IN THE SUPREME COURT OF NEW ZEALAND

SC 39/2005
[2005[NZSC 76

	BETWEEN	TRANS OTWAY LIMITED Appellant
	AND	IAN BRUCE SHEPHARD AND CHRISTINE MARGARET DUNPHY Respondents

Hearing: 11 November 2005

Court: Elias CJ, Blanchard, Tipping, McGrath and Eichelbaum JJ

Appearances: P D McKenzie QC and D M Law for Appellant
H L Thompson for Respondents

Judgment: 1 December 2005

JUDGMENT OF THE COURT

A. The appeal is dismissed.

B. The respondents are awarded costs of $15,000 together with disbursements to be fixed.

REASONS

(Given by Blanchard J)

[1] At the end of March 2003, at a time when it was insolvent, Newman Carrying Ltd entered into a written agreement to sell certain of its assets to the appellant, Trans Otway Ltd, for $371,000 plus GST. That sum was payable in cash. By the same agreement, Newman agreed to sell its client list to Trans Otway. The agreement required Newman to provide Trans Otway with a written list of its clients,

together with contact names, addresses and phone numbers and details of activity of the client accounts for the previous twelve months.

[2] The agreement provided as follows in relation to the client list:

> (e) The purchaser [Trans Otway] will pay to the vendor [Newman] the sum of $94,996.73 including GST for such client details, such payment to be made by the purchaser acknowledging that the vendor has made full payment of all sums due and owing to the purchaser.

At the time of the agreement Newman had an overdue debt of $94,996.73 owing to Trans Otway.

[3] Within a few days settlement occurred between the two companies. Trans Otway paid the $371,000 plus GST and received title to the assets. It was provided with the client list. It appears Newman then ceased trading. On 16 May 2003, and therefore well within the specified period in s 292 of the Companies Act 1993, Newman was put into liquidation by resolution of its shareholders.

[4] In relevant part s 292 provides:

> **292 Transactions having preferential effect**
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> (1) In this section, transaction, in relation to a company, means—
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> (a) A conveyance or transfer of property by the company:
> (b) The giving of a security or charge over the property of the company:
> (c) The incurring of an obligation by the company:
> (d) The acceptance by the company of execution under a judicial proceeding:
> (e) The payment of money by the company, including the payment of money under a judgment or order of a court.
>
> (2) A transaction by a company is voidable on the application of the liquidator if the transaction—
>
> (a) Was made—
> (i) At a time when the company was unable to pay its due debts; and
> (ii) Within the specified period; and
> (b) Enabled another person to receive more towards satisfaction of a debt than the person would otherwise have received or be likely to have received in the liquidation—
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> unless the transaction took place in the ordinary course of business.

It has not been suggested that the agreement was made in the ordinary course of Newman's business.

[5] The liquidators, who are the respondents to this appeal, gave notice under s 294 of the Act asserting that the "payment made by set-off" by Newman to Trans Otway of $94,996.73 was a voidable transaction. Trans Otway applied to the High Court for an order under s 294(2) that the transaction not be set aside. The High Court declined to make such an order.[1] It has not yet made any order under s 295 nor determined whether recovery should be denied under s 296(3). The Court of Appeal dismissed Trans Otway's appeal against the s 294(2) decision.[2]

The judgments below

[6] As often occurs, the argument has changed as the case has progressed through the courts. There was concentration in the High Court and the Court of Appeal on whether in respect of the $94,996 there had been a payment of money by Newman in terms of the definition of "transaction" in s 292(1)(e). The High Court found that there had been, rejecting submissions that it was the entire purchase agreement which was the transaction and that the payment by Newman was merely a component. The High Court said that Trans Otway agreed to pay a separate and specific sum for the client list and that the fact that Trans Otway might now consider the list to be of little or no value did not change the nature of its contractual bargain. Trans Otway agreed to allow Newman to pay its debt in the manner that it did.

[7] The Court of Appeal also concluded that there had been a payment by Newman. The two debts had both been paid by set-off and Newman's debt had thereby been paid *by* Newman. In circumstances where the set-off was not a unilateral act by Trans Otway, the Court said, it was of the view that although the transfers of the assets, including the client list, were also transactions under s 292(1), the liquidators had been entitled to pick and choose when electing to challenge only the set-off. The Court said that the payment of Newman's debt clearly enabled

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1 CIV 2003-404-15409, 30 April 2004, Master Sargisson.
2 [2005] 3 NZLR 678 (Anderson P, William Young and Chambers JJ).

