLR 295, 298.
51. Supra n 46.

the age of the goods, the best evidence of value available is the invoiced price ...".[52] The invoiced price was, of course, the price at which the goods were supplied to the company by the preferred creditor. Similarly, in *Re Trendent Industries Pty Ltd (in liq)*,[53] Mr Justice Needham ordered the preferred creditor to repay the "ex works value" of the steel supplied to the company, not the value of the steel repossessed by the creditor.[54] If the liquidator brings an action to recover the proceeds of sale of the property by the preferred creditor, as distinct from damages, this very action may be taken to have affirmed the sale and the liquidator may be prevented from recovering any deficiency in the sale price in the form of damages.[55]

By assessing the value of the property at the time of the preferential transaction, the court sometimes confers a windfall upon the company at the expense of the preferred creditor. This will inevitably occur where the preference takes the form of a transfer of goods because the goods become "second-hand" as from the date of the transfer. The windfall might be even greater in respect of property which is subject to dramatic fluctuations in value. Take, for instance, a transfer of company shares in favour of an unsecured creditor. If the shares plummet in value after the preference occurs, who bears the loss: the preferred creditor or the unsecured creditors as a whole? On the reasoning in *Re Trendent Industries Pty Ltd (in liq)*[56] and *Re Jubilee Furniture*[57] the liquidator could recover the value of the shares at the date of the transfer. With respect, this is more a form of retribution than mere compensation. If the liquidator had recovered the specific property transferred, namely the shares, the loss would be borne by the unsecured creditors as a whole in the liquidation of the company. If the preferred creditor has not caused the fall in value, for example, by failing to take up a rights issue on the shares, he should only be liable to transfer the shares back to the company or to pay the liquidator the market value of the shares at the time of the court's order.[58]

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52. Ibid, 766 (emphasis added).
53. (1983) 8 ACLR 115. Contrast *Re Riddle; Ex parte Official Assignee; Wilson (Respondent)* (1895) 16 LR (NSW) B & P 133; 6 BC 12; *Re Allen; Ex parte Official Assignee; Union Bank of Australia (Respondents)* (1894) 15 LR (NSW) B & P 97; 5 BC 36, where the date of the preferential transaction, ie the repossession of the goods by the creditor, was selected as the appropriate date for determining the value of the goods.
54. See eg *Marks v Feldman* (1870) LR 5 QB 275.
55. *Smith v Baker* (1873) LR 8CP 350 (by analogy with the tort of trover).
56. Supra n 53.
57. Supra n 46.
58. Compare *Butler Egg & Egg Pulp Marketing Board* (1966) 114 CLR 185, 191; *Hiort v London and North Western Railway Co* (1879) 4 Ex D 188, 195; *Craig v Marsh* (1935)

There may well be cases where the liquidator would be reluctant to avoid the preference in these circumstances because the property recovered might not be sufficient to compensate the company's estate for the fact that the preferred creditor would acquire a right to prove in the estate for the full value of his debt once he disgorged the preference. In this situation the other unsecured creditors would actually be worse off if the liquidator elected to avoid the preference instead of allowing it to stand. Yet the preferred creditor cannot disgorge the preference on his own initiative and prove for his debt in the liquidation of the company. He is stuck with the preference.

Conversely, where the shares have increased in value and the liquidator elects to avoid the preference, the creditor might wish to pay the liquidator the market value of the shares at the date of the original transfer. But it is unlikely that the court would limit the liquidator's recovery to this amount. The liquidator should be entitled to recover the specific shares or their market value at the date of the judgment.[59] If the preferential transaction results in a benefit to the company's estate, the preferred creditor is not entitled to an allowance to compensate him for this resulting benefit.[60] This is illustrated by *Re Gordon; Ex parte The Trustee*,[61] which arose in a different context. The respondent saved the debtor's tractor from being repossessed by a hire purchase company by purchasing it from the company and then hiring the tractor to the debtor on condition that he be paid half the purchase price and interest out of the debtor's next crop. When the crop was harvested the agreed payment was made. There was no doubt that it was an undue preference but the respondent argued that he had come to the debtor's rescue and that his hiring of the tractor conferred a benefit on the debtor's estate and, consequently, his creditors. Nevertheless, Mr Justice Paine allowed a full recovery of the amount of the preference on the ground that the respondent was fully aware of the debtor's insolvency and that he did not attempt to obtain the

35 SR (NSW) 323, 329-330.

59. Compare *Sacks v Miklos* [1948] 2 KB 23; *Aitken v Gardiner* [1956] 4 DLR (2d) 119; *Amorelly v The City of Melbourne Bank* (1887) 13 VLR 431. See F A Trindade and P Cane *The Law of Torts in Australia* (Melbourne: Oxford University Press, 1985) 253-254.

