COMMENT

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DEFAULTING DIRECTOR/GUARANTORS — RECOVERING MONEY FROM COMPANY OFFICERS FOR CREDITORS

The first Companies Acts expected relatively little of directors. The new process of incorporation, once its benefits became apparent after *Salomon* v *Salomon,*[1] freed company promoters and management from many of the burdens of ultimate personal responsibility that attended partnerships and sole proprietorships.

Limited liability was supposed to encourage investment in commercial and industrial ventures. It did that. But from the first it was apparent that some of the "investors" in these limited liability companies, namely those who became unsecured creditors, had lost much. Limited liability was often enjoyed at their expense. And they could not even rely on the stated capital of the company being intact, as *Salomon* v *Salomon* and *Re Wragg*[2] demonstrated.

There were other problems, too, so much so that respected commentators such as Kahn-Freund slammed *Salomon* and like decisions as "calamitous".[3] One complaint was that some investors, for whom limited liability's advantages were not intended anyway, were abusing the privilege. Today virtually any business, no matter how small or what its purpose, can incorporate with almost no issued capital. And should these companies fail, their officers, who are often also their owners, can usually go scot-free, their personal assets untouched while creditors lament.

The legislatures considered a variety of solutions. Overseas we saw the imposition of minimum capital requirements, the effective prohibition of the issuance of shares at a discount and real controls on non-cash consideration share issues. None of these measures has been effectively adopted in Australia yet. Likewise our controls on improper reductions of capital and the unjustified payments of dividends are practically ineffective. In truth, the notion that a company's paid up capital is available as a "guarantee fund" for creditors in the event of failure is

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1 [1897] AC 22.

2 [1897] 1 Ch 796.

3 Kahn-Freund, "Some Reflections on Company Law Reform" [1944] MLR 54, 54.

spurious. The truth is that unsecured creditors are extremely vulnerable in the event of corporate collapse.

More recently the legislatures have taken another tack. They have long accepted that those who run companies should bear more of the burden of corporate losses. While we have not yet adopted the admirable French solution of making officers prima facie liable for all the debts and liabilities of the insolvent company,[4] we have zeroed in on the defaulting director, albeit in a haphazard way. This note looks at one common type of default and the judicial and legislative responses to it.

Director guarantees his company's overdraft

It is a common enough scenario: a company gets into financial difficulties; the dominant director, who has personally guaranteed the company's overdraft with its bank, continues to bank incoming money but draws very little from the overdrawn account; in time, with more going in than coming out, the overdraft is reduced or even wiped out; then and only then the company goes into liquidation. In effect the director denies the general body of creditors the benefit of the guarantee which would have been called up if the company had folded up with its "usual" level of overdraft in existence. Bluntly put, the officer swindles the creditors.[5]

Similar facts arose in Australia in *Re Timbatec Pty Ltd,*[6] and in New Zealand in *Re Linney & Co Ltd.*[7] Liquidators sought to take action against the officers concerned under the respective Bankruptcy Acts. In both cases the liquidators failed. The Courts found that s 122 of the Bankruptcy Act 1966 (Cth)[8] or its equivalent could not be used to call the appropriate officers to account. However, a recent Australian decision, *Kyra Nominees Pty Ltd (in liq)* v *National Australia Bank*

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4 See Article 99 of the French Companies Act of 13 July 1967. It says that officers of the insolvent company are, at the court's discretion, severally or jointly liable for the company's debts if the capital and assets do not cover them. As Goldman, "Legal Implications of Establishment in France" in *Commercial Operations in Europe* (eds Goode and Simmonds 1978) 200 comments: "the liability under article 99 of the 1967 Act is *presumed.* It is for the directors (or other persons enumerated in the provision) to establish they have acted diligently, according to the obligations of a remunerated agent, and that the insufficiency of assets does not result from their fault or neglect". See also Frommel & Thompson, *Company Law in Europe* (1975) 226; Meinhardt, *Company Law in Europe* (3rd edn) F-14A(iii).

5 Kitto J in *Hardie* v *Hanson* (1960) 105 CLR 451, 463 spoke of "swindling creditors out of their money". The UK *Cork Report* of 1982 entitled *Insolvency Law and Practice,* Cmnd 8558, paras 1270-1276 commented on defects in the present English law relating to sureties and guarantors and succinctly summarised the present position there.

6 (1974) 24 FLR 30.

