IN THE COURT OF APPEAL OF NEW ZEALAND

CA76/2013
[2013] NZCA 489

BETWEEN	VIVIEN JUDITH MADSEN-RIES AND HENRY DAVID LEVIN Appellants
AND	RAPID CONSTRUCTION LIMITED Respondent

Hearing: 2 October 2013

Court: Harrison, White and Priestley JJ

Counsel: R P Coltman and A C N de Hamel for Appellants
B D Gustafson for Respondent

Judgment: 16 October 2013 at 10.30 am

JUDGMENT OF THE COURT

A The appeal is dismissed.

B The appellants must pay the respondent costs for a standard appeal on a band A basis together with usual disbursements.

REASONS OF THE COURT

(Given by Harrison J)

Introduction

[1] The liquidators of Giant Engineering Ltd (in liq) (Giant) appeal against a decision of Associate Judge Abbott that the respondent, Rapid Construction Ltd (Rapid), had established a statutory defence to the liquidators' application for an

order seeking repayment of a sum of money on the ground that the payment constituted a voidable transaction.[1]

[2] The liquidators' appeal falls for determination solely on the application of the statutory test contained in s 296 of the Companies Act 1993 (the Act) to undisputable facts.

Background

[3] Rapid is an event management and construction company. Prior to its liquidation, Giant manufactured and supplied equipment in the scrap metal and rubbish collection industry. Rapid and Giant had provided services to each other since 2007.

[4] In or about August 2009 Giant suffered a disruptive fire at its business premises. Rapid and another of Giant's customers agreed to continue trading with the company and help it to re-establish its business. Rapid's director, John Paul Hume, gave unchallenged evidence in the High Court (which was accepted by the Associate Judge) about the nature of the arrangement. In essence, Rapid agreed to provide Giant with materials for work which Giant was undertaking for Rapid and other customers. On periodic completion of Giant's services the companies were to calculate the value of each other's respective contributions, and make a payment to settle the net difference.

[5] In late October 2010 the parties calculated that Giant owed Rapid $129,482.22 and Rapid owed Giant $90,713.50. On 4 November 2010 Giant paid $15,930.38, leaving a balance owing to Rapid of $113,551.84. That sum remained owing following Giant's payment of an additional invoice for $13,374.09 in December 2010. On 7 January 2011 the parties swapped cheques for the amounts of their respective indebtedness; that is, Giant paid Rapid $113,551.84 and Rapid paid Giant $90,713.50. Giant was then in a state of insolvency.

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1 *Madsen-Ries v Rapid Construction Ltd* [2012] NZHC 3572.

[6] The liquidators gave Rapid notice of an intention to set aside Giant's payment of $113,551.84 because it was a voidable transaction in terms of s 292 of the Act.[2] Rapid failed to file a notice of objection within the statutory period. As a result, the transaction was set aside automatically under s 294(3).[3]

[7] The liquidators applied to the High Court under s 295 for an order that Rapid repay the sum of $113,551.84. Rapid opposed on the ground that the transaction was part of a genuine trading arrangement. Thus any order should be limited to the difference between the value of the swapped cheques. Given that Rapid had contemporaneously paid Giant $90,713.50, the difference was $22,838.34.

High Court

[8] Associate Judge Abbott held that Rapid had established that (a) the payment was made in good faith;[4] (b) in circumstances where Rapid did not have reasonable grounds for suspecting Giant was or would become insolvent;[5] and (c) Rapid had altered its position in the reasonably held belief that the transfer of the payment was valid and would not be set aside.[6] In view of its satisfaction of s 296 Rapid was entitled to retain or offset $90,713.50, with Rapid being ordered to repay the balance owing of $22,838.34. Having only succeeded in part, the liquidators now appeal to this Court.

Appeal

[9] The sole issue on appeal is whether the Associate Judge erred in determining that the three elements of the statutory defence were met. Section 296(3) relevantly provides:

> A court must not order the recovery of property of a company (or its equivalent value) by a liquidator, whether under this Act, any other

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2 Such notice must be given under s 294 of the Companies Act 1993.

3 Rapid was required to serve a notice of opposition within 20 working days under s 294(3), the last date for compliance being 6 October 2011.

4 At [27] applying Companies Act 1993, s 296(3)(a).

5 At [35] applying s 296(3)(b).

6 At [48]–[49] applying s 296(3)(c). The term "property" as used in s 311A of the Companies Act 1955, the predecessor to s 296, has been interpreted to include the payment of money: *MacMillian Builders Ltd (in liq) v Morningside Industries Ltd* [1986] 2 NZLR 12 (CA) at 15–16. The same position must logically follow under the new provision.