Trans Otway to receive more towards satisfaction of that debt than Trans Otway would otherwise have received or be likely to receive in the liquidation. If Trans Otway were now proving in the liquidation, it would receive "a very much lower figure" in respect of its debt from Newman.

Discussion

[8] At the hearing in this Court Mr McKenzie QC, who had not appeared below, said that the appellant was no longer advancing the argument that there had not been a payment of the $94,966 by the debtor company. There had been a payment which was set off against another payment and, in view of the fact that Newman had agreed that this should be done, counsel did not find it possible to deny that there had been a payment of the debt *by* Newman.[3] It was therefore accepted by the appellant that to the extent of the set-off there had been a transaction by the company made at a time when it was unable to pay its due debts and within the specified period.

[9] Referring to s 292(2)(b), Mr McKenzie submitted that Trans Otway had not received more towards satisfaction of the debt than it "would otherwise have received or be likely to have received in the liquidation." He gave two reasons. First, in considering the effect of the transaction and the benefit to Trans Otway the Court of Appeal had taken too narrow a view by focusing only on the set-off. It should have looked more widely at the agreement as a whole and taken account of the reasons why the parties to it had entered into the agreement and framed it in the way which they did. The transaction involved the whole agreement. Counsel relied by analogy on the "running account" cases in Australia and referred us to the following passage in the judgment of the High Court consisting of Dixon, Williams and Fullagar JJ in *Richardson v The Commercial Banking Co of Sydney Ltd*:

> In considering whether the real effect of a payment was to work a preference its actual business character must been seen and when it forms part of an entire transaction which if carried out to its intended conclusion will leave the creditor without any preference priority or advantage over other creditors the payment cannot be isolated and construed as a preference.[4]

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[3] It is unnecessary for the purposes of this appeal to say anything concerning the question of what may constitute a payment under s 292(1)(e). We leave open the question of the correctness of the Court of Appeal's distinction between unilateral and consensual set-off.

[4] (1952) 85 CLR 110 at 132.

Citing that statement the Court of Appeal of Victoria commented in *VR Dye & Co (a firm) v Peninsula Hotels Pty Ltd (in liq)*:

> In each case the court is obliged to look at the transactions between the parties in a manner which accords with the commercial realities. It is not a matter of isolating particular individual steps in the course of a business relationship so as to give one element a different characteristic from that which the totality of that relationship would evidence. That is but one aspect, but a principal aspect, of the running account cases which have realistically faced the way in which companies and other parties carry on business when close to insolvency. [5]

[10] Whilst respectfully concurring with what is said in those passages we nevertheless reject counsel's argument on the facts of this case. Looking at the agreement as a whole, it can be seen that Newman sold some assets for an agreed price of $371,000 plus GST payable in cash and also sold the client list for an agreed price of $94,966 payable by means of the set-off. The same benefit of the set-off, such as it might be, was present as an element or component of the wider agreement. Its effect can be no different when considered in the context of the whole agreement. Although Mr McKenzie did not say so directly, what counsel would in reality have the Court do is to look behind the price which Trans Otway agreed to pay for the client list and which the debtor company agreed to accept and to treat the client list as having little or no real value. That would require a re-appraisal of Trans Otway's bargain, which is not an exercise it is appropriate to undertake on an application under s 294,[6] especially since the figure for the client list could not be examined in isolation without regard to the value ascribed by the parties to the other assets. The difficulty of the exercise in the particular case, even if the Court had been prepared to undertake it, was illustrated later in Mr McKenzie's oral submissions when he referred to evidence that in the negotiations preceding the agreement Newman had been seeking a goodwill payment for its business of at least $100,000. It is not without significance that Newman's directors, Mr and Mrs Newman, were parties to the agreement and accepted a three year non-competition restriction.

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5 (1999) 32 ACSR 27 at para 36.

6 Cf an application by a liquidator under s 297 or s 298 where the value of the consideration or benefit is directly put in issue.

[11] Counsel's argument receives no support from the "running account" cases, which do not contemplate any revaluation of an agreed consideration. The transactions in those cases involved a series of payments between the creditor and the debtor company whereby the balance of the account fluctuated. It is entirely proper and in accordance with commercial reality where the creditor is extending further credit to a debtor company to have regard to the net effect of the payments in determining whether overall the creditor has been preferred, and to set them aside only to that extent. Where the payments are the consideration for transfers of assets by the company, to do so does not engage the court in a re-assessment of the values attributed by the parties and obviously therefore accepted by the creditor.

