Defending a Liquidator's Claim for Repayment of a Voidable Transaction

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I Introduction

One of the aims of company legislation is to ensure that all unsecured creditors share equally in the distribution of the assets of a company in liquidation. In order to achieve this aim the legislation contains provisions which allow a liquidator in certain circumstances to "claw back" company property transferred to creditors in the two year period prior to the liquidation. The legislation also recognises that in some circumstances it may be unjust to order such a creditor to repay property to the liquidator and provides some protection for those creditors. This paper considers the defence that can be raised by a creditor in response to a liquidator's claim for repayment.

This topic requires a consideration of the defence available, under section 296(3) of the current Companies Act 1993 ("the Act"), to a creditor who has received property pursuant to a voidable transaction which has been set aside after the liquidation of the debtor company. Section 292 of the Act determines whether the transaction is voidable. Essentially the transaction will be voidable if it has the effect of preferring one creditor over other creditors in the liquidation, was made within two years of liquidation, at a time when the company was unable to pay its due debts and did not take place in the ordinary course of business. Section 296(3) provides that the court can deny recovery by the liquidator of the property transferred pursuant to a voidable transaction, in whole or in part, if the requirements of the section are met. Essentially the section provides some protection to creditors who act in good faith and alter their position in the reasonably held belief that the transaction is valid. This paper will consider the requirements of the section in detail and discuss the types of circumstances where the defence might operate. The paper will begin by considering the history of the defence. Each of the elements of the defence will then be discussed.

It should be noted at the outset that sections 296(1) and (2) of the Act also provide defences to claims for recovery by liquidators from third parties who have received company property from the person who obtained it from the company pursuant to the voidable transaction. Those persons will not be required to repay property to the liquidator if they can show that they acquired the property for valuable consideration and without knowledge of the circumstances of the voidable transaction. This protects the bona fide purchaser for value without notice, a third party whose innocence has long been recognised. The purpose of this paper is to consider the defence available under section 296(3) and the position of the bona fide third party will not be considered further.

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[Accepted for publication August 1997]

II The History of section 296(3) of the Companies Act 1993

Section 296(3) provides:

> Recovery by the liquidator of property or its equivalent value, whether under section 295 of this Act or any other section of this Act, or under any other enactment, or in equity or otherwise, 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 or her position in the reasonably held belief that the transfer to that person 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.

The defence was first incorporated into statute in New Zealand by section 58(6) of the Insolvency Act 1967. Section 58(6) was adapted from section 94B of the Judicature Act 1908[1] which establishes a similar defence where money has been paid under a mistake.[2] The common law relating to payments made under mistake now rests within the law of restitution where the defence of "change of position" is now recognised.[3] In examining the relief available to parties to voidable transactions under Australian law, James O'Donovan referred to the defence of change of position which is available in actions for money had and received, the common law basis for recovery of preferences.[4] The similarities between section 296(3) and the doctrine of equitable estoppel are also very strong. The defence has its roots grounded firmly in equity.

The defence available under section 58(6) of the Insolvency Act 1967 was incorporated into the Companies Act 1955 by the 1980 amendment to that Act which introduced section 311A(7). Section 296(3) is identical to section 311A(7) apart from some minor semantic changes. Cases which interpret section 311A(7) therefore remain relevant to a discussion of section 296(3).

III The Requirements of 296(3)

Four elements must be established in order to successfully raise the defence and avert repayment, in whole or in part, of property transferred pursuant to a voidable transaction which has been set aside. The elements are:

1 The property that is the subject of the voidable transaction was received in good faith;

2 The person from whom recovery is sought has altered his or her position;

3 That person had a reasonably held belief that the transfer was validly made and would not be set aside; and

4 The circumstances are such that it would be inequitable to order recovery or recovery in full.[5]

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1 Inserted by the Judicature Amendment Act 1958.

2 R J Sutton, *The Law of Creditors' Remedies in New Zealand* (1978) at para 6.01.

3 See for example, *Lipkin Gorman* v *Karpnale Ltd* [1991] 2 AC 545.

4 J O'Donovan, "Undue Preferences: Some Innocents 'Scape Not the Thunderbolt' " (1992) 22 UWAL Rev 322 at 328.

5 *Andersen's Company Law* (Butterworths) at 1-326.

