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Banks and the Recovery of Voidable Preferences

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Abstract
A liquidator of an insolvent company and a trustee of a bankrupt's estate are empowered by statute to set aside certain transactions, including payments, entered into or made by a debtor prior to the debtor's winding up or bankruptcy, as the case may be. This power to avoid antecedent transactions devolves from a legislative attempt to ensure, so far as possible, that creditors receive equal treatment according to an established scheme for the division of a debtor's assets amongst creditors.

The purpose of this article is to address the following issues: 1. What are the basic features of a liquidator's power to recover voidable preferences, 2. In what circumstances will a bank be exposed to preferential transactions, and where this occurs, what remedies are available to the bank, if any, to avoid liability?

Keywords
liquidator's powers, banks, bankruptcy, insolvency

BANKS AND THE RECOVERY OF VOIDABLE PREFERENCES

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Introduction

A liquidator of an insolvent company and a trustee of a bankrupt's estate are empowered by statute to set aside certain transactions, including payments, entered into or made by a debtor prior to the debtor's winding up or bankruptcy, as the case may be.

This power to avoid antecedent transactions devolves from a legislative attempt to ensure, so far as possible, that creditors receive equal treatment according to an established scheme for the division of a debtor's assets amongst creditors.

The purpose of this article is to address the following issues:

1. What are the basic features of a liquidator's power to recover voidable preferences?[1]
2. In what circumstances will a bank be exposed to preferential transactions, and where this occurs, what remedies are available to the bank, if any, to avoid liability?

It is appropriate to focus on the position of banks when dealing with the subject of preference claims because not surprisingly, many of the reported cases have involved banks under attack for receiving alleged preferential benefit from insolvent customers.

The following factors contribute to the frequency of preference actions involving banks:

- Banks play a central role in the operation of virtually every business, via bank accounts used for the deposit and safe keeping of business income.
- Most businesses borrow money from a bank, generally in the form of an overdraft facility. A bank may or may not hold adequate security for its loans.
- Due to the nature of the banker/customer relationship banks maintain relatively close contact with a customer's day to day activities and thereby are often acquainted with the customer's business problems.

1 Although this paper primarily deals with the position of a liquidator the discussion applies generally to the position of a trustee in bankruptcy.

- One of the classic indicators of insolvency centres on the action of a bank in the dishonour of a customer's cheques.
- The liabilities of a company to its bank are usually guaranteed by the company's directors. In an insolvency situation those directors may, for personal reasons, take steps to ensure that the bank is paid ahead of other creditors who have not been guaranteed.
- Banks are substantial organisations which have the resources to satisfy a successful claim by a liquidator if an action is pursued through litigation.

Although banks are highly susceptible to the receipt of potential preference payments they are not entirely without protection. A bank, unlike general creditors, may be entitled to claim a banker's lien on funds paid into a bank account, or to combine a customer's accounts to offset a credit account against a debit account.

Payments are not the only transactions that can be attacked as preferences. A liquidator can also challenge security taken by a bank to shore up a customer's existing indebtedness at a time when the customer's state of solvency is in doubt.

What issues arise when a bank takes security for a past debt? Where collateral security is held what are the dangers of releasing that security in exchange for a payment which may later be challenged as a preference? These practical problems connected with preferential transactions are also dealt with in this article.

The Section

Section 451(1) of the *Companies (South Australia) Code* provides as follows:

> A settlement, a conveyance or transfer of property, a charge on property, a payment made or an obligation incurred, by a company that, if it had been made or incurred by a natural person, would, in the event of his becoming bankrupt, be void as against the trustee in bankruptcy, is, in the event of a company being wound up, void as against the liquidator.

This provision incorporates the avoidance provisions of the *Bankruptcy Act 1966* including the preference provision, section 122. The effect of section 451 is to assimilate the law governing insolvent companies with that governing bankrupt individuals.

What is the Liquidator Required to Prove?

To establish a voidable preference a liquidator must prove that the company:

— has made a payment, conveys or transfers property, settles property, charges property or incurs an obligation;

— in favour of a creditor of the company;

— which has the effect of giving the creditor a preference, priority or advantage over other creditors of the company;

— within six months prior to the commencement of the winding up of the company;

— at a time when the company was insolvent and unable to pay its debts from its own money as the debts fell due for payment.

