When will a third party payment be a preference?

Rambaldi v Federal Commissioner of Taxation [2017] FCAFC 217 – 18 December 2017

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Summary

Often debtors will finally agree to pay debts in circumstances where there is a possibility that the payment could later be clawed back as a preference.

One strategy to minimise the risk is to require the payment be made by a solvent third party (and not by the debtor). However, the strategy will only be effective in certain circumstances and the third party must not be discharging a debt to the insolvent debtor.

This article reviews two recent cases in which creditors received payments of old debts from solvent third parties and were able to successfully resist applications by a bankruptcy trustee and liquidator who were seeking to claw back the payments as a preference.

Background

It is common for a creditor to want to structure a payment arrangement with a debtor in such a way that minimises the chance of the payment being clawed back as a preference should that debtor later become insolvent. A method often used by diligent creditors is to direct the payment made from a solvent third party. There are, however, a number of issues that creditors need to be mindful of if they choose to rely on this type of arrangement as a defence to a potential future preference claim.

The recent decisions of *Rambaldi v Commissioner of Taxation* [2017] FCA 567 and FCAFC 217 and *Evolvebuilt Pty Limited* [2017] NSWSC 901 are helpful in identifying the types of issues the Courts will consider if called upon to determine whether such a payment arrangement is in fact a preference.

Rambaldi v Federal Commissioner of Taxation [2017] FCA 567 – 25 May 2017

This decision is the subject of an earlier TurkAlert by Pieter Oomens and Rosanna Maoirana dated June 2017. To summarise, the issue for determination in *Rambaldi* was whether a payment made by a third party lender on behalf of a woman who later became bankrupt was a preference payment pursuant to section 122(1) of the *Bankruptcy Act 1996* (Cth). The bankruptcy trustees argued that the transaction had the effect of giving the Commissioner a preference over other creditors. The recipient contended that the money was never property of the bankrupt and therefore the transaction could not amount to a preference.

The Court found that, inter alia, where a third party loan is created exclusively for a specific purpose such that the borrower (debtor) is not free to apply the money for any other purpose, the loaned monies never become the property of the debtor and they are not recoverable by the insolvency practitioner. Instead, the money is held by the debtor on *Quistclose* trust for payment to the creditor.

The *Quistclose* trust position is firmly established in a long line of authority. It is described most simply in the case of *Australasian Conference Association Ltd v Mainline Constructions Pty Ltd (in liquidation)* (1978) 141 CLR 335 at 353:

> *"…where money is advanced by A to B, with the mutual intention that it should not become part of the assets of B, but should be used exclusively for a specific purpose, there will be implied (at least in the absence of an indication of a contrary intention) a stipulation that if the purpose fails the money will be repaid, and the arrangement will give rise to a relationship of a fiduciary character, or trust."*

Accordingly, the application was dismissed with costs. The bankruptcy trustees sought leave to appeal to the Full Court of the Federal Court.

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In a unanimous judgment the Full Court of the Federal Court dismissed the appeal. The position in respect of third party payments was therefore upheld. However, of significance in the judgment is the Full Court's finding that the funds paid by the third party were in fact not held on a *Quistclose* trust.

The Full Court held that since the funds passed directly from the third party to the Commissioner, no *Quistclose* trust came into effect because no legal or equitable interest in the property ever passed to the bankrupt.

Despite this view, it did not change the Court's position that a preference claim under section 122 of the *Bankruptcy Act 1996* (Cth) was not made out. The Full Court said that the bankrupt was never entitled to the loan money and she never had possession or ownership of it. The loan money never became her property.

In the matter of Evolvebuilt Contracting Pty Limited [2017] NSWSC 901 – 6 July 2017

This matter was a preference claim brought by the liquidators of Evolvebuilt Contracting Pty Ltd ('Evolvebuilt').

In 2012, Built NSW Pty Ltd ('Built NSW') subcontracted Evolvebuilt to undertake work on the ANZ Project in Pitt Street, Sydney. In turn, Evolvebuilt hired secondary subcontractors to perform additional work. The ANZ Project was affected by flooding which resulted in a revised construction program. A dispute arose between the various parties for non-payment: Evolvebuilt was not paid by Built NSW and the secondary subcontractors were not paid by Evolvebuilt.

Evolvebuilt approached Built NSW to pay the secondary subcontractors directly, following the dispute being referred to the CFMEU (Construction, Forestry, Mining and Energy Union). Built NSW agreed to make the payments and proceeded to do so. These payments later became the subject of the preference action.

A few months later Evolvebuilt was wound up. The liquidators commenced a preference claim against Built NSW submitting that although Built NSW made the impugned payments, those payments were made on behalf of Evolvebuilt.

The Court found that the impugned payments were not unfair preference payments on the following primary grounds:

Firstly, the Court determined that the words 'from the company' in section 588FA(1)(b) of the *Corporations Act 2001* (Cth) require that the insolvent company must have directed that the payments occur. Evolvebuilt had no legal right to require Built NSW to pay secondary subcontractors; Built NSW's compliance was discretionary. In fact, the Court found that Built NSW acted pursuant to a separate agreement it had with CFMEU, to which Evolvebuilt was not a party, in response to industrial pressure applied by CFMEU and in order to retain the labour force on the project.

Secondly, the payments were made out of Built NSW's assets, and not out of any asset to the benefit of which Evolvebuilt was entitled. Even though Built NSW's payments had the effect of discharging Evolvebuilt's indebtedness to the secondary subcontractors, it did not follow that Evolvebuilt was a party to the transaction for the purposes of section 588FA of the *Corporations Act 2001* (Cth). The funds used to pay the secondary contractors were never available to Evolvebuilt and therefore could not have been used to satisfy other creditors.

Implications

The takeaways for creditors from *Rambaldi* and *Everbuilt* are as follows:

1. Creditors can seek to structure a payment arrangement in such a way that a *Quistclose* trust is created for their benefit.

2. For a *Quistclose* trust to have this effect a creditor must, at a minimum:

   a) Ensure the third party payer is not also discharging its own debt to the debtor;

   b) Specify that the sole purpose of the loan is to discharge the debtor's debt to the creditor; and

   c) Make sure both these points are documented in writing.

3. As occurred in *Rambaldi*, a creditor may also wish to seek to have the third party lender draw the cheque in favour of the creditor and pay the creditor directly.

4. Creditors should ensure that any payment made by a third party is on its own behalf, as in *Evolvebuilt*, rather than pursuant to an arrangement with the debtor. This can be done, for instance, by devising a contract that explicitly states that the payment is being made without the debtor's involvement.

5. Creditors should ensure that payments from a third party are not made from an asset to which the debtor was otherwise entitled. This is because the funds used to pay the creditor are arguably part of the debtor's estate and it is reducing the pool of assets that would otherwise be available to pay that debtor's creditors.

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