Appendix

Fraudulent Preference

After I prepared this section, I concluded that it not only fell outside of the focus of the rest of the paper, but that it might make an already long paper unbearable. Having done the research, however, I decided to include this aspect of the matter as an appendix.

1. Certain transactions will be invalid if challenged by a liquidator of an insolvent company. The **Companies Act** provides:[1]

> *"Any conveyance, mortgage, delivery of goods, payment, execution, or other act relating to property which would, if made or done by or against an individual, be deemed in his bankruptcy a fraudulent preference, or a fraudulent conveyance, assignment, transfer, sale or disposition, shall, if made or done by or against a company, be deemed, in the event of its being wound up, a fraudulent preference of its creditors, or a fraudulent conveyance assignment, transfer, sale or disposition, as the case may be, and be invalid accordingly".*

2. The **Bankruptcy Act** adds:[2]

> *"(1) Every conveyance or transfer of property, or charge thereon, every payment, every obligation, and every judicial proceeding, made, incurred,*

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1 Section 295(1)

2 Section 115

taken or suffered, by any person unable to pay his debts as they become due from his own moneys, in favour of any creditor or any person in trust for any creditor, with a view of giving such creditor a preference over the other creditors, shall, if a provisional order take effect against the person making, taking, paying or suffering the same within six months after the date of making, taking, paying or suffering the same, be deemed fraudulent and void as against the Trustee".

3. For a transaction to be invalid as a "fraudulent preference," therefore, the following must be present:

   a. The company must have been commercially insolvent, i.e., unable to pay its debts as they fall due;

   b. The transaction must be in favour of a creditor;

   c. The transaction must have been "with a view of giving such creditor a preference over the other creditors";

   d. The transaction must have taken place within 6 months of a winding up order.

4. It should be noted that this claim can only be brought by the liquidator and cannot be brought by an individual creditor. **Buckley on the Companies Act** states[3]:

   "Whether the transaction is a fraudulent preference or not, it cannot be impeached as such for the benefit of a single creditor or class of creditors,

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3 (13th Edition), page 648

but only for the benefit of the general body of creditors."

5. As the **Bankruptcy Act** indicates, the transaction is void "as against the Trustee." Notwithstanding however, that the creditor cannot bring this action for its sole benefit, this is an important provision because if the result is that there are certain transactions which the liquidator will not be bound to honour, there may be more assets to be shared for the benefit of all the creditors.

Insolvency

6. It should be noted that the section refers to "commercial insolvency," and not "balance sheet insolvency." In other words, a company may not be insolvent in the sense that its total assets exceed its liabilities, but still be insolvent under this section because its liquid assets cannot meet its current liabilities. This is an example of what has euphemistically been called a "mismatch" of long term assets and short term liabilities.

Creditor

7. In some cases, the issue has been as to who is a creditor within the meaning of the statutes. In **Re Blackpool Motor Car Company Limited. Hamilton v Blackpool Motor Car Company Limited,**[4] Buckley J. cited with approval the dictum of Vaughn

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4 [1901] 1 Ch, 77

Williams J. in **Ex parte Read**,[5] which sought to define the word "creditor" in section 48 of the **UK Bankruptcy Act** 1883. Section 48 is in *pari materia* to Section 115 of the **Bankruptcy Act** [which is cited above]. Vaughn Williams J had this to say:

> *"I have to decide this question merely upon what seems to me to be the true construction of the Act of Parliament, and I need not trouble myself to distinguish between legal and equitable considerations. Now, Mr. Barnard was a creditor of the bankrupt in the sense that, if bankruptcy supervened, he would have had a right to prove and to share in the distribution of the bankrupt's assets. That being so, what is the meaning of the word 'creditor' in s.48? The Act contains no definition of the word, and, therefore, to arrive at the meaning I must look at the history of the section. One knows that the doctrine of fraudulent preference was introduced to prevent payments made by insolvent debtors in contemplation of bankruptcy-that is to say, in contemplation of the administration by the Court of the bankrupt's estate rateably amongst those persons who would be entitled to share in the distribution of that estate. In my judgment, when once I arrive at that I must come to the conclusion that the word 'creditor' in s.48 must mean a person who would be entitled to prove and to share in that distribution. I think the Legislature in enacting the section intended to prevent a payment to anybody who, but for such payment, would share in the administration of the bankrupt's estate. I think, therefore, that the word 'creditor' means any person who, at the date of the payment to him, would have had to come in and prove and rank with the other creditors in the bankruptcy. A surety would be such a person. I hold, therefore, that you may make a fraudulent*