7 [1925] NZLR 907.

8 Section 122(1) reads:

> "A conveyance or transfer of property, a charge on property, or a payment made, or an obligation incurred, by a person who is unable to pay his debts as they become due from his own money (in this section referred to as "the debtor"), in favour of the creditor, having the effect of giving that creditor a preference, priority or advantage over other creditors, being a conveyance, transfer, charge, payment or obligation executed, made or incurred —
>
> (a) within 6 months before the presentation of a petition on which, or by virtue of the presentation of which, the debtor becomes a bankrupt; or
>
> (b) on or after the day on which the petition on which, or by virtue of presentation of which, the debtor becomes a bankrupt is presented and before the day on which the debtor becomes a bankrupt,
>
> is void as against the trustee in the bankruptcy."

Ltd,[9] has found s 122 may be effective against the principal creditor in such situations. It seems, too, that s 556 of the Companies Code, the wrongful trading provision, may provide another answer. *Re Timbatec Pty Ltd* meanwhile provoked an interesting legislative innovation in the 1981 Companies Code – namely, s 453(5) and (6). It promises to be a potent weapon in the liquidator's armoury.

Payments as challengeable preferences

The Western Australian decision, *Kyra Nominees Pty Ltd (in liq)* v *National Australia Bank Limited*,[10] may have surprised liquidators. A director was one of the guarantors of an overdrawn current account. This director saw to it that the overdraft was reduced steadily in the company's last days by a policy of banking incomings as usual but drawing very little from the account. The director thereby hoped to relieve himself of his obligations under the guarantee. As Burt CJ concluded, "Without putting too fine a point on it the intention was to throw all the loss on to the 'lamenting creditors' ".[11]

The liquidator successfully sued the bank, the principal creditor, to recover $188,990.66. This was the amount of the overall reduction of the company's bank account over a period of less than one month, just prior to the passing of a resolution voluntarily to wind up the company. These payments preferred the bank over many other unsecured creditors to the extent of the sum alleged. The altered pattern of deposits to and withdrawals from the bank account had the effect of giving the bank itself a preference. Accordingly, the payments were void as undue preferences under s 122 of the Bankruptcy Act 1966 (Cth).[12]

"In the ordinary course of business"

The bank was unable to shelter behind the defences in s 122(2) of the Bankruptcy Act.[13] The Court at first instance had found that the payments to the bank were made both in good faith and in the ordinary course of business.[14] But the Supreme Court looked at the motives and business operations of *both* the debtor and the creditor bank and held it to be not in the ordinary course of business for a debtor to pay a creditor with the motive of preferring that creditor, even though the creditor knew nothing of that intention. Burt CJ surmised that the payments were made "with the intention of preferring the bank so as to avoid liabilities under the guarantees".[15] The intention of throwing the loss onto the creditors "is, I think, enough to establish that the payments

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9 (1986) 4 ACLC 400 (Burt CJ, Pidgeon and Rowland JJ).

10 Ibid.

11 Ibid 405.

12 Reproduced in part, above n 8. By s 451(1) of the Companies Code [formerly s 293 of the UCA], s 122 of the Bankruptcy Act is incorporated into corporate liquidation law.

13 Section 122(2) reads:

"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;

(b) The rights of a person making title in good faith and for valuable consideration through or under a creditor of the debtor; or

(c) A conveyance, transfer, charge, payment or obligation of the debtor executed, made or incurred under or in pursuance of a maintenance agreement or maintenance order."

14 Wallace J, reported at (1986) 4 ACLC 58.

15 Supra 9 at 405.

were not made in the ordinary course of business . . ."[16] Pidgeon J concluded:

> "There was an intention on the part of the appellant [the company, through its officer] to prefer the respondent [bank] and I would consider this intention and the manner it was carried out are sufficient to indicate that the payment was not made in the ordinary course of business, giving that term the meaning the cases have given it."[17]

Rowland J added:

> "the finding that the payments were made for the dominant purpose of reducing the debt rather than using the overdraft facility . . . shows that the overall transactions involved in the payments viewed in the light of the small counter-payments could not have been in the ordinary course of business."[18]

His Honour admitted that really he was saying that the payer lacked good faith too, so that a second link of the s 122(2) defences was missing. This overlapping of the two criteria or phrases is regrettable, if only because it is confusing. In essence the Supreme Court says that the lack of good faith in the *payer* means the transaction was not in the ordinary course of business.