The six month relation back period operates from the date that an application for the winding up of the company is filed at Court or, in the case of a voluntary liquidation, the date of the company's resolution to wind up.

It is usually not difficult for a liquidator to satisfy himself that a relevant transaction has occurred in the six month period prior the commencement of winding up. With payments made by cheque a liquidator will, as part of his initial investigation, examine the company's bank statements and identify any payments which might be preferential.

To establish that the effect of a challenged payment conferred a preference or advantage on a creditor over other creditors in general, the liquidator need only establish that the creditor received payment whereas at least one other creditor remains unpaid.

Payment by the Debtor

Where a challenged transaction is a payment to a creditor the payment must be made 'by the company'. This does not mean, however, that the payment in question must come from the company's own money. A 1980 amendment to the *Bankruptcy Act* (section 121(1A)) widened the definition of the term 'payment' to include payments not made from the debor's own money. Payments out of money due to, or belonging to, the company are caught even if the payments are made by a third party[2].

The position is different, however, if a payment is make by a third party out of the third party's own money. Thus, if a bank is a creditor of Company A but receives payment from Company B the payment is not a preference, even if as a result Company A incurs an obligation to Company B. Such a payment would not deplete Company A's assets available for unsecured creditors; it would simply replace one unsecured creditor (the bank) with another (Company B).

The Running Account Principle

On a literal interpretation of section 451 all payments made to a creditor during the relation back period may be attacked by a liquidator[3]. In certain relationships this would work unfairly against the creditor and

2 For example a situation where a third party owes a debt to the company and is instructed by the company to pay that sum to one of the company's creditors in lieu of repayment.

3 These basic principles are discussed in *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266; *Rees v Bank of New South Wales* (1964) 111 CLR 210: *Richardson v Commercial Banking Co of Sydney Ltd* (1952) 85 CLR 110 and *Re Weiss; Ex parte White v John Vicars & Co Ltd* [1970] ALR 654.

as a consequence the court will look to determine what net advantage the creditor has received from trading with the debtor.

This is known as the 'running account' principle which dictates that where a payment forms an integral and inseparable part of an entire transaction then the whole of the transaction must be looked at to determine whether the creditor has gained an advantage or has been preferred.

To illustrate this type of relationship, take a supplier of goods who supplies goods to his customer on credit terms where the price of goods supplied and payments received are recorded on a running account statement or monthly invoice. For example, assume that a supplier is owed $100,000 and in the three months prior to the winding up of its customer goods to the value of a further $200,000 are supplied. In that same period the customer makes payments of $220,000 to the supplier which have the effect of reducing the supplier's overall debt from $100,000 to $80,000. In this situation the supplier's advantage is a net improvement of $20,000.

In a banker/customer relationship the running account exception applies to an overdrawn account where credits and debits are recorded chronologically as funds are paid into the account only to be drawn out up to the account limit.

A running account will come to an end when there is no longer a mutual assumption by debtor and creditor that their relationship will continue as a running account. Therefore, if a supplier gives notice to a customer that it will no longer supply goods on credit and demands repayment of the current debt the running account is terminated and the effect of any payment to the creditor from that point may be viewed separately from earlier payments.

Similarly a bank's running account with a customer will end where the bank freezes an overdraft facility and requires repayment or reduction of the debt.

A liquidator is free to choose any point during the six month relation bank period to show that from that point on a creditor has received preferential advantage. If, say, a customer's account is overdrawn to $20,000 three months prior to the company's winding up but the debt growns to $30,000 one month later, only to be reduced to $20,000 at the time of winding up the liquidator can attack as preferential the reduction of the debt from $30,000 to $20,000 ie a net benefit of $10,000.

The Position of a Secured Creditor

A payment made to a secured creditor will not ordinarily be classified as preferential because the creditor already enjoys priority over general creditors by virtue of and to the extent of its security. If, however the realisable value of the creditor's security is less than the amount of its debt the creditor will receive a part preference if its debt is paid in full.

This is illustrated by the case *Yeomans v Lease Industrial Finance Ltd*[4] where a financier had leased equipment to a company for a period of four years payable by instalments. The lease agreement was personally guaranteed by the company's directors. Less than two months prior to the company's winding up a cheque paid to the company by one of its customers was endorsed in favour of the financier and applied to satisfy the payout due under the lease agreement.