The first point to note is that the Court of Appeal has accepted that the reference to "property" in the section includes money payments.[6] In practice it appears that the section is most commonly used to protect payments of money, often by cheque, made by the company prior to its liquidation. It has been acknowledged by the Court of Appeal that the elements of the defence are cumulative and all must be satisfied to succeed with the defence.[7] It is also clear that the onus of proving the elements of the defence falls on the recipient of the property.[8] The section may operate as a complete defence to a liquidator's claim for recovery or the recipient of the property may be able to mitigate the loss to him or her by persuading the court that recovery should be denied "in part". Each of the elements of the defence will now be considered.

1 Good Faith

The first element of the defence requires the recipient to establish that the property was received in "good faith". The Court of Appeal in *Re Orbit Electronics Auckland Ltd (in liq)*[9] accepted Thorp J's definition of "good faith" in the High Court. His view was repeated by Casey J as follows:[10]

> "good faith" in terms of sec 311A(7) must at least require that the recipient of the property or monies be shown to have honestly believed that the transaction would not involve any element of undue preference either of himself or any guarantor.

This definition seems to require a lack of realisation by the recipient that he or she, in receiving the property, ends up in a more advantageous position compared to other creditors of the company. It appears that Casey J considered more than just this point in deciding that the payment in question was not received in "good faith".

In the case, WH Jones Ltd & Co (London) Ltd ("WH Jones") procured and shipped goods to Orbit Electronics Auckland Ltd (in liq) ("Orbit") drawing bills payable at 90 or 120 days. Orbit's governing director, Ross guaranteed payment. Orbit went into voluntary liquidation on 7 November 1983 having paid two of WH Jones' bills on 4 November 1983. The bills were not due for payment until 7 November 1983 and 28 January 1984 and totalled $25,092.99. The liquidator challenged the payments and the High Court found that they were to be set aside as voidable preferences and declined to grant relief under section 311A(7). The appeal was against the refusal to grant relief under section 311A(7) only. After setting out the above definition of "good faith" the court held that there was an absence of good faith on the part of WH Jones because there had been telexed communications between the parties before the payments were made which showed that WH Jones was aware that Orbit was in financial difficulty,

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6 *MacMillan Builders Ltd* v *Morningside Industries Ltd* [1986] 2 NZLR 12 at 16 per Somers J.

7 *Orbit Electronics Auckland Ltd (in liq)* (1989) 4 NZCLC 65,170 at 65,172.

8 Supra n 6.

9 (1989) 4 NZCLC 65,170.

10 Ibid at 65,171.

liquidation was likely and that any payment made to WH Jones could be attacked by a liquidator. WH Jones' awareness of the position of other creditors was not directly discussed although the points that were discussed would have had a bearing on this question.

In *Re Bee Jay Builders Ltd,* Tipping J made the comment that the payment in question was received in good faith because: "[the recipient] had no idea that Bee Jay was in financial difficulties".[11] However in *Bank of New Zealand* v *Prelam Industries Ltd (in liq)*[12] Tompkins J held that a bank which received payments in reduction of the company's overdraft, received those payments in "good faith" even though the bank had received a telephone call from the company's accountant, before the payments were made, advising that the company was considering forwarding a letter to all its creditors requesting that a "moratorium be put in place". The court seemed to be persuaded that the bank received the payments in good faith because there had been no mention of possible liquidation or receivership prior to the payments being made. The court required more than an awareness that the company was in financial difficulty to remove good faith. The telephone call referring to a possible moratorium would have indicated that the company was in financial difficulty but it did not result in a lack of good faith.