Such an interpretation is supported by the High Court in *Taylor* v *White,*[19] which was cited by all three judges. *Taylor* v *White* is by no means on all fours with the facts in *Kyra Nominees.* It can be distinguished. But it is firmly supportive of the thrust of the latter case. *Kyra Nominees Pty Ltd (in liq)* is notable mainly because it finds that the *debtor's* motives or intention *of themselves* can take the transaction outside the ordinary course of business.

While the decision on these facts was to be welcomed, some concern is justified. When are creditors safe? They can rarely dig into or fathom the debtors' subjective motives, yet those motives, the shadows in the payers' minds, may sink the payee creditors. Their innocence is not enough to protect them.

This offends well-entrenched notions of fairness. In real property law, for example, fraudulent parties have long been able to pass good title to innocent parties receiving for value. It is at the very least arguable that s 122(2)(a) of the Bankruptcy Act intends to enact that very principle and that the provision intends us to look at the states of mind and actions of the payee creditors only, to examine the payment from their perspective. The form of the wording suggests that it is only the payee's consideration, usual course of business and good faith that are to be considered in s 122(2)(a) of the Bankruptcy Act.[20] An argument that the usual course of business is to be judged objectively and that the state of mind of the payer is irrelevant is attractive. As Rich J stressed in *Downs Distributing Co Pty Ltd* v *Associated Blue Star Stores Pty Ltd (in liq):*

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16 Ibid.
17 Supra n 9 at 409-410.
18 Supra n 9 at 413.
19 (1964) 110 CLR 129, 143, 161.
20 See Kitto J in dissent in *Taylor* v *White,* ibid, esp 142 ff.

> "It is therefore, not so much a question of fairness and absence of symptoms of bankruptcy as of the everyday usual or normal character of the transaction. The provision . . . speaks of the course of business in general. But it does suppose that according to the ordinary and common flow of transactions in affairs of business there is a course, an ordinary course. It means that the transaction must fall into place as part of the undistinguished flow of business done . . . ."[21]

If they prove to be effective, s 453(5) and (6) of the Companies Code are a better route to get at the defaulting director than this stretching of the meaning of "ordinary course of business" evident in *Kyra Nominees Pty Ltd (in liq).*

The better view on s 122(2)(a), it is respectfully suggested, is that as long as the transaction, viewed objectively, falls into the common flow of business and forms "part of the ordinary course of business carried on, calling for no remark and arising out of no special or particular situation",[22] then the innocent payee bank or other creditor should be able to rely on that, irrespective of the motives of the payer. Certainly the business of both payer and payee must be assessed. But the assessment should be on an objective basis, free from the taint of the motives of the payer. Then only an odd pattern of business, or the like, will compromise an innocent payee's claim of ordinary course of business. The state of mind of the payer *of itself* should not be enough to destroy the "ordinary course of business" limb of a bank's, or any other payee's, s 122(2) defences.

There is no real reason to suppose that *Kyra Nominees* will encourage increased vigilance by banks. Changes in a customer's business practices, notably changes to the pattern and reduction of the volume of withdrawals on an account, is more closely monitored so that the banks may become aware that it is being preferred. If they have not already done so, banks may well alter their guarantee documents to ensure the director's guarantee remains in place if payments to the bank are set aside as undue preferences. This has probably long been a practice of prudent banks.

Although it is not at the core of the decision in *Kyra Nominees,* it is evident that any significant alteration to a debtor's pattern and volume of withdrawals may compromise a bank's ability to raise the s 122(2) defences. While it is, of course, a question of fact and degree in each set of circumstances, some small guidance may be taken from the facts in *Kyra Nominees.* In 27 days an overdraft was reduced from \$292,021.64 to \$103,030.98, a reduction of about 65%. The recent pattern had been an overdraft fluctuating above the bank's \$200,000 limit. This limit was later increased to \$300,000. Rowland J concluded:

> "The bank reconciliation statements together with the extraordinarily large number of cancelled cheques and cheques that were drawn but not signed at or about March

21 *Downs Distributing Co Pty Ltd* v *Associated Blue Star Stores Pty Ltd (in liq)* 76 CLR 463, 477. See also *Re Southern Cross Commodities Pty Ltd (in liq)* (1985) 3 ACLC 28.