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5 [1897] 1 QB 122, 123

preference by a payment to or for the benefit of a surety who has not yet been called upon to pay as surety. It is not disputed that at the date of the payment into the bank Barnard was a person who had a right of proof under s.37 in respect of his contingent liability as acceptor of the bill. He had a right, therefore, to share in the distribution of the bankrupt's assets; and under the circumstances I hold that the payment into the bank was a fraudulent preference of Barnard by the bankrupt."

8. In short " creditor" means any person who at the date when the charge or payment is made would have been entitled, to prove in a bankruptcy and share in the distribution of the bankrupt's estate.

Preference

9. Moral fraud is unnecessary and a fraudulent intention need not be specifically proved. That intention may be inferred from surrounding circumstances. An assignment by a debtor of property in settlement of (or as security for), a past/existing debt, is a fraudulent preference whatever the motives of the parties may have been. However, an assignment of property partly in consideration for a past/existing debt and also in consideration of a further advance, is not a fraudulent preference if the advance is made in order to enable the debtor to carry on its business and the lender reasonably believes that the advance will enable the debtor to do so. Where, however, the real purpose of the assignment is to secure an

existing debt and the advance is merely a sham to conceal this fact, the assignment will be a fraudulent preference.

10. It should therefore be noted that a transfer by a debtor of some or all of his property, is not necessarily a fraudulent preference, if it is made bonafide and for a present equivalent paid to him, which need not be the same value as the property assigned or charged nor equal in value to his existing debts. In **Mercer v. Peterson**[6] Cockburn C.J. had this to say:

> *"The cases decide that, generally speaking, an assignment by a trader of his whole property for a past debt is an act of bankruptcy, because the result must inevitably be to defeat and delay his creditors. Now here there was first an agreement made on the 9th of December, 1865, whereby, in consideration of the defendant's taking up a bill of exchange, the trader promised to assign to him the whole of his effects. But even at that time the parties seem to have been contemplating a further advance, although there was no stipulation then that it should be made, and therefore no obligation on the defendant's part to make it. In the interval, however, between the date of the agreement and the giving of the bill of sale, a further advance was arranged for, and actually made, upon the understanding that it was "to be included in the bill." Now, in order to see what the real consideration for the giving of the bill was, we are not confined to the bill itself; and here the consideration may well have been partly the original agreement, and partly the further advance. The bill, therefore, may be said to have been given on*

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6 (1868) LR 3 Exch. 104

a twofold consideration, the one past, the other present or future. And it has been held that where a trader assigns his whole property, but receives in return a ***fair equivalent,*** *the transaction is not void under the bankrupt laws. It is too late to question the propriety of the decisions to that effect, although I fear that where a trader makes over his whole estate, even for a fair equivalent, and even though he really have a bonafide intention of going on with his business, in the end the present advance is too often dissipated, and the creditors receive no benefit from it.*

The simple question then is, whether the sum of 64l. can be considered an equivalent for the transfer of the trader's property? The effects we may take to have been worth 115l., and even if the 64l. were the sole consideration, I think we should be justified in holding it to have been a substantial consideration sufficient to support the subsequent transaction. There is nothing in this case to negative the proposition---on the contrary, there is much to affirm it--that the trader obtained a fair present equivalent for the bill."

11. It should also be noted that the disputed transaction must be voluntary. The debtor's act must be deliberate or spontaneous as the word "preference" connotes an act of free will (See the analysis of this topic in **Williams on Bankruptcy**[7]). The debtor must have chosen to do the act.