In Official Assignee of DS Edmonds Electrical Ltd (in liq) v *Tyree Power Ltd,* Hillyer J, in dealing with two elements of the defence under section 311A(7)—good faith and the reasonably held belief— referred to the fact that the recipient was aware that the company was in financial difficulty and decided that, "it would therefore know that getting an assignment" of money owed to the company would give it an advantage over other creditors.[13]

The Australian case of *Rees* v *Bank of New South Wales*[14] held that a bank had not acted in good faith when it was aware that all the company's receipts were being used in reduction of its overdraft in circumstances where the company was not paying its debts on time. This knowledge would have indicated, not only that the company was in financial difficulty but also that the overdraft was being reduced in preference to payment of other creditors.

These cases indicate that "good faith" in receiving the property can be absent where there is an awareness of one or more of the following factors by the recipient:

- the company is in financial difficulty;
- there is a likelihood of insolvency or liquidation of the company; and/or
- the advantageous position of the recipient in comparison with other creditors.

The most acceptable means of determining whether "good faith" exists is to consider all of the above factors in the context of the surrounding circumstances. It must be borne in mind that the court will often be required to determine what the recipient was aware of by drawing inferences from the surrounding facts. This point was made by the Court of Appeal in *Westpac Banking Corp* v *Nangeela*

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11 [1991] 3 NZLR 560 at 563.
12 (1989) 4 NZCLC 65,071.
13 [1993] MCLR 237 at 240.
14 (1964) 111 CLR 210.

Properties Ltd (in liq)[15]. The existence of one of the above factors may enable the court to draw an inference about one of the other factors as was done by Hillyer J in the *Tyree Power* case[16] mentioned above. The courts are unlikely to define the meaning of "good faith" further as further definition will only limit future application of the term.

In a recent article considering Australian bankruptcy law, Andrew Keay[17] makes the interesting point that there is an overlap in the meanings of the terms "good faith" and "in the ordinary course of business". He considers these terms in the context of section 122(2)(a) of the Australian Bankruptcy Act 1966 which provides that a person can defend an action for recovery of a voidable preference if it can be established that:

- he or she was a purchaser, payee or encumbrancer;
- in the ordinary course of business;
- in good faith; and
- gave consideration at least as valuable as the market value of the property received.

Keay refers to some Australian cases where courts have referred to the overlap in the meaning of both terms.[18] He also points to the Australian case of *Re Lee Furniture Pty Ltd (in liq)*[19] where it is made clear that the terms are distinct concepts. He refers to the following statement from that case: [20]

> the concept of ordinary course of business is wider [than good faith] in the sense that although a payment may be made and received in good faith, the circumstances may show that it was not made in the ordinary course of business.

This approach must be correct in New Zealand because section 292 itself provides that a transaction will not be voidable if it was made "in the ordinary course of business". If the meaning of this phrase were equated with "good faith" then satisfaction of the first element of the section 296(3) defence would result in the transaction not being a voidable preference at all. The meaning of "in the ordinary course of business" must be wider than good faith, although good faith may be one of the elements required to establish "in the ordinary course of business". The following comments of Sinclair J in the High Court judgment in *MacMillan Builders Ltd* v *Morningside Industries Ltd* must be viewed in the context that they were made prior to the "ordinary course of business" being included in section 292 as a complete defence to a voidable transaction claim. His comments were: "it is my view that in relation to a voluntary winding

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15 (1986) 3 NZCLC 99,588 at 99,591.

16 [1993] MCLR 237.

17 Andrew Keay, "The 'In the Ordinary Course of Business' Element in Preference Law: Has it Passed its Use By Date?"(1997) 5 Insolvency LJ 41.

18 *Telecom Australia* v *Russell Kumar and Sons Pty Ltd (receivers and managers appointed) (in liq)* (1993) 10 ACSR 24 and *Spedley Securities Ltd (in liq)* v *Sparad (No 100) Ltd* (1993) 12 ACSR 32.

19 (1983) 8 ACLR 251.

20 Ibid at 253.

up, payments made in the ordinary course of business ought to be treated as payments coming within subs 7(a) and (b) of s 311A ... [In] the case of a voluntary winding up a payment made in the ordinary course of business and not tainted in any way ought to be retained by the recipient".[21] "Good faith" and "in the ordinary course of business" must be treated as different concepts.