22 Ibid.

> or early April, when combined with the appellant's then bookkeeper's evidence, supports the arithmetic of the apparent objective, which was to reduce the overdraft."[23]

By contrast, in *Re KDS Construction Services Pty Ltd*[24] the company's pattern of dealings with the bank showed that the account was usually in debit but, for brief periods, in credit. Accordingly, the bank was able to discharge its onus of showing that paying off the overdraft was in the ordinary course of business. Kelly ACJ could not infer, from an objective view of the circumstances, that there was sufficient reason for the bank to form a suspicion that there was insolvency and a preference within the meaning of s 122(4)(c).

Wrongful trading by the debtor company's officers: another approach

In some circumstances s 566 of the Companies Code could be applied to such facts. In *Kyra Nominees Pty Ltd (in liq)*, the Court found that the company was insolvent as at the date of the first of the impugned payments into the overdrawn bank account. If any other trading debts had been incurred by the company after that date, would s 556 have applied to make the directors liable for such new debts, providing the director(s) knew or ought to have known there were "no reasonable grounds to expect" that the company would be able to repay its debts as they became due?

Just such a question faced the New Zealand Court of Appeal in *Re Casual Capers Ltd (in liq.)*[25] A controlling director, in the last stages of the company's existence,

> "systematically banked monies and failed to apply available funds for the benefit of all creditors and continued the trading operations of the company only so long as it was necessary to avoid liability under her guarantee to the bank. In this way she displayed, in the words of Kitto J in *Hardie* v *Hanson* (1960) 105 CLR 451 at p 463: 'an actual purpose, consciously pursued, of swindling creditors out of their money . . . ' "[26]

The director had applied money for her own purposes and to her own advantage. Accordingly, she had carried on the business over the relevant period with intent to defraud creditors, it being a proper inference that when the company continued to incur debts there was no reasonable prospect of the new creditors' being repaid. The director's deliberate purpose was to relieve her own obligations at the expense of the other creditors.

The liquidator had relied on the pre-1980 New Zealand provision, s 320(1) of the Companies Act 1955. It required "intent to defraud creditors" or a "fraudulent purpose". These are more onerous tests than that of the current Australian wrongful trading provision, s 556(1) of the Companies Code. As Bisson J remarked, the New Zealand provision required proof of actual dishonesty and "real moral blame".[27] This decision may help with an interpretation of s 556(5) of the Australian

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23 Supra n 9 at 412.
24 (1986) 4 ACLC 250.
25 (1983) 1 NZCLC 98,590.
26 Ibid 98,596.
27 Ibid 98,594.

Code, which concerns fraudulent trading. *Casual Capers* encourages Australian liquidators seeking to bring home an action under the less demanding s 556(1) to look closely at the director/guarantor's trading activities. Culpability there must be, but proof of 'real' moral wrongfulness is not required. All that is needed is proof that there were reasonable grounds to expect that the company would not be able to pay its debts as and when they became due (providing that the defences in subs (2) are not available to the defendant). During the weeks or months that the overdraft account is being refilled and no or few withdrawals take place, the company may incur new debts as part of its trading activities (stock purchases, for example). A director/guarantor may be held personally responsible under s 556(1) for these new debts for which no payment is made before liquidation. An officer/guarantor in breach of s 556(1) of the Code would be jointly and severally liable with the company for the debts. It is also noteworthy that s 556(3A) affirms that civil liability of an officer under s 556(1) has to be decided only on the balance of probabilities.

In *Re Casual Capers Ltd (in liq)* the defendant director was personally liable for $9,600 worth of stock bought when the director knew the company was insolvent. That amount was to be paid to the liquidator and formed part of the assets of the company available for distribution to creditors generally. It did not go to the particular creditors whose debts formed the quantum of the claim.

Section 453(5) of the Code: a direct attack on the problem

Section 453(5) was added to the 1981 Companies Code in the major redrafting of the legislation. There is every reason to believe it was drafted to catch just the sort of activity revealed by the facts of *Re Casual Capers (in liq), Kyra Nominees Pty Ltd (in liq)* v *National Australia Bank Ltd* and a cabinet of liquidators' files revealing directors wriggling out of potential liabilities under bank overdraft guarantees.