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7 18th ed pg. 384

12. Accordingly, where a creditor forces or pressures the bankrupt to make payment to the creditor or to charge its property in favour of the creditor, the Court is likely to consider those circumstances as tending to rebut the presumption of a preference. It is therefore unlikely that where the act which is alleged to be a preference, was done in the ordinary course of dealing and is done with the main view of continuing to trade, that the Court will regard that act as constituting a fraudulent preference. The Court's decision will however depend on the evidence which is before it.

13. In **Re TW Cutts (a bankrupt), Ex parte Bognor Mutual Building Society v. Trustee in Bankruptcy**[8], Lord Evershed MR considering Section 44(1) of the **Bankruptcy Act 1914**, stated at page 541:

> *"I shall not attempt for myself any exhaustive exposition of the requirement of the sub-section: but, so far as those requirements are in issue in the present appeal it may, I think, now be safely stated; (i) The onus is on the person alleging a "fraudulent preference" to prove to the satisfaction of the Court that the payment impugned was made by the debtor "with a view of" preferring the payee over his other creditors; in other words, the onus is on the person alleging a fraudulent preference (normally, as here, the trustee in bankruptcy) to prove the fact of the debtor's requisite state of mind, that is, his intention. (ii) It is competent for the court to draw the inference of intention to prefer from all the facts of the case, particularly when there is no direct evidence of intention before it; but the inference should not be drawn,*

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8 [1956] 2 All ER 537

threatened by the creditor concerned, or fear of such proceedings is not for this purpose a voluntary payment."

15. In **Re FP & CH Matthews Ltd.**,[12] a company whose shares were all owned by its two directors, M and his wife, ran into financial difficulties and began borrowing from a bank. M and his wife executed joint and several unlimited guarantees of the company's borrowings in favour of the bank and a legal charge on their home. Two months before the company went into voluntary liquidation, M paid money into the company's account with the bank and cleared its overdraft and transferred money form the current account to pay off and clear the loan account. The Liquidator sought an order that the payments to the bank should be treated as a fraudulent preference. The Court held that the payments constituted a fraudulent preference and were void. They were made knowing that the company was unable to pay its debts as they became due and deliberately made to pay the bank ahead of other creditors. The Court of Appeal considered in particular the point in time at which the matter has to be considered. Lawton LJ stated:

"It seems to us that, as a matter of language, the section is directed solely to the time when the payment is made. The section is contemplating that the inability to pay debts as they arise coexists with the payment which is in question. It is true that the payment must be 'with a view of' preference. But we see no reason for divorcing the point of time at which the view of preference exists from the time of payment. It seems to us that there is 'a

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12 [1982] 1 All ER 338

view of' preference if the company, being unable to pay its debts as they arise, decides to pay one creditor in full ahead of the others. We do not think that the section, in this respect, is looking to future events. In particular, when the pre-requisite for the operation of the section is that, at the time of the payment, the debtor should be unable to pay his debts as they arise, we think it is unlikely that the draftsman would, without any express words, introduce considerations of whether the debtor will be able to pay his debts at some future time. We do not think that, on the language of the section, that question arises at all.

The result, in our view, is that if the debtor, at the time when he makes the payment, genuinely believes that he can then pay his debts as they fall due there can be no intention on his part to prefer; there is then no knowledge on his part of insufficiency of assets which could indicate any intention to prefer."[13]

The Burden of Proof

16. Where there is an allegation that a company has given a fraudulent preference to a creditor, the onus of proof is on the person who alleges that there has been such a preference. Consequently, that person also has the burden of establishing the relevant intention or "view." See, e.g., **Re Eric Holmes (Property) Ltd.**[14]

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13 ibid, page 343

14 [1965] Ch. 1052

17. In **Peat** v. **Gresham Trust**[15] Lord Tomlin had this to say

> *"The onus is on those who claim to avoid the transaction to establish what the debtor really intended and that the real intention was to prefer. The onus is only discharged when the court, upon a review of all the circumstances, is satisfied that the dominant intent to prefer was present. That may be a matter of direct evidence or of inference, but where there is no direct evidence and there is room for more than one explanation it is not enough to say that there being no direct evidence the intent to prefer must be inferred."*

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15 ibid, at page 262