The liquidator produced evidence that the value of the equipment was worth substantially less than half of the amount paid to the financier. The liquidator was successful in his preference action to recover the difference between the value of the equipment and the payment made.

The Issue of Insolvency

The establishment of a company's insolvency is, in most cases, the most difficult requirement the liquidator must satisfy in order to succeed in a preference recovery.

A company's inability to pay its debts as they become due from its own money must be established by the liquidator to have existed at the time of the transaction he seeks to set aside. It is not enough to prove insolvency at the date of liquidation or the date of commencement of winding up. If a liquidator seeks to attack a series of payments stretching over, say, a three month period he must present evidence of the company's insolvent financial position at the time of each payment.

Insolvency can be demonstrated if the company has insufficient money to meet liabilities that are due for payment. A company's money includes not only cash resources but also money which can be obtained relatively quickly by the sale, conversion, mortgage or pledge of assets. Assets do not necessarily mean all of a company's assets, however, because it has been held that a company will be insolvent if it must cease its business operations (eg by selling its business) to generate the cash to repay liabilities falling due. It follows that the company's assets must be in a readily realisable form if they are to figure in the solvency formula.

The debts of a company include all liabilities which would be provable in a winding up and include any debts due and payable to non-arm's length friendly creditors, such as to a director or an associated company. Evidence that a director or shareholder of a company has personal resources which could be made available to the company to pay debts or that the company could borrow money (unsecured) from a third party are not relevant to the issue of insolvency because the company must be able to pay its debts from its own money.

Statutory Defence to Preference Claims

Once a liquidator has established to a Court's satisfaction the five elements of a voidable preference he is entitled to judgment for his claim. Invariably however a defendant creditor will raise and seek to rely on the statutory

4 (1987) 5 ACLC 103.

defence conferred by section 122(2)(a) of the *Bankruptcy Act* which, so far as it is relevant provides:

> "Nothing in this Section affects:—
>
> (a) the rights of a purchaser, payee or encumbrancer in good faith and for valuable consideration and in the ordinary course of business. . . ."

The intent of the defence is to protect innocent creditors who at the time of their dealings with the company were genuinely unaware of the company's insolvency and did not receive an unfair advantage over other creditors.

The creditor carries the onus of satisfying each of the three conditions of the defence which we examine below.

Valuable Consideration

Valuable consideration is present where a payment is made in satisfaction of a prior indebtedness. It follows that any payment of a debt due to a creditor will satisfy this limb of the statutory defence, and for this reason valuable consideration is rarely a disputed issued in a preference action.

Good Faith

To secure protection, a preference transaction must be one in good faith, that is, the creditor must have acted honestly, not believing that the company was insolvent or that the creditor was being preferred ahead of the other creditors. This element of the defence requires subjective appraisal of the creditor's state of mind at the time that the payment etc was received.

Even if the creditor is able to establish that he acted with subjective honesty section 122(4) of the *Bankruptcy Act* creates an inference to negate good faith if the liquidator can show that the transaction occurred under such circumstances that the creditor knew or had reason to suspect that the debtor was insolvent and that the effect of the transaction would give the creditor a priority or advantage over other creditors who may not be paid in full in a winding up.

In contrast to the subjective test of good faith which the creditor must establish the liquidator bears the onus of establishing the facts to bring section 122(4) into operation. The court must find that a reasonable man of business, in the shoes of the creditor, would have had an actual apprehension or fear that the company was insolvent and that the effect of the transaction would prefer that creditor over other creditors.

A bank's actions are the actions of its officers so normally one would assess the state of a bank's mind by reference to the knowledge of the bank manager responsible for an insolvent company's account.

Being large organizations, banks may receive information about a customer's account at different levels in their structure. This raises an interesting dilemma: Can a reason to suspect insolvency arise from the collective knowledge of various bank officers at head office level and at branch level?

This issue was considered in *Re Chisum Services Pty Ltd*[5] where a petition to wind up a company was advertised in a Government gazette and a trade publication. The publications were received at the bank's head office and it was the bank's practice to distribute copies to branches several days later. Certain payments, alleged to be preferences, were received by the bank after notice of the winding up petition came to the attention of the bank's head office but before the branch manage learnt of the petition.