2 Alteration of Position

The second element which must be established in order to succeed with the defence is that the recipient of the property must show that it altered its position after receiving the property. The following are examples of the types of actions which recipients might claim amount to an alteration of their position:

- mere receipt of payment;
- continuing to supply goods or services which are not paid for;[22]
- releasing a guarantor; [23] and
- (in the writer's opinion) deciding not to exercise a Romalpa clause.

Each of these actions will be considered below but before considering them it is important to note that what is required is some action which the recipient would not have undertaken if the property had not been received. This view was taken by Holland J in *Re Paul Finch Holdings Ltd* [24] where he held that the payment of school fees, reduction in indebtedness and use of funds as family income, after receipt of company property, was not an alteration of position because there was no evidence that these things would not have occurred in any event. In *Re Bee Jay Builders Ltd* Tipping J made the following consistent statement:[25]

> The essence of an alteration of position for present purposes seems to me to be a deliberate course of conduct, be it act or omission, following receipt of the impugned payment which course of conduct the recipient would not have taken but for receipt of the payment and belief in its validity.

After some conflicting statements from the Court of Appeal in *Nangeela Properties*[26] and *MacMillan Builders Ltd* v *Morningside Industries Ltd*[27], it now seems settled that mere receipt of a payment cannot amount to an alteration of position even if the receipt is into an overdrawn bank account with a consequent reduction in indebtedness. The following statement of Richardson J in *Nangeela* is very helpful: [28]

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21 (1985) 2 NZCLC 99,370 at 99,374.
22 See *Re Bee Jay Builders,* supra n 11.
23 See *Nangeela Properties,* supra n 15.
24 (1989) 4 NZCLC 64,774 at 64,778.
25 Supra n 11 at 566.
26 Supra n 6.
27 [1986] 2 NZLR 12.
28 Supra n 15 at 99,592.

> First it is implicit in the scheme and language of the subsection that the receipt of a payment cannot itself constitute an alteration of position. It is what is done subsequently that has to be considered .... Secondly "altered" is used as a transitive verb. It denotes change which he, the receiver of the payment, has effected. It is only where used as an intransitive verb, as in "his position has altered" , that the word extends to a change imposed on him by external agencies or circumstances. The requirement of para [311A(7)] (a) is that the receiver of the payment has altered his position and that language is not apt to cover inaction, at least where it is not the product of a deliberate decision on his part.

The case concerned a payment made to Westpac in reduction of the company's overdraft two weeks prior to the company going into voluntary liquidation. The Court of Appeal accepted that the payment was a voidable preference and decided that relief was not available under section 311A(7). The bank argued that there had been an alteration of its position in that the level of the company's indebtedness to the bank was reduced and the bank had not used its rights to claim any overdrawn sum from UDC as guarantor. However the evidence showed that there had been no conscious decision by the bank not to claim from UDC and the validity of a claim against UDC was uncertain because the required documentation had not been completed.

McMullin J acknowledged that: "Inaction may be the result of a conscious decision which, nonetheless, results in an alteration of position. Deciding not to pursue a guarantor would be an example." [29] However he held that on the facts of this case there was no evidence that the bank ever made a conscious decision to accept the payment and alter its position by deliberately forgoing some right.

The conflict in views—on whether receiving a payment can amount to an alteration of position—arose when, less than six month later, the Court of Appeal held in *MacMillan Builders* that acceptance of cheques and payment of them into an overdrawn account was an alteration of position.[30] It was also stated that there may not be an alteration of position if the cheques are paid in an account in credit.[31]

Subsequently the High Court decisions in *Paul Finch* [32] and *Bee Jay Builders* [33] have adopted the approach taken in the *Nangeela* case. This approach seems correct as the fact of "receipt" is one of the requirements of the defence, separate from "alteration of position". In *MacMillan* a distinction seemed to be drawn between the act of accepting the cheque and the act of paying the cheque into the overdrawn account. The decision seems to equate accepting the cheque with "receipt" and payment of the cheque into the overdrawn account with "alteration of position". The flaw in this analysis was pointed out by Holland J in *Paul Finch*[34] where he noted that acceptance of a cheque is not receipt of payment until the cheque has been honoured. He went on to say that presentation of the cheque to the bank may be no more than a step in the receipt of payment and