60. *Re Gordon; Ex parte The Trustee* (1933) 6 ABC 167. But the plaintiff's damages may be reduced where the goods are improved in circumstances where the defendant did not behave in wilful disregard of the plaintiff's rights. See *Reid v Fairbanks* (1853) 13 CB 692; 138 ER 1371; *Murno v Willmott* [1949] 1 KB 295. See also *Re Grezzana; Painter v Charles Whiting & Chambers Ltd (No 2)* (1932) 5 ABC 233. Compare *Hamilton v Commonwealth Bank of Australia* (unreported), NSW Supreme Court, 2 October 1992 No 3176 of 1990), where Hodgson J suggested that a preference claim could include a claim for profits because it was intended to restore the full value of the preference.

61. (1933) 6 ABC 167.

approval of the debtor's other creditors. The respondent's risk was considerably reduced by the security he had in the form of the tractor. In any event, the respondent was prepared to take the risk and could not, therefore, resist a full recovery, although no order for costs was made against him. He received no compensation for the benefit which he conferred on the estate during the period that he retained the preference. This result may be contrasted with the position of a constructive trustee who is required to account for trust property. The court may be inclined to grant the constructive trustee a generous allowance for his time and expenses if the trust estate has benefited from his actions.[62]

It appears, therefore, that the courts are able to apply a double standard in awarding damages. Any principle which produces different results depending upon fluctuations in the value of the property concerned is not a principle at all. It is submitted that the liquidator should only be allowed to recover the specific property transferred to the preferred creditor or the value of that property at the date of the declaration. If the property has fallen in value the liquidator generally should be able to recover the property or its reduced value. Only where the preferred creditor is responsible for the fall in value should the liquidator be entitled to recover the specific property plus damages for conversion.[63] This is the logical consequence of the preferential transaction being valid until it is avoided: the risk lies with the liquidator as agent of the company.

Conversely, where the property transferred to the preferred creditor increases in value, the liquidator should be entitled to recover the property itself or the increased market value of the property at the date of the declaration. This is not a windfall at the expense of the creditor; it is merely the consequence of a fluctuation in the value of the property which the company itself would have enjoyed if the preference had not occurred.

Where the preferred creditor has gone into liquidation, the action in conversion may be of more concern to the liquidator of the preferred creditor than to the creditor itself. One advantage of an action in conversion as a common law form of "tracing" is that it is available against *the liquidator of the preferred creditor* even if the liquidator has disposed of the debtor's chattels to a bona fide purchaser.[64] The debtor can recover damages in conversion against the liquidator in his personal capacity, as distinct from his representative capacity. The rationale is that the creditor's liquidator ac-

62. See *Phipps v Boardman* [1967] AC 46.
63. Compare *Re Sotiros, Ex parte Hungerford and Spooner* (1931) 4 ABC 125.
64. See M Scott "The Right to 'Trace' at Common Law" (1965) 7 UWALR 463, 480.

quired no title to the specific goods and is, therefore, liable for damages for conversion when the goods are sold to the bona fide purchaser. However, this particular advantage of common law tracing is probably not available to a liquidator in proceedings to recover an undue preference because it is predicated on the assumption that no title to the goods passed to the preferred creditor or its liquidator. By contrast, a transfer of specific goods to a preferred creditor is valid until it is avoided. Consequently, the creditor acquires a valid title to the goods even if the transfer is later avoided as an undue preference. Thus, no action should lie against the liquidator of the preferred creditor in his personal capacity.

In detinue and conversion cases it appears that the courts have been unable or unwilling to accommodate the legitimate claims of innocent creditors who have improved the property or who have been compelled to disgorge the full amount of a preference even though it has fallen in value. Perhaps the courts need a broader charter than these relatively rigid forms of common law tracing allow.

THE NEW ZEALAND MODEL

Across the Tasman a more sophisticated regime exists for dealing with creditors who alter their position in reliance upon the validity of a preferential transaction. Section 311A of the New Zealand Companies Act 1955, which was inserted in the Principal Act by section 20 of the New Zealand Companies Act 1980, provides in sub-section (7):

> Recovery by the liquidator ... may be denied wholly or in part if -
>
> (a) the person from whom recovery is sought received the property in good faith and has altered his position in the reasonably held belief that the transfer or payment of the property to him was validly made and would not be set aside; and
>
> (b) in the opinion of the Court it is inequitable to order recovery or recovery in full, as the case may be.

In *Westpac Banking Corporation v Nangeela Properties Limited (in liq)*,[65] Mr Justice Richardson stated that the obvious purpose of the provision is "to give the Court a discretion to protect the position of the person who has taken property in good faith and altered his position in reliance on the bona fides of the transaction."[66] His Honour added: "Clearly it applies where such a person has subsequently disbursed the money or dealt with the property in

65. (1986) 3 NZCLC 99588.
66. Ibid, 99592.

such a way that it would be inequitable to insist on full recovery."[67]

The requirements of the sub-section are cumulative. First, it must be established that the person from whom recovery is sought received the property in good faith. Presumably the recipient carries this onus. "Good faith" at least requires that the recipient of the property or moneys be shown to have honestly believed that the transaction would not involve any element of undue preference *either* to himself *or* to any guarantor.[68]