The liquidator argued that the bank had an aggregated mind for the purpose of deciding whether the bank acted in good faith. Therefore the bank should be taken to know of the customer's imminent demise as soon as the gazette and trade publication were received at head office. Wooten J disagreed. He addressed the issue as follows[6]:—

> "If an officer at head office had information, eg, that a petition had been presented against a company, which was not sufficient to give him reason to suspect the matter set out in sub-section 124(4)(c), and the manager of the branch had other information which also was not on its own sufficient to provide reason to suspect those matter, yet the two lots of information if present in one mind would have been sufficient to provide reason to suspect these matters, would the bank lose its protection? . . . I would be inclined to answer the question in the negative."

The situation would be different according to Wooten J if an officer in the head office of the bank had reason to suspect that a customer at one of its branches was insolvent even if no officer in the branch had such reason for suspicion[7].

Ordinary Course of Business

To determine whether a transaction has occurred in the ordinary course of business the court will have regard to what constitutes the normal trading relationship between a particular debtor and a creditor.

The classical test to determine ordinary course of business was stated by Rich J in *Downs Distributing Co Pty Ltd v Associated Blue Star Stores Pty Limited (In Liquidation)*[8] as follows:—

> "The transaction must fall into place as part of the undistinguished common flow of business . . . It should form part of the ordinary course of business carried on, calling for no remark and arising out of no special or particular situation".

The type of conduct that constitutes a departure from ordinary business practice is often difficult to identify. In many cases it boils down to a matter of degree, that is, the extent to which a transaction is unusual or out of the ordinary.

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5 (1982) 7 ACLR 641.
6 Ibid at pp 649-650.
7 Ibid at p 651.
8 (1948) 76 CLR 463.

Although much depends on the particular circumstances of each case the transactions listed below have been found in recent decisions to have fallen outside the concept of ordinary business. Commonly the cases involve circumstances where a creditor has taken collection action to recover an outstanding debt:

- the payment of a debt to a creditor after the creditor had served a section 364 notice.
- the presentation of a winding up petition by a creditor extracting payment.
- the payment of a judgment debt after a company's goods had been seized in execution of a debt
- the issue of a writ and payments made pursuant to an arrangement for payment of a debt by periodical instalments.
- a debt partly paid after the creditor issued a trading statement with adhesive labels bearing the words "final notice" and "payment within 7 days or legal action will be taken".
- payments frequently made to a creditor late or by post dated cheques.
- payments made by rounded figures without reference to specific liabilities.

A transaction does not necessarily have to be unusual to be out of the ordinary course. The authorities also establish that a transaction that complies with ordinary business practice will nevertheless not be in the ordinary course of business if it is made in contemplation of insolvency with the design of avoiding the priorities of creditors in a winding up. Thus, if a debtor company facing liquidation makes a payment with intention to prefer a particular creditor (perhaps because the creditor has been guaranteed by the company's directors) then that payment will not be made in the ordinary course of business.

In *Kyra Nominees Pty Ltd (In Liquidation) v National Australia Bank Limited*[9] the Western Australian Full Court held that a series of payments by a company to a bank to reduce the company's overdraft liability at a time when the company was insolvent were not made in the ordinary course of business. The company's directors had guaranteed the overdraft. With the intention of reducing the amount due to the bank the directors paid into the company's account all business receipts whilst withholding payments to other creditors. Although the payments were made as ordinary deposits and the bank was found to have acted in good faith the Court applied a principle established by the High Court in *Taylor v White*[10]. In that case the High Court held that once it was proved that a payment had been made with the sole or dominant view of preferring a creditor it was impossible to say that it had been made in the ordinary course of business. This principle applies even if the intention to prefer is not made known to the payee.

The decision in *Kyra Nominees* poses an obvious danger to banks who, in the pecking order of creditors, often receive favoured treatment

9 (1986) 4 ACLC 400.
10 (1963-64) 110 CLR 129.

from their customers, generally for the reason that the bank's debt is guaranteed by the customer's directors.

Although the *Kyra Nominees* decision has been criticised in some quarters as a harsh result it has undoubtedly strengthened a liquidator's standing in preference actions. A bank may have acted in good faith according to its normal banking practices and yet still lose a preference claim because, unknown to the bank, the creditor has opted to reduce its exposure to the bank at a time when other creditors were not being paid.

Evidence that a bank has been preferred may be construed from the debtor's actions as was the case in *Kyra Nominees.* A liquidator may also rely on a director's testimony as to his state of mind when payments were made. An intention to prefer may also be present where payments are made to favoured creditors such as family members, employees and creditors whose custom the directors may seek to preserve.