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29 Ibid at 99,595.
30 Supra n 6.
31 Ibid at 17.
32 Supra n 24.
33 Supra n 11.
34 Supra n 24 at 64,778.

accordingly cannot be an alteration of position which must be subsequent to the receipt. This approach was adopted by Tipping J in *Bee Jay Builders*.[35] It is the writer's view that this must be the correct analysis.[36]

Continuing to supply materials to the company which subsequently went into liquidation was held to have been an alteration of position in *Re Bee Jay Builders*.[37] A payment of $10,000 was made by the company to brick supplier in the month prior to the liquidation. After receiving the payment and because the payment had been received the brick supplier supplied further materials to the value of $2,387. The court was satisfied that the further supply of materials was an alteration of position because the delivery would not have been made if the payment had not been received. The liquidator was denied recovery in part, not to the extent of the value of the further materials supplied.

In *Bee Jay Builders* [38] it was argued on behalf of another creditor, Plumbing World Ltd (who had received a payment subject to challenge), that because there was a Romalpa clause in the relevant supply agreement, Plumbing World was not a creditor at all but retained title to the materials supplied until paid in full. This argument was rejected by Tipping J who held that Bee Jay's primary duty under the contract was to pay the price. There was no suggestion in the case that there had been an alteration of position, after accepting the payment, in deciding not to exercise the rights available pursuant to the Romalpa clause. The facts of the case may not have warranted such an argument but it seems that it could have merit in an appropriate case. The alteration of position would be similar to the alteration involved in deciding not to pursue a guarantor, which was accepted as a possibility by McMullin J in *Nangeela*.[39]

What is required to satisfy the alteration of position element is some act or conscious decision not to act, after receipt of the property, and that act or decision not to act must be something which would not have occurred if the property had not been received. Peter Watts, in the New Zealand Law Commission, *Contract Statutes Review*,[40] expresses the view that the requirement of some conscious decision or action is unjust. He suggests that an alteration of position resulting from a complete failure to act on the part of the recipient would satisfy the defence available under section 94B of the Judicature Act 1908 if the phrase "has so altered his position" were replaced with "his or her position has so altered". A similar amendment to section 296(3) seems justified and would produce results more in line with the defence of change of position available under the law of restitution.

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35 Supra n 11 at 566,

36 See however *Thomas* v *Houston Corbett & Co* [1969] NZLR 151 at 164, where North P accepted, in relation to s 94B of the Judicature Act 1908, that the alteration of position may occur prior to a mistaken payment by cheque actually being paid into the recipient's bank account.

37 Supra n 11.

38 Ibid at 564.

39 Supra n 15 at 99,595

40 Report No 25 (May 1993) at paras 4.16-4.21.

3 Reasonably Held Belief that the Transfer was Valid and Would Not be Set Aside

The third element of the defence requires the recipient to show that the alteration of position has happened in the reasonably held belief that the transfer was validly made and would not be set aside. This seems to suggest that the recipient must be unaware of the liquidator's power to claw back property transferred pursuant to a voidable transaction. It is a question of fact but like the "good faith" requirement the court's conclusion on this point will generally be drawn from inferences taken from the surrounding circumstances. It is difficult to see what this requirement adds to the good faith requirement other than the fact that it requires good faith to be evident at the time of the alteration of position as well as the time of receipt. Judges have made little comment as to the meaning of the term. In *MacMillan* Somers J commented: [41]

> It will seldom be the case that a person who receives a cheque in the ordinary course of business has any occasion to address his mind consciously to the validity of the payment to him. He will assume it in the absence of some reason to the contrary. In such cases the fact that a payment is received in good faith of itself must be sufficient, when accompanied by an alteration of position as a consequence of the receipt, to satisfy the provisions of subs (7)(a). Where the payee is put on notice in circumstances other than receipt in the ordinary course of business there may be initial doubt or grounds for reconsidering the matter. Whether a finding of a reasonably held belief can be made in such cases will turn on what is disclosed in evidence.