[12] The argument on which Mr McKenzie rightly placed greater weight and which had been in the forefront of the appellant's application for leave to appeal, was that in making an assessment under s 292(2)(b) the Court of Appeal had not taken account of a statutory direction in s 310(1) of the Companies Act which, it was submitted, would have applied if liquidation had intervened after the agreement had been entered into but before settlement occurred and the set-off was effected; in other words, at a time when Newman's debt to Trans Otway and Trans Otway's debt to Newman for the client list both remained outstanding. Section 310(1) provides:

> **310 Mutual credit and set-off**
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> (1) Where there have been mutual credits, mutual debts, or other mutual dealings between a company and a person who seeks or, but for the operation of this section, would seek to have a claim admitted in the liquidation of the company,—
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> (a) An account must be taken of what is due from the one party to the other in respect of those credits, debts, or dealings; and
> (b) An amount due from one party must be set off against an amount due from the other party; and
> (c) Only the balance of the account may be claimed in the liquidation, or is payable to the company, as the case may be.

That direction is, however, subject to a qualification in s 310(2):

> (2) A person, other than a related person, is not entitled under this section to claim the benefit of a set-off arising from—

(a) A transaction made within the specified period, being a transaction by which the person gave credit to the company or the company gave credit to the person; or

(b) The assignment within the specified period to that person of a debt owed by the company to another person—

unless the person proves that, at the time of the transaction or assignment, the person did not have reason to suspect that the company was unable to pay its debts as they became due.

[13] It was Mr McKenzie's argument that, if Trans Otway could have satisfied subs(2), a set-off of the two debts would have been obligatory in the liquidation of Newman if it had not previously occurred. In that case, it was submitted, Trans Otway would have gained no advantage from the payment of its debt by Newman by means of the set-off which occurred prior to the commencement of the liquidation.

[14] Up to this point, the argument is plainly correct. As Vaughan Williams J said in *In re Washington Diamond Mining Company*:

> You cannot prefer a man…by merely putting him in the very position in which he would be if a bankruptcy followed. [7]

Citing this dictum, Derham puts the matter in this way:

> If A and B are indebted to each other, and A makes a payment to B in satisfaction of his indebtedness in circumstances where B similarly discharges his indebtedness to A, or if A and B merely agree that the cross-demands should be set one against the other and cancelled, then A's payment, or the agreement for a set-off, will not be construed as a preference in his subsequent bankruptcy if the cross-demands were such that in any event they would have given rise to a set-off. The fact that the debts would have been set-off in the bankruptcy means that the arrangements have not worked to the detriment of the other creditors of the bankrupt. [8]

[15] It has long been a general policy of insolvency law that obligations between a creditor and an insolvent are to be assessed on a net basis. Derham[9] traces its origins as far back as an Elizabethan bankruptcy statute, (1570) 13 Eliz., c7. In this country the Statutes of Set-off of 1728 and 1734[10] have always authorised the setting-off of liquidated sums and are preserved by s 3 of the Imperial Laws Application Act 1988.

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7 [1893] 3 Ch 95 at 104.
8 *The Law of Set-Off* (3ed 2003) at para 13.10.
9 Ibid, para 6.22.
10 2 Geo 2, c.22 and 8 Geo 2, c.24.

As developed in the courts of equity, the right to assert a set-off encompasses unliquidated claims. It is regarded as unfair that someone who owes an amount to an insolvent person should have to pay it in full whilst exposed to the peril of receiving only a dividend, or nothing at all, from the estate in respect of an amount owed by the insolvent. It is this policy which is recognised in s 310(1), in the requirement that in a company liquidation the balance between the company and its creditor must be taken on a net basis after set-off has occurred.

[16] It follows that, if regard is paid only to s 310(1), Trans Otway was not preferred in the way described in s 292(2)(b). In his admirably succinct submissions Mr Thompson, for the respondent liquidators, accepted as much. But he contended that, as required by s 310(2), it had not been shown by Trans Otway that at the time of the transaction Trans Otway did not have reason to suspect that Newman was unable to pay its debts as they fell due.