Banker's Lien

In the recent High Court decision of *National Australia Bank Limited v KDS Construction Services Pty Ltd (In Liquidation)*[11] it was held that a payment made to a bank by an insolvent customer was not a preference because the bank was entitled to a lien on the payment and therefore occupied the position of a creditor with security.

The facts of that case concern a company that maintained an account with the appellant bank. Approximately one month prior to the winding up of the company a cheque for $100,000.00 was deposited into the account which was then $60,000.00 overdrawn. The Trial Judge found that when the cheque was banked the bank was a payee in good faith and that the transaction took place in the ordinary course of business.

The company was allowed to draw on the proceeds of the cheque on the following day. At the time discussions took place between a company director and the bank manager concerning the company's financial problems and the allocation of the surplus funds which took the transaction outside of the ordinary course of business.

The Full Court of the Supreme Court of Queensland held that payment was received by the bank on the second day when the cheque was cleared for payment and not on the day when the cheque was deposited. As the events which took the payment out of the ordinary course occurred on the second day the bank had received a preference and could not establish the statutory defence.

The bank appealed to the High Court and relied for the first time on the existence of a banker's lien. The bank argued that from the moment that the cheque was handed to the bank for collection the bank was entitled at law to a lien on the proceeds of the cheque.

The High Court allowed the appeal on the basis of the lien which placed the bank, viz-a-vis the payment, into the category of a secured

11 (1987) 12 ACLR 663.

creditor. According to the Court "so long as the cheque is received in good faith and in the ordinary course of business, a payment made to the collecting bank by the paying bank in discharge of that lien cannot amount to a preference, priority or advantage[12]".

What constitutes a banker's lien? A banker's lien is a security that is peculiar to banking. By operation of law a bank has a lien on all bills, promissory notes and cheques coming into its possession from a customer as security for the whole of the customer's indebtedness to the bank.

A banker's lien is distinguishable from other security rights conferred on a bank where documents (such as a certificate of title to land or share script) are handed to the bank as security. There the bank would stand possessed by agreement with the security provider of an equitable mortgage by deposit. A lien, on the other hand, arises whether or not the customer intended that the bank should obtain security over a particular class of documents delivered to the bank. A lien arises by virtue of the banker/customer relationship and can only be excluded by an express or implied agreement that the bank is not to have a lien.

There are other circumstances in which a lien will not apply. No lien attaches to any securities coming into a bank's hands for the purpose of safecustody. No lien can attach to money or security known to a bank to be affected by a trust or not to be the actual property of a customer. Furthermore, no lien can arise where securities are lodged with a banker as security for a particular liability or special purpose.

Although resort to a banker's lien worked effectively for the bank in the *KDS Services* case in practice a lien on cheques will provide only limited protection to a bank because in mose preference challenges the bank will be aware of a customer's insolvency prior to receiving cheques deposited into a customer's account. Hence good faith on the part of the bank is not present. A lien will only operate in favour of the bank where the events which are capable of dispelling good faith or ordinary course of business occur during the time taken to clear a cheque.

Bank's Right to Combine Accounts

Another right conferred[13] on a bank in a banker/customer relationship, is a right to combine a customer's accounts. If a customer has a credit balance in one account and a debit balance in another, the bank may combine the two accounts. The bank can, in effect, treat all accounts of a customer at all brances of the bank as one combined account.

A banker's right to combine accounts is akin to a creditor's right of set off although the two remedies have different origins. If a company is wound up any creditor of the company who is also a debtor is entitled to set off the debt owed to the company against the debt owed in return. This right of set off is conferred by section 86 of the *Bankruptcy Act*, provided there has been mutual credits, mutual debts and other mutual dealings between the debtor and the other party. An account is taken of

12 Ibid at p 669.

13 Unless excluded by express or implied agreement.

what is due from each party to the other, and the balance owing, if any, is claimable.

By comparison a bank's right to combine accounts entitles the bank to claim the proceeds of a customer's deposited funds and to apply them against the bank's debt in an overdrawn account. This power can be exercised without the customer's consent and notice may not be required. Although this remedy is discretionary it can only be exercised when an event occurs that ends the bank's obligation to meet a customer's cheques. These events obviously include the bankruptcy or liquidation of a customer.