Section 453(5) and (6) read:

"(5) Where –

(a) a disposition of property is made by a company within the period of 6 months before the commencement of the winding up of the company;

(b) the disposition of property confers a preference upon a creditor of the company; and

(c) the disposition of property has the effect of discharging an officer of the company from a liability (whether under a guarantee or otherwise and whether contingent or otherwise),

the liquidator –

(d) in a case to which paragraph (e) does not apply – may recover from that officer an amount equal to the value of the relevant property, as the case may be; or

(e) where the liquidator has recovered from the creditor in respect of the disposition of the relevant property –

(i) an amount equal to part of the value of the relevant property; or

(ii) part of the relevant property,

may recover from that officer an amount equal to the amount by which the value of the recovered property exceeds the sum of any amounts recovered as mentioned in sub-paragraph (i) and the amount of the value of any property recovered as mentioned in sub-paragraph (ii).

(6) Where –

(a) a liquidator recovers an amount of money from an officer of a company in respect of a disposition of property to a creditor as mentioned in sub-section (5); and

(b) the liquidator subsequently recovers from that creditor an amount equal to the whole or part of the value of the property disposed of,

the officer may recover from the liquidator an amount equal to the amount so recovered or the value of the property so recovered."

The intention of the legislature in enacting s 453(5)

There is nothing in the *Explanatory Memorandum* accompanying the 1981 Companies Code explaining the intention of s 453(5). Clearly, the provision is aimed at officers and others with inside knowledge. It forms part of a section aimed at promoters, officers and related companies, and persons associated with those persons, who have in some way used their knowledge and position to advantage themselves at the company's expense. The legislature had the interests of creditors firmly in mind when drafting the provisions. The legislature also singles out the officers in particular. Being insiders, they are in a position to know and use their knowledge of the company's demise. In effect, the law presumes there is or should be no such person as an innocent or uninformed director when the company slides into liquidation.

It seems very likely that the provision was drafted to overcome the effect of such decisions as *Re Linney & Co Ltd*[28] and, more important, *Re Timbatec Pty Ltd.*[29] These were cases on the Bankruptcy Act. They concerned s 122(1) of the Bankruptcy Act 1966, or its equivalent in New Zealand. In both cases an insolvent company paid a debt guaranteed by a surety or several sureties.

In *Re Linney* the sureties or guarantors were directors. The company was slipping into liquidation. The company ceased payment on all but small and pressing accounts. All the rest of the company's takings were paid into the bank to wipe out an overdraft. This overdraft was secured by a personal undertaking of the director. The New Zealand court was asked to find that this payment was a fraudulent preference of the directors themselves. The directors admitted that they had made or caused to be made these payments to get rid of their liabilities as sureties. Ostler J was most reluctant to permit this behaviour, but he was forced to find that sureties were not creditors within the meaning of the New Zealand provision at issue. They were only guarantors of the company's debt ,to the bank. Only if they had been called upon to pay, and had paid, this debt would they have become creditors. In summary, what the directors did in seeing to the paying off of the overdraft was not a fraudulent preference of themselves. This decision was largely a matter of the drafting of the New Zealand statute.

28 [1925] NZLR 907.
29 (1973) 24 FLR 30.

A similar decision arose in *Re Timbatec.*[30] The Australian Bankruptcy Act 1966 was at issue. The court held, in similar circumstances to those in *Re Linney*, that it was not proper to treat the payment to the principal creditor as a payment in favour of the surety or guarantor within the meaning of s 122(1), and then to invalidate it only to the extent to which it had the effect of favouring the contingent creditor (guarantor). Accordingly the liquidator could not establish that the transaction at issue was a preference within s 122 or liable to be avoided.

There was clearly some difficulty with the law. The NCSC recognised this and suggested amendments. As a result s 453(5) in the 1980 drafting of the Code was drafted. The ill to be remedied was undoubtedly the escaping from responsibility by officers of the failing company.

Interpretation of s 453(5)

The wording of s 453(5) is clear enough. Perhaps it does not quite say enough. It could be argued that the word "preference" in paragraph (b) means more than its ordinary meaning. In essence, creating a "preference" means merely creating (by a payment or other disposition) an advantage for one creditor over the other creditors, or putting one creditor in a better position in relation to the other creditors. This is its ordinary meaning. The *Shorter Oxford Dictionary* defines "preference" as a "priority or payment given to a certain debt or class of debts".