In this statement Somers J seems to be equating the meanings of "good faith" and "the reasonably held belief". In the writer's view it would be more straightforward if the reference to the reasonably held belief were deleted from the section and it was made clear that "good faith " is required both at the time of receipt and at the time of alteration of position.

4 Inequitable to Order Recovery

The fourth element requires the recipient to persuade the court that it would be inequitable in all the circumstances to order recovery or recovery in full. This gives a complete discretion to the court. Most judges have taken the view that it will be inequitable to order recovery in circumstances where the recipient will suffer a detriment if ordered to repay and will end up in a worse position than he or she would have been in if the property had not been received at all. This approach seems to be consistent with the defence of change of position as applied in the law of restitution and also the requirements of equitable estoppel. This view is reflected in the comments of Somers J in *MacMillan* where he stated: [42]

> The word "inequitable" carries the connotation of unfair or unjust; and while it would be wrong to attempt to limit the circumstances which may be so described it will commonly be because to order repayment will leave the original recipient in a worse position than if he had never received the money at all.

[41] Supra n 6 at 17.
[42] Ibid.

He also refers to the consideration of whether a detriment will be suffered by the recipient if required to repay.

Other cases have considered the question in the light of all the surrounding circumstances including the object of the legislation, the *pari passu* principle and the position of the other unsecured creditors. In *Mowtown Farm and Garden Ltd* v *Cormack*,[43] Williamson J commented that in exercising the discretion, the purpose and fundamental premise of insolvency law, to treat creditors equally, must be borne in mind. He went on to say: "the Court must bear in mind the overall position so far as all creditors are concerned and the need for creditors, particularly the ones who do not have a close association of supply of materials to be treated equally."[44]

Kim Chai Chiah, in his article, "Voidable Preference"[45], agreed with the approach of Williamson J. He submitted that having regard to the basis for voidable preference law— the recovery of assets for equitable distribution amongst all the creditors— the protection should not be lightly granted. His view is that the exception should be regarded only as a special concession to enable the courts to deal with cases involving hardship.

This is not the view taken by James O'Donovan.[46] He advocated that consideration should be given to introducing a defence provision similar to section 296(3) into Australian liquidation law. He referred to the fact that, historically, Bankruptcy Courts were Courts of Equity and yet equitable relief in Australia has been granted only sparingly to innocent creditors who received a preference. He made the comment that "equality is not always equity". The writer agrees with he views of O'Donovan and believes that the focus of the enquiry should be directed to the impact of an order for repayment on the recipient of the challenged payment not the creditors as a whole. This approach is more in line with the development of the defence of "change of position" in the law of restitution which is where the defence's origins can be traced to.[47]

IV Conclusion

Overall, it appears that it is not easy to satisfy all the elements required to obtain relief under section 296(3). This is partly because granting of relief is discretionary and the court is required to consider whether it would be "inequitable to order recovery". This makes it difficult to predict the outcome of claims for relief. Broadening the application of the defence to cover alterations of position which have occurred without any conscious decision on the part of the recipient would bring the defence more into line with the defence of change of position available under the law of restitution. The defence could be clarified if the "reasonably held belief" requirement was removed and replaced with a requirement that good faith must exist both at the time of receipt and at the time of alteration of position. It would also be easier to predict the outcome of claims

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43 (1995) 7 NZCLC 260,682.

44 Ibid at 260,686.

45 (1986) 12 NZULR 1 at 22.

46 Supra n 4 at 336.

47 Via the law governing recovery of payments made under a mistake.

for relief under the section if the reference to the court's opinion on the equitableness of recovery were replaced with a requirement that the recipient must show that he or she will suffer a detriment if ordered to restore all or part of the property. This would reduce the court's ability to take account of the overall position of creditors, which the writer submits should not be considered in this enquiry. As the remedy is discretionary the court would still have power to take account of any outstanding factors not considered when looking at whether a detriment will be suffered. The other elements of the defence are appropriate and seem to operate satisfactorily.