The right to combine accounts is not available if the bank is aware that the customer holds one account in his own right and one account in some other capacity, for example as a trustee. For the same reason an overdrawn account in one customer's name cannot be set off against a credit balance in a joint account. In addition the amounts owing by the customer to the bank must be immediately due and payable before the right to combine accounts can be exercised. Therefore unmatured or contingent liabilities cannot be offset against a customer's credit funds.

In the preference context the exercise of a bank's right to set off accounts cannot constitute a preference because the bank's entitlement to this advantage is conferred by operation of law.

Guarantees and Preferences

Assume that a bank is owed a debt by a company supported by guarantees from the company's directors. The principal debt is repaid but within six months the company is placed into liquidation and the liquidator challenges the payment as a preference. If the bank is forced to disgorge the payment what is the status of the director's liability as guarantors of the company's debt?

The position at law is that payment of a guaranteed debt will absolutely discharge a guarantor from liability notwithstanding that the payment be later set aside as a preference. This was decided in *Commercial Bank of Australia v Carruthers*[14]. In that case the defendant had guaranteed payment of a debt to the plaintiff bank. The guarantor had promised to pay to the bank "all debts or sums of money now owing or payable or unpaid". Payment of the debt was duly made but within six months the debtor became bankrupt. The bankrupt's trustee successfully challenged the payment as a preference. The bank then took action against the guarantor but it was held that the guarantor had been discharged from liability as a result of the payment.

A guarantor will not escape liability in these circumstances where the guarantee contains a provision stating that any payment made to the creditor and later avoided by application of any statute will not release the guarantor from liability. The purpose of this clause is to restore the rights of the parties to the position they would occupy if the payment had not been made in the first place.

14 (1964-65) NSWR 1197.

To protect a bank against the result in *Carruthers' case* a liability reviving provision, commonly called a Carruthers clause, is an essential term of a well drawn guarantee.

Security from the Debtor

We have already seen that a bank may be caught unawares that it has received a preference, and in a *Kyra Nominees* situation there is very little that a bank can do to guard against this problem. It is a trite recommendation that banks should be wary of unsecured lending. Good security is a bank's best protection against undue preferences. Commonly a bank has no security from the borrower but instead relies on collateral security from guarantors such as a mortgage over a company director's home.

As we have seen, if the borrower repays the bank's debt the guarantor is prima facie entitled to a release of his security. However as the bank has no security from the borrower, the payment may be attacked as a preference if the borrower goes into liquidation within a period of six months. Although the bank may be able to revive the guarantor's liability by resort to a Carruthers clause in the guarantee document the security that the bank previously held will have been discharged and cannot be revived. The bank is left in a position of claiming against the guarantor in an unsecured capacity. This result can be avoided by taking adequate security from the borrower or alternatively making the loan in the first place to the party who is able to provide the security.

How Can a Bank Guard Against Preferences?

If a bank is 'awake' to receiving a potential preference the bank may decide to change its usual course of action when dealing with a financially troubled customer.

We have seen earlier that a bank may avoid a preference by insisting that its debt be paid by a third party, not the debtor, out of the third party's funds. Generally a creditor cannot insist that its debt be repaid by a source other than the debtor. Whether such a payment can be organised to suit the convenience of a creditor will depend on the strength of the creditor's bargaining position and the resources available to the debtor.

When taking security from a debtor for a pre-existing debt a bank faces sweating out a difficult six month period before the security is immune from a liquidator's challenge as a preference. Consider, however, the following situation where a bank's action to guard against a preference may succeed. Assume that a bank seeks security from a customer for its previously unsecured overdraft account. A debenture charge is granted. The bank is aware that the company is experiencing financial difficulties and may be insolvent. Clearly, the charge will be subject to challenge if the customer goes into liquidation within a period of six months from the date of creation of the charge.

To protect its newly taken security the bank must do everything within its power to ensure that the company survives the relation back period.

Any unpaid creditor of the company is entitled to issue winding up proceedings upon the expiry of a notice of demand giving the debtor 21 days to pay the creditor's debt. If there is a reasonable prospect that a company may stay out of liquidation for six months following the creation of the bank's security the bank itself should consider selectively paying creditors' demands to avoid the bringing of a winding up action. By taking the risk of paying certain creditors' demands the bank may protect the validity of its security.