> enactment, or in law or in equity, if the person from whom recovery is sought (A) proves that when A received the property—
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> (a) A acted in good faith; and
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> (b) a reasonable person in A's position would not have suspected, and A did not have reasonable grounds for suspecting, that the company was, or would become, insolvent; and
>
> (c) A gave value for the property or altered A's position in the reasonably held belief that the transfer of the property to A was valid and would not be set aside.

[10] Rapid bore the onus of making out all three grounds for a defence under s 296. The evidence was within a limited compass. Apart from documents (mainly email exchanges and invoices), there were two principal affidavits: from Mr Levin for the liquidators and Mr Hume for Rapid. Mr Levin's affidavit was largely a reconstruction of events and expression of opinion on the issues. Neither Mr Levin nor Mr Hume was called for cross-examination.[7]

Decision

(a) Good faith (s 296(3)(a))

[11] The first question is whether Rapid proved that it acted in good faith. In summary, the recipient of a disputed payment must show an honest belief that the transaction would not involve any element of undue preference either to itself or any guarantor.[8] A creditor is likely to fail this test where it has actual or implied knowledge of the company's financial difficulties – for example where the company's cheques are dishonoured, there is a failure to pay debts on time, or other circumstances indicate serious cash flow problems.[9] An awareness of financial difficulty, however, is not necessarily enough to establish a lack of good faith. An example is *Grant v Shears & Mac Ltd* where the High Court found that the creditor

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7 One other affidavit was before the Court, from a Ms Riddle, a solicitor at Fortune Manning, solicitors for the liquidators. Her affidavit simply details the notice to set aside procedure followed in this case.

8 *Levin v Market Square Trust* [2007] NZCA 135, [2007] 3 NZLR 591 at [54] approving *Re Orbit Electronics Auckland Ltd (in liq), WH Jones & Co (London) Ltd v Rea* (1989) 4 NZCLC 65,170 (CA) and *Re No One Men Ltd (in liq), Meltzer v Axiom International Ltd* (2001) 9 NZCLC 262,671 (CA).

9 *Levin v Market Square Trust* at [54]. See also *Rees v Bank of New South Wales* (1964) 111 CLR 210.

had acted in good faith despite a threat to serve a statutory demand as a result of a late payment.[10]

[12] In the High Court Mr Coltman accepted that Rapid would not have known of Giant's financial circumstances.[11] Nevertheless, on appeal he submits that viewing the evidence in its broader context – in particular emails exchanged from July 2010 – it was clear Giant was experiencing cash flow and liquidity difficulties; that Rapid had knowledge Giant was struggling financially; and accordingly that Rapid could not have received this payment in good faith. For example in an email sent on 8 October 2010 Terry Lemon, Giant's director, said "I won't know if I can give you any funds straight away as we are waiting for to [sic] large payments to be made. We have been promised some payments for tonite [sic] but not sure if they will arrive. Will let you know tomorrow".

[13] However, as Mr Gustafson emphasises, Mr Hume's unchallenged evidence was of an honest belief of no element of undue preference in the reciprocal payment arrangement. Rapid knew about the fire, and agreed to the cheque swap arrangement for the purposes of assisting Giant. Giant's former solicitor, Alan Jones, supported this evidence. In a letter to the liquidators he explained that the arrangement was chosen because of its desirability in accounting terms (showing transparently the exchange in cash flows in and out of the accounts).

[14] Mr Hume assumed that Giant had sufficient insurance cover for any losses suffered from the fire and any impact was "primarily logistical and not financial". Payments were not always made regularly. For example, Mr Lemon's 8 October 2010 email, on which Mr Coltman relied, was followed by his email sent on 22 October advising that some money had been received and requesting Rapid's financial details so he could make a payment. Indeed, throughout his correspondence Mr Lemon advised that Giant was receiving money and was able to make payments.

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10 *Grant v Shears & Mac Ltd* [2012] NZHC 1772.
11 At [27].

[15] Mr Coltman relies on concerns expressed by the Associate Judge about the $15,930.38 payment made by Giant to Rapid on 4 November 2010 as follows:[12]

> ... Giant paid Rapid the sum of $15,930.38 on 4 November 2010, immediately after Rapid had rendered the