CREDIT ISSUES

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CAN A QUISTCLOSE TRUST OVERCOME THE UNFAIR PREFERENCE LAWS?

Background

In 1970 the House of Lords in *Barclays Bank Ltd v Quistclose Investments Limited* ("Quistclose") [1970] AC 567 considered who was entitled to moneys in the following circumstances:

- Rolls Razor Ltd ("Rolls Razor") declared a dividend to shareholders, but did not have the funds to pay the dividend;
- Quistclose agreed to lend Rolls Razor the funds for the sole purpose of paying the dividend and drew a cheque for £209,719 for that purpose;
- Barclays Bank ("Barclays") opened a separate account for the dividend cheque to be paid into, and had agreed that the sole purpose of those funds was to pay the dividend;
- On the same day Rolls Razor went into voluntary liquidation; and,
- Barclays sought to apply the funds against debts on other accounts Rolls Razor held with it.

The House of Lords held that where:

(a) a debtor undertakes to use loan funds in a specific manner; and,
(b) the loan funds are segregated from its pool of general assets; and,
(c) the debtor becomes insolvent;

then the lender's money becomes refundable to the lender, thereby making it unavailable to pay the debtor's other creditors. Arrangements of this type give rise to what is commonly known as a Quistclose trust.

Legislation

Section 122(1) of the *Bankruptcy Act 1966* Cth ("BA") provides that:

"A transfer of property by a person who is insolvent ("the debtor") in favour of a creditor is void against the trustee in the debtor's bankruptcy if the transfer:

(a) had the effect of giving the creditor a preference, priority or advantage over other creditors; and,
(b) was made in the period that relates to the debtor."

In a bankruptcy arising from a creditor's petition, the recovery period is six months before presentation of the petition against the debtor and ending immediately before the date of the bankruptcy. Such transactions are commonly referred to as unfair preferences.

Under Section 58 of the BA, when a debtor becomes bankrupt, any after-acquired property of the bankrupt vests in the Trustee in Bankruptcy, as soon as it is acquired by, or devolves upon, the bankrupt. Further, Section 116(1) of the BA states that all property that belonged to, or was vested in, a bankrupt at the commencement of a bankruptcy, or has been acquired by the bankrupt after the commencement

of a bankruptcy, or has been acquired by the bankrupt after commencement of the bankruptcy but before his or her discharge, is divisible amongst creditors. Section 116(2) of the BA excludes property held by the bankrupt in trust for another person.

The wording of the *Corporations Act 2001* Cth ("CA") dealing with the recovery of unfair preferences is somewhat different. Under Section 588FA of the CA, a transaction is an unfair preference if:

(a) the company and a creditor are parties to the transaction (regardless of any third party involvement); and,
(b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt, more than the creditor would receive in respect of the debt if the transaction were set aside; and,
(c) the creditor were to prove for the debt in a winding-up of the company.

Unlike the BA, there is a non-exhaustive definition of 'transaction' in Section 9 of the CA.

***Rambaldi v Commissioner of Taxation* [2017] FCA 567**

Facts

The facts, which were not disputed, were as follows:

- on 15 November 2013 Ms Alex failed to comply with a bankruptcy notice issued by the Deputy Commissioner of Taxation ("ATO");
- on 18 March 2014 the ATO issued a creditor's petition against Ms Alex;
- on 1 June 2014 Quality Australia Investments Pty Ltd ("QAI") entered into a loan agreement with Ms Alex, an associated company and a trust to lend them the sum of $131,000;
- it was a condition of the loan agreement that the loan funds were only to be used to pay Ms Alex's tax debt and associated legal fees;
- Ms Alex signed an authority authorising and directing QAI to pay $126,000 to the ATO;
- on 7 July 2014 the ATO received a bank cheque; and,
- Ms Alex was declared bankrupt on 8 December 2014. Trustees in Bankruptcy ("the Trustees") were then appointed.

Issue at trial

The only issue was whether or not the loan funds from QAI constituted property of the bankrupt. The Trustees submitted that the funds advanced by QAI were property of the bankrupt. The ATO submitted that the funds had been held on a Quistlose trust for payment to the ATO and that if such trust failed, then the funds would have to be repaid to QAI.

Arguments

The Trustees argued that where payments are made to a creditor by a third party in reduction of the indebtedness of the debtor to the creditor, then the payments are made from the property of the debtor. There was no intention evident in the authorities cited that, if the payment to the debtor fails, the money was repayable to the third party.

The ATO argued, based on Quistclose, that that the payment was made for a specific purpose, namely repayment of tax debt. The mutual intention of the parties impressed the payment monies with a trust and for repayment to QAI, if that purpose failed.

Judgment

Justice North, of the Federal Court of Australia, noted that there was an important distinction between the case law relied upon by the Trustees and the case law relied upon by the ATO. Whilst both parties had relied on case law where third parties made payments of debts owed by the debtor to a creditor, the cases relied upon by the Trustees involved payments made from the property of the debtor, where there was no intention to form a trust.

Justice North considered the written agreement between QAI, Ms Alex and the associated company to determine the intention of the parties. His Honour held that the agreement disclosed an intention by all parties to use the loan monies for the sole purposes of making payment to the ATO and her solicitors. The only distinction between this case and Quistclose was the way payment of the funds was made by QAI to the ATO.

There was no doubt that the intention of the parties was that money was provided only for payment to the ATO. Accordingly, the loan funds did not become the property of Ms Alex. Therefore those funds were not recoverable by the Trustees.

The position would likely have been different, if the debtor was a company in liquidation. That is because Section 588FA of the CA is expressed in different terms to Section 122 of the BA. The definition of 'transaction' in the CA is in wide terms and may extend wider than those dealings caught by Section 122 of the BA. According to the Full Court of Australia *In the matter of Emanuel (No 14) Pty Ltd (In Liquidation) v Blacklaw & Shadforth Pty Ltd* [1997] FCA 667, even if there was a Quistclose trust in a corporate insolvency, that would mean only that there would only be a change in machinery employed by the parties in extinguishing the company's indebtedness. It would have no bearing on the nature of the transaction, between the parties. Whilst that portion of the judgment is obiter, it is a judgment of an appellate Court and other Courts are bound to follow it. One interpretation of the judgment is that a Quistclose trust is not a defence to corporate preference recovery proceedings. Logically, it would appear inconsistent for a Quistclose trust to be a defence to a preference claim under the BA, but not under the CA. More recent Australian developments in the law concerning the administration of trust assets, when a corporate trustee goes into liquidation, have created further difficulties.

Conclusion

In bankruptcy, the payment of a debt by a third party to a creditor may avoid the unfair preference regime of the BA, if the parties had a mutual intention that the monies were to be paid solely for a particular purpose. The question in each case is whether the parties intended the money to be at the disposal of the debtor, or whether the funds were to be used exclusively for the purpose of paying the indebtedness to a specific creditor. The ATO's defence was a novel one in a bankruptcy preference recovery proceeding. In the appropriate circumstances, we may expect more revenue authorities to argue that unfair preference payments ought not to be recoverable, due to the existence of a Quistclose trust.

If you are defending an unfair preference claim received from a Liquidator or Trustee in Bankruptcy, do not hesitate to contact Woodgate & Co. for sensible commercial advice.

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