A different ploy to last out the six month period is for a bank to enforce its security and appoint a receiver and manager. The appointment may serve two purposes. First, the receiver will take control of the company's business and will be notified very early of any creditor's demands or outstanding section 364 notices. The company's funds can be applied to pay the most pressing creditors to thwart a winding up. Second the appointment of a receiver and manager often dissuades general creditors from taking action to wind up the company.

Another scenario in which a bank can imporve its position from an unsecured creditor to a secured creditor without exposing itself to a liquidator's challenge is taken from the decision *The Commissioner of the State Bank of Victoria v Judson*[15].

In that case a company had an overdraft with the State Bank of Victoria which was unsecured except for mortgages granted by the company's directors over their own land to support personal guarantees. The overdraft had an approved limit of $35,000. By 6 January 1983 the overdrawn amount had increased to about $40,000. On that day the company executed a debenture charge in favour of the bank over its assets other than book debts. The company was wound up on 9 May 1983 and a liquidator was appointed. At the point of winding up the bank's debt was $41,340. There had been regular payments into and out of the company's account however the overdrawn figure did not rise above about $40,000 prior to liquidation.

The bank issued proceedings seeking a declaration that the charge was valid and effective as against the liquidator.

The liquidator retaliated by seeking, inter alia, a declaration that payments totalling $40,222 paid into the account between 6 January 1983 and 9 May 1983 were void as preference payments.

The liquidator's argument was that the payment of the monies to the bank in the period prior to winding up conferred a preference or advantage on the bank. Applying the "running account" principle discussed earlier in this article Fullagar J held that the bank had not received a preference because the debt due to the bank at the time of creation of the charge, about $40,000, stood at that approximate level at the time of winding up. Apart from the change of status from an unsecured creditor to a

15 (1985) 3 ACLC 576.

secured creditor the debt due to the bank was not reduced. The debenture charge was valid because it was supported by new advances made after its creation.

Weakness of Liquidator's Position

Although it is relatively easy in principle for a liquidator to establish a prima facie preference in practice this is not always the case

The company's books and records may be lacking or may have been inadquately maintained. A liquidator can call for production of copy bank statements but important correspondence, letters of demand etc passing between a company and its creditors may be missing from the company's records. Directors and exemployees are often unco-operative with a liquidator, especially if a director, for example, has guaranteed the bank's debt which, if challenged, would revive the director's liability under his guarantee.

Many insolvent administrations are without assets. A liquidator may call upon the creditors of a company to indemnify or fund his actions but creditors are often reluctant to throw good money after bad. A liquidator is not expected to spend his own money to pay legal costs associated with a preference action. Indeed, a liquidator without funds is unlikely to expend any great effort in the investigation of a company's affairs in the first place.

The fact is that many liquidators will stop after dispatching standard form demand letters to all recipients of company payments in the six month period prior to winding up. A trickle of payments may come in from creditors fearful of the liquidator's threat of litigation. The bulk of creditors, however, will either ignore the demand or write back denying liability in reliance on the defence of good faith and ordinary course of business.

Very few court actions are commenced by liquidators relative to the number of demands made. In practice, a bank's best bet probably is to deny liability for an alleged preference even if there is an appreciable risk that the liquidator's action may succeed. If proceedings result only a small number of preference claims actually go to trial. In the majority of cases the liquidator's action is settled for an amount less than the amount of the claim.

Conclusion

A logical way of viewing preferences is that it is better to receive a payment from a struggling debtor, knowing that the payment may have to be repaid if the debtor goes into liquidation, than not to be paid at all. The same viewpoint holds true when taking security for a previously unsecured debt which may later be invalidated as a preference. There are a number of factors to take into account when assessing a creditor's risk, the most relevant of which is that many debtor companies do manage to 'survive' the six month danger period and hence a preference does not eventuate.

Generally speaking an agressive creditor will be more successful at collecting his debts than a passive creditor. An aggressive creditor who resorts to pressure, demands and summons will also, on balance, be subject to more preference claims simply because he will be paid more often by debtors who end up in liquidation or bankruptcy. Holding back may avoid preference contests but only at the risk of missing out altogether.

Banks will also benefit from the aggressive approach. Applying maximum pressure on customers to repay their debts or to produce security where appropriate will expose banks to the risk of a preference but in the scheme of things only a small number of preference claims eventuate or are pursued.