Secondly, the recipient of the property must have altered his position. The receipt of a payment does not in itself constitute an alteration of position within the sub-section,[69] still less does the receipt of a cheque which does not amount to payment until the cheque is honoured.[70] To determine whether the recipient has altered his position, the court must examine what occurred *after* the receipt of the payment.[71]

A person does not alter his position within the meaning of the sub-section simply by inaction, unless his failure to act resulted from a conscious decision on his part. For example, in *Westpac Banking Corporation v Nangeela Properties Ltd (in liq)*[72] the court found that the corporate recipient had not altered its position because it had not deliberately decided to refrain from enforcing a collateral undertaking given by another party; it had simply accepted the payment and did not address the question of enforcing the collateral undertaking, which lapsed through the effluxion of time. Nor does the recipient alter its position where it banks the company's cheque and uses the proceeds in the ordinary course of its business to meet its own debts.[73] Furthermore, an individual recipient's payment of his current liabilities which he might have satisfied in any event does not amount to an alteration of position.[74]

To qualify for relief under section 311A(7), the recipient must also

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67. Ibid.
68. *Re Orbit Electronics Auckland Ltd (in liq); W H Jones & Co (London) Ltd v Rea* (1989) 4 NZCLC 65170, 65171 (CA), approving a statement by Casey J at first instance: (1988) 4 NZCLC 64237, 64244.
69. *Westpac Banking Corporation v Nangeela Properties Ltd (in liq)* (1986) 3 NZCLC 99588.
70. Cf *MacMillan Builders Ltd (in liq) v Morningside Industries Ltd* (1986) 3 NZCLC 99879, which is not consistent with *Westpac Banking Corporation v Nangeela Properties Ltd* (1986) 3 NZCLC 99588 and appears, therefore, to be of dubious authority. See *Re Paul Finch Holdings Ltd* (1989) 4 NZCLC 64774.
71. *Westpac Banking Corportion v Nangeela Properties Ltd* supra n 65.
72. Ibid.
73. *Re Paul Finch Holdings Ltd* (1989) 4 NZCLC 64774.
74. Ibid.

establish that he altered his position "in the reasonably held belief that the transfer or payment of the property to him was validly made and would not be set aside". It is clear from the terms of the sub-section that "in the process of receiving the payment, the payee must form a belief on reasonable grounds that it is validly made and will not be set aside and, by its acceptance, alter his position to the extent that total or partial recovery from him would be inequitable".[75]

The word "inequitable" carries the connotation of unfair and unjust.[76] A common ground for relief under the sub-section might be where an order for repayment or recovery of the preference would leave the original recipient in a worse position than if he had never received the preference in the first place.[77] It is not inequitable to order recovery in full where the recipient used the preferential payment to meet current liabilities and day-to-day living expenses in the ordinary course of events.[78] It might be different where a preferred creditor has released a guarantee of the company's debts in reliance upon the validity of the payment.[79] One classic example of where it would be inequitable to allow recovery of the disposition from the creditor is where the creditor can establish that the liquidator was not entitled to avoid the disposition in the first place.[80]

CONCLUSION

In these troubled times when unsecured creditors receive paltry dividends in company liquidations, it is fashionable for commentators to discount the claims of innocent creditors who received the benefit of a preference. If they are required to disgorge the preference for the benefit of unsecured creditors as a whole they attract little sympathy. It is important to remember that,

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75. *Westpac Banking Corporation v Nangeela Properties Ltd (in liq)* (1986) 3 NZCLC 99588, 99595.
76. *MacMillan Builders Ltd (in liq) v Morningside Industries Ltd* (1986) 3 NZCLC 99879, 99884.
77. Ibid.
78. *Re Paul Finch Holdings Ltd* (1989) 4 NZCLC 64774.
79. Cf *Bank of New Zealand v Prelam Industries Ltd (in liq)* (1989) 4 NZCLC 65071 (where it was not inequitable because the recipient's guarantee was still effective). If the guarantee itself contains a provision preserving or reviving the guarantor's liability where a payment by the principal debtor or a co-guarantor is successfully attacked as an undue preference it will not be inequitable to order repayment in full. See *Commercial Bank of Australia Ltd v Carruthers* [1964-5] 2 NSWR 1197. This is not as much of a problem in New Zealand where the undue preference provision does not specifically provide that a preference is "void as against the liquidator."
80. *Re Huberg Distributors Ltd (in vol liq) (No 2)* (1987) 3 NZCLC 100211.

historically, Bankruptcy Courts were Courts of Equity and that the pari passu principle has a distinguished pedigree in equity. Yet equitable relief has been granted only sparingly to innocent creditors who received a preference. Only recently have the courts begun to accept a change of position as a defence to an action for money had and received, and the all-or-nothing nature of this defence may not be flexible enough to produce a just result for an innocent creditor. Indeed, where the property transferred to the preferred creditor has fallen in value since the date of the transfer the court can allow the liquidator to recover the value at the date of the transfer. And an innocent creditor will receive no allowance for any benefits which he confers upon the estate of the company while he retained the preference.

Our courts need an express power to grant relief to creditors who receive the benefit of an undue preference in good faith and alter their position in the reasonable belief that the transaction is valid. Equality is not always equity.