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Case Comment

Unlawful preferences and proprietary rights

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Case: G&M Aldridge Pty Ltd v Walsh [2002] B.P.I.R. 482 (HC (Aus))

L.Q.R. 28 THOMPSON Land Ltd, a property developer from the State of Victoria, took out a loan with the ANZ Banking Group secured by a floating charge over its assets. The bank subsequently called in the loan, an event that triggered the automatic crystallisation of the charge, but allowed Thompson to continue trading. Thompson then paid off four contractors using cash and securities that were caught by the crystallised charge. What remained of the bank's security was insufficient to repay the loan in full. Thompson's liquidator sought to recover the payments from the contractors on the ground that they were unlawful preferences under the applicable equivalent ***L.Q.R. 29*** of Insolvency Act 1986, s.239, a claim upheld by the High Court of Australia in *G. & M. Aldridge Pty Ltd v Walsh* (2001) 203 C.L.R. 662.

It was common ground that the payments were made during the statutory twilight period and that Thompson was insolvent at the time. The only issue was whether the payments gave the contractors a "preference, priority or advantage over other creditors". As the floating charge had already crystallised, the assets used to make the payments belonged in equity to the bank. The contractors argued that they had not made a priority gain at the expense of the other unsecured creditors because the assets would not have been available to meet the claims of those creditors in any event. We can demonstrate the plausibility of this contention by considering the case of a fixed charge. If a company transfers assets the subject of a fixed charge to pay a debt owing to an unsecured creditor (X) without the consent of the charge-holder (Y), the basic question to ask is whether X is better off as a result, measuring any improvement in X's position by reference to a hypothetical liquidation arising at the time of the transfer: see *Calzaturificio Zenith Pty Ltd v N.S.W. Leather & Trading Co Pty Ltd* [1970] V.R. 605 at p.610; *Re Ledingham-Smith* [1993] B.C.L.C. 635 at pp.640-641. X acquires nothing of any value from the company at the point of transfer because he receives Y's property. The only circumstance in which X does receive value from the company at the point of transfer is where Y's security, immediately before the transfer, was worth more than its claim against the company. X then receives assets representing the company's equity of redemption which would have been available to general creditors in an immediate liquidation. However, there was no such surplus in *Aldridge* and it is beyond argument that the contractors were paid out of assets that would otherwise have gone to the bank.

The problem that troubled the court was what happens if, after the transfer, the original owner either does not, or can no longer, recover its property. The bank allowed the company to continue trading after the charge had crystallised and so it was always possible that its property might find its way into the hands of selected creditors, "with or without the bank's knowledge, in circumstances where the bank either could do nothing, or might choose to do nothing, to undo that result" (p.673). The fact that the bank's property would not have been available for distribution to unsecured creditors in Thompson's liquidation was irrelevant; what mattered was that, in the absence of any action against them by the bank, the contractors had enjoyed and retained the benefit of the payments whereas other creditors had received nothing. In this respect, it is clear that the court regarded *Aldridge* as being on all fours with its earlier decision in *Richardson v Commercial Banking Co of Sydney Ltd* (1952) 85 C.L.R. 110, a case concerned with the crediting of a client's cheque to her insolvent solicitor's overdrawn bank account. The court held that this payment was recoverable from the bank as a preference even though it had received trust ***L.Q.R. 30*** property that would not have been available to the solicitor's creditors had it remained in his hands. By receiving property that the client had made no attempt to recover, the bank ended up in a better position than other unsecured creditors: it got paid; they were left to prove in the solicitor's bankruptcy. Moreover, they were

"exposed to the competition upon the assets of the proof of the defrauded owner" (p.137), a reference to the bankrupt's exposure to a personal claim by his client for conversion of the cheque and/or breach of trust.

The *Aldridge/Richardson* problem amounts to a three-cornered priority conflict between the (allegedly) preferred creditor (X), the original owner (Y) and the debtor's unsecured creditors, with the added twist that the court cannot make a binding determination of Y's rights because Y is not party to the proceedings. By adopting a literal construction of the phrase "preference, priority and advantage over other creditors", the court has strongly reinforced the norm that unsecured creditors should be treated equally to reach what may be perceived as a fair outcome in the proceedings before it. Even so, the decision is anomalous. The object of preference law is to prevent the company's assets from being distributed in violation of the established order of priority. Whilst X clearly gains in our scenario, X's gain is not made at the expense of other unsecured creditors. Thus, it is not clear why those creditors should be regarded as any more deserving than X from the perspective of insolvency law. The point that other creditors were exposed to dilution of their claims by virtue of the bank's proof is also not compelling. The increase in Y's claim resulting from the transaction is matched by a corresponding decrease in X's claim. One claim is substituted for the other and the overall impact on the distribution of the insolvent estate is surely neutral.

If we could say that the assets used to pay the contractors were somehow released from the bank's charge on or before payment, we would then have a more satisfying justification for the outcome in *Aldridge.* The contractors could be said to have acquired *company* (rather than bank) property which should have been made available to unsecured creditors as a whole. The position would then be the same as if the payments had been made *before* the floating charge crystallised. We can give the theory legs by concentrating on the bank's conduct in the period between the date of crystallisation and the making of the payments. There are three possibilities. First, the bank may have waived its rights over the assets used to effect payment. Second, by allowing the company to continue trading the bank may have caused its charge to decrystallise, thus restoring the company's power to dispose of its assets in the ordinary course of business free of the security. Finally, and perhaps best of all, it could be argued that the company had apparent authority to dispose of the charged assets until such time as the contractors were put on notice of the fact that the charge had crystallised ***L.Q.R. 31** (see R.M. Goode, *Legal Problems of Credit and Security,* (2nd ed., 1988) at pp.70 and 90). These points were not argued or discussed.

If we accept the *Aldridge* theory that insolvency law requires X to share its gain with the other unsecured creditors, a party in X's position is potentially exposed to an action by the liquidator and a claim by Y, with the possibility of having to pay twice. There was a strong presumption in *Aldridge* and *Richardson* that Y had no surviving proprietary rights against X. However, as Y was not a party in either case, Y's rights could not be determined. The court cannot simply infer that Y's rights are exhausted unless the issues between X and Y are *res judicata.* This may explain why the court did not consider the arguments advanced in the preceding paragraph of this note which serve to cut off Y's proprietary rights at the time of the transaction. Even if we presume that there is no property or traceable substitute left in X's hands which Y can claim, Y may have a personal action against X (a distinct possibility in *Richardson* where the bank's receipt was wrongful because the branch manager knew that the cheque was client money).

The decision in *Aldridge* rests on a strong version of the *pari passu* principle which will doubtless appeal to those who argue that insolvency law has too much respect for the rights of secured creditors. At present, there is no guarantee that an English court would arrive at the same outcome, as an office-holder in this jurisdiction faces the additional hurdle of establishing that the company was "influenced by a desire" to prefer: Insolvency Act 1986, s.239(5) and see *Re M.C. Bacon Ltd* [1990] B.C.L.C. 324. Numerous commentators have made the case for the abolition of the section 239(5) requirement and the remodelling of the cause of action along Australian lines. If the consensus prevails, *Aldridge* may be a taste of things to come.

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