[17] The reason for this qualification of the general rule in s 310(1) is to prevent a creditor from taking opportunistic advantage over other creditors by engineering a situation in which it also becomes a debtor of the company at a time when it must be taken to have appreciated the company's insolvent position.[11] Derham comments that the qualification, which is of long-standing, has the effect

> …of discouraging dealings in debts owing by the bankrupt or the company, as the case may be, in a way that would negate the principle of a pari passu distribution of the bankrupt's or the company's property. [12]

[18] Because the judgments below did not refer to s 310(1), the effect of s 310(2) on Trans Otway has not yet been determined. There is evidence in the affidavits in the case, however, which bears on the state of mind of Trans Otway's director, Mr Otway, when he reached agreement with Mr Newman. Both counsel therefore requested us to decide on the basis of that material whether Trans Otway has

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[11] In this context, as para (a) of subs(2) makes clear, the transaction is not of course the set-off itself but the event giving rise to the potential claim to assert it.

[12] At para 6.52.

discharged the burden of proof under s 310(2) rather than remitting that question to the High Court.

[19] We find that the appellant has not discharged that burden. To begin with, unpromisingly for the appellant, its debt had been overdue for payment for more than two years, notwithstanding that during that time the two companies had apparently not been trading with each other and notwithstanding that $68,000 of the debt was undisputed by Newman. That situation alone would be likely to have suggested to Mr Otway that Newman simply could not pay. Then, after negotiations began for the possible sale of Newman's business to Trans Otway, Mr Newman told Mr Otway that the business was experiencing cash flow difficulties. He said it was because a change in Newman's accounting systems had meant that some of Newman's customers were slow to pay it. Whatever the reason, however, the acknowledgement of a cash flow deficiency would certainly have been a further indication to Mr Otway of Newman's inability to pay its debts as they became due.

[20] In these circumstances, on 20 March 2003, Trans Otway had served a statutory demand on Newman for the debt owing to it. Mr Otway deposed that he did so because he had decided that Newman was "not genuine and was simply stalling". No payment was afterwards received and Mr Otway admitted in an affidavit that it had become clear to him that Newman was not going to pay the money it owed. He nevertheless averred he was unaware that Newman was insolvent. That may be so – Mr Otway had not seen any accounting records of Newman – but it does not address the statutory test in s 310(2), which is that the creditor must show that it did not have "good cause to suspect" a state of insolvency, not that it did not know of the insolvency.

[21] In a statement which has long been regarded as authoritative on the statutory test, Kitto J said in *Queensland Bacon Pty Ltd v Rees* that a suspicion that something exists is

> …more than a mere idle wondering whether something exists or not; it is a positive feeling of actual apprehension or mistrust, amounting to "a slight opinion, but without sufficient evidence", as Chambers's Dictionary expresses it. Consequently, a reason to suspect that a fact exists is more than a reason to consider or look into the possibility of its existence. The notion

> which "reason to suspect" expresses…is, I think, of something which in all the circumstances would create in the mind of a reasonable person in the position of the payee an actual apprehension or fear that the situation of the payer is in actual fact that which the sub-section describes – a mistrust of the payer's ability to pay his debts as they become due and of the effect which acceptance of the payment would have as between the payee and the other creditors. [13]

Kitto J added that the test is an objective one. Hodgson J has conveniently summarised the position in *Hamilton v Commonwealth Bank of Australia*:

> I accept that *Queensland Bacon* shows that it is insufficient that the circumstances give a reason to suspect the debtor *might* be insolvent: they must be such that the creditor should have suspected that the debtor *was* insolvent…[*Emphasis in original*] [14]

[22] On the basis of the material before the Court, it seems to us that there would have been every reason for Trans Otway to suspect at the time the agreement was entered into that Newman was actually insolvent. It was owed a substantial and long overdue debt – the greater part never in dispute - which it believed it was not going to be able to recover, from a company which it knew to be experiencing cash flow difficulties.

[23] It follows from this conclusion that in the liquidation Trans Otway would not have been entitled to rely upon s 310(1) and receive the benefit of a set-off. Consequently, it fails the test in s 292(2)(b). It did receive more by way of the payment by way of set-off, namely payment in full of its debt, than it would otherwise have received or be likely to have received in the liquidation.

Result

[24] The appeal by Trans Otway is accordingly dismissed. The respondents are entitled to costs in this Court in the sum of $15,000 together with their reasonable disbursements, to be fixed if necessary by the Registrar.

Solicitors:
Wood Ruck, Manukau for Appellant
McMahon Butterworth, Auckland for Respondents

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[13] (1966) 115 CLR 266 at 303.
[14] (1992) 9 ACSR 90 at 113.