A director faced with liability under s 453(5) would no doubt argue that preference in s 453(5) means a preference within the broadest meaning of s 122 of the Bankruptcy Act, that is, incorporating the ss (2) defences open to a payee in good faith and for valuable consideration and in the ordinary course of business. In other words, a director might argue that if the bank, for example, could make out the defences under s 122(2), then there is no preference within the meaning of s 453(5). Thus, the argument would continue, even though the director fully intended to reduce her contingent indebtedness by paying into an overdraft account (over which she had given a guarantee), the fact that the bank did not know about, or could not be expected to know about, the insolvent nature of the company would protect that director.

This cannot be what s 453(5) was intended to allow. Cases on s 122 of the Bankruptcy Act draw distinctions between "preference" on the one hand and "preferences that can be defended" on the other. *Re KDS Construction Services Pty Ltd* is just the most recent of these.[31] There is no reason to import into s 453(5) all of the s 122(2) defences, which after all are intended as defences for a creditor, not for an officer. If such a defence were available to a guarantor, it would make a mockery of the new provisions. Any officer, who is also the guarantor seeking to reduce her vulnerability as her company sinks into trouble, could insulate herself from s 453(5) simply by seeing to it that any incoming company money goes or accrues to the creditor who holds the guarantee in preference to other creditors. As long as the creditor paid can reasonably be said to be

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30 Ibid.

31 (1986) 4 ACLC 250, 252-253. See also *Re Timbatec Pty Ltd* (1974) 24 FLR 30, 38; *Richardson* v *The Commercial Banking Co of Sydney Ltd* (1952) 85 CLR 110, 128; McDonald, Henry and Meek, *Australian Bankruptcy Law and Practice* (5th edn) para 6878. Section 122 of the Bankruptcy Act 1966 itself talks of preferences and of preferences that are void.

unsuspecting of the impending insolvency or of the guarantor's motives, the surety would succeed in escaping s 453(5).

Liquidator need not proceed against principal creditor first

The new section is aimed at officers of the company. The provision clearly contemplates action against the officers before, or instead of, action against the principal creditor. Section 453(5)(d) specifically anticipates action against an officer where a liquidator has not recovered from the creditor. Paragraph (e) deals with the situation where the liquidator has successfully recovered something from the creditor already. Section 453(6) is also helpful. It anticipates the situation where the liquidator recovers first from an officer and then later from the creditor. In summary, the liquidator need not take action against the creditor as a prerequisite to proceeding against the guarantor.

Also these provisions, which assume action may or may not be taken against the creditor as well, arguably indicate the legislature anticipated that often the principal creditor would be shielded by the protective provisions of s 122(2) of the Bankruptcy Act 1966. In other words, the legislature anticipated that action against the creditor itself would be fruitless. This supports an argument that, even if the creditor in favour of which the guarantee is drawn may have defences, this should not stop an action against the surety or guarantor himself under s 453(5).

Other components of s 453(5)

The other requirements of s 453(5) are not troublesome. Paragraph (a) says there must be "a disposition of property" within six months of commencement of winding up. The words " a disposition of property" have a wide meaning. They mean to transfer or alienate or convey property officially or in legal form. Certainly payment into a current bank account is a disposition in these terms. "Property" is usually interpreted widely. Money is undoubtedly property.

To take the overdraft bank account situation, every time money is paid into such an account there is a disposition in favour of the bank. This is so, even though when the bank pays out to a third party on the customer's cheque the bank is only an agent of the customer.[32] Thus a payment by a customer into an overdrawn account can be viewed as a contractual repayment of a loan and, in these terms, a disposition of property. Some assistance can also be drawn from taxation law cases which generally take a broad view of the meaning of "disposal" of property. They have included in the word's ambit transactions and dealings which do not amount to changes of beneficial ownership.[33]

Under paragraph (b) the disposition of property must confer a preference upon a creditor of the company. Certainly a bank is a creditor. In *Re Timbatec,* the principal creditor was not a bank but a company called PGH Sales Pty Ltd. Just to recap, what was sought in that case was a declaration that the transaction under which the insolvent company paid PGH was invalid. The payment had the effect of giving

32 See *Paget's Law of Banking* (8th edn) 132; *Re Hone (a Bankrupt)* [1950] 2 All ER 716, 719; *Blackburn and District Benefit Building Society* v *Cunliffe* (1885) 29 ChD 903, 912; *Cuthbert* v *Robarts, Lubback & Co* [1909] 2 Ch 226, 233, 235.

33 See *Ord Forrest Pty Ltd* v *Commissioner of Taxation (Cth)* (1974) 48 ALJR 48; see also (1974) 48 ALJ 460-461.

the surety a preference to the extent to which the surety's liability under the guarantee was satisfied. The liquidator was unsuccessful. That case led to the drafting of s 453(5). In *Kyra Nominees Pty Ltd (in liq)*, too, payments into an overdraft account were made with the "intention of reducing the total debit in the overdraft account and accordingly they each amounted to a preference".[34]

Paragraph (c) requires that the disposition of property have the effect of discharging an officer from a liability under a guarantee. To take the obvious example, the payment by the company into an overdrawn bank account would have the effect of discharging an officer's contingent liability under a written guarantee. There should be no difficulty with the requirement, at least on its wording.

Unlike s 122 of the Bankruptcy Act, s 453(5) of the Code does not specifically require that the company be insolvent at the relevant time. However, on the strength of the wording of s 122(1), one could claim there is no preference until the company is unable to pay its debts as they fall due. While the fact remains that the wording does not require insolvency at the time of the contested payment, without it there is arguably no preference as commonly understood.

Proof of insolvency can be difficult. Insolvency, sometimes called commercial insolvency, means inability to pay one's debts as they fall due from your own money. Inability must be distinguished from unwillingness. In the words of Barwick CJ in *Sandell* v *Porter:*

> "But the debtor's own monies are not limited to his cash resources immediately available. They extend to monies which he can procure by realisation, by sale, or by mortgage or by pledge of his assets within a relatively short time — relative to the nature and amount of the debts and to the circumstances, including the nature of the business, of the debtor. The conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn from evidence of a temporary lack or inability. It is the debtor's inability, utilising such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due, which indicates insolvency."[35]

Burt CJ warned in *Kyra Nominees Pty Ltd (in liq)* that a company does not show it is able to pay its debts out of its own money simply "because it is able to borrow money on an unsecured basis to enable it to do so".[36]

In *M & R Jones Shopfitting Co Pty Ltd (in liq)*[37] insolvency was not proved. The court emphasised the need for good evidence of insolvency as at the date of the challenged payments. Evidence of dishonoured cheques is generally not enough of itself. There may be reasons other than insolvency for the dishonouring. For example, there may be a change in policy at the bank, or there may be a pattern of dishonouring of cheques followed by a prompt putting in of funds on the part of the

34 Supra n 9 at 407 per Pidgeon J.
35 (1966) 115 CLR 666, 670.
36 Supra n 9 at 405.
37 (1983) 7 ACLR 445.

debtor and subsequent acceptance of the dishonoured cheques by the bank. This is what happened in *M & R Jones Shopfitting*. The company had always succeeded in satisfying the bank. The court sympathised that "a manager could hardly be expected to suspect that a company was insolvent merely because it had an overdraft of an amount which he had thought it safe to allow".[38] Later the court noted: "the dishonoured cheques were paid within a reasonably short period. In those circumstances why should the manager have suspected insolvency?"[39]

Barwick CJ added in *Queensland Bacon Pty Ltd* v *Rees*:

> "A great number of quite solvent people . . . would find themselves temporarily short of cash and under a necessity to make arrangements to cover the 'shortfall' in overdraft accommodation."[40]

However, His Honour acknowledged that dishonouring of cheques would nearly always call for some enquiry by the bank and in some circumstances — repeated dishonouring, for example — would provide grounds for suspicion of insolvency.

Likewise a liquidator, seeking to challenge payments to the principal creditor itself, as was done in *Kyra Nominees Pty Ltd (in liq)*, might rely on changes in bank policy, such as a reduction in the overdraft credit limit or a demand for a reduction in the overdraft account, as indicating that the bank was aware of the insolvency of the company. Then, under s 122(4) of the Bankruptcy Act, providing the bank knew or had reason to suspect that the debtor was insolvent, the bank (creditor) shall be deemed not to be a payee in good faith. The usual defences would not be available.

Advising a director who is a surety

Certainly director/guarantors may well be apprehensive when their financially-troubled companies are paying off overdrafts. They could be faced with the situation where their companies have paid off the overdraft, yet under s 453(5) they personally must pay out another sum to the liquidators.

The law now encourages directors to keep banks fully informed of the state of solvency of their companies. Should the worst happen and the company slide into liquidation, then payments to the informed banks within the statutory six month period may well be void as undue preferences. The banks, because they know about the state of solvency, may not be able to use the s 122(2) defences.

The liquidator may first go after the bank. The bank in turn would no doubt turn on the director and ask for fulfilment of the guarantee. But the liability of the guarantor under the guarantee may well have been extinguished if the guaranteed overdraft has been repaid. It depends on the terms of the guarantee and whether or not they have been drafted to meet the contingency of a challengeable repayment by an insolvent company. In *Commercial Bank of Australia* v *Carruthers*[41] the rights of the creditor seeking to recover £600 from the guarantor were not reinstated.

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38 Ibid 454.
39 Ibid.
40 (1966) 115 CLR 266, 293.
41 [1964] NSWR 1197.

Acting in the company's best interests

Liquidators could also mount an argument outside the statutes. It could be argued that directors, who divert company money into paying off an overdrawn account over which they have given a guarantee, are not acting in the best interests of the company. A breach of this general law duty may render the directors liable to the company for the amount diverted. This depends upon a finding that the duties, which are owed to the company, require heed to the interests of the creditors. There is a strong trend in company law in this direction, at least in the situation where the company is insolvent or in a shaky financial position.[42] This sort of breach of duty or misfeasance argument was unsuccessful in *Re H Linney & Co Ltd.* Ostler J reasoned that "the directors of a company are not trustees for the company's creditors, but only for the company".[43] That was certainly true in 1925. It is not so today, at least where the company is in financial distress.

Conclusion

Liquidators have gained a variety of weapons to test out on the defaulting director/guarantor. A recharged s 122 of the Bankruptcy Act may be the first resort, if only because the High Court decision in *Taylor* v *White* firmly supports the recent finding in *Kyra Nominees.* This approach has policy problems centering on the issue of whether a payer's wrong can taint an innocent payee. The limits of s 556 of the Companies Code are still being interpreted by the courts. There is potential for it to be used, in appropriate circumstances, against the guarantor in the manner of the successful foray in New Zealand in *Re Casual Capers.* But s 453(5) and (6) of the Companies Code offer the most promise of all. They encourage a frontal assault on the guarantor. Only a questionable interpretation of the provisions would deny their effectiveness against officer/guarantors who wipe out the company's overdraft to save themselves from the fate that will befall other creditors of the company.

POSTSCRIPT

Since this comment went to print, the Supreme Court of South Australia (in Banco) (King CJ, Bollen and Cox JJ) handed down its decision in *Matthews* v *Geraghty* [1986] 4 ACLC 727. That case concerned s 453(5) of the Companies Code.

In line with one of the arguments advanced above, the Court held that the protection under s 122(2) of the Bankruptcy Act for transactions that are done in good faith for valuable consideration and in the ordinary course of business is *not* imported into the word "preference" in s 453(5) of the Companies Code to insulate an officer from proceedings. Bollen J commented at 731: "I think that if Parliament had intended to provide protection for transactions of the type contemplated by sec 453(5) it would have said so and defined circumstances attracting protection. It has not done so."

The Court also affirmed that payment by the company into its bank account was a "disposition of property" for the purposes of s 453(5). The company paid over $20,000 into a current account. Exercising a right of set off, the bank itself transferred $10,577.40 of that into a second account of the company, which had been overdrawn by exactly $10,577.40. The overdraft was guaranteed by the defendant officers by way of mortgage over their home.

This "disposition" and internal transfer of money gave a "preference" to the bank within the meaning of s 453(5). They also relieved the officers from their liability under the guarantee. Accordingly, the Court found that the liquidator should have succeeded in his action against the company officers for the recovery of the amount of the original overdraft debit in the second account (ie, $10,577.40).

ALR:6(5)

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42 See *Walker* v *Wimborne* (1975) 137 CLR 1, 7; *Ring* v *Sutton* (1980) 5 ACLR 546, 547-548; *Re 67 Budd St Pty Ltd* v *The Commonwealth* (1984) 2 ACLC 190, 197; *Permacraft (NZ) Ltd (in liq)* v *Nicholson* (1982) 1 ACLC 487, 509; on appeal (1985) 2 ACLC 453; *Kinsela* v *Russell Kinsela Pty Ltd (in liq)* (1986) 4 ACLC 215.

43 [1925] NZLR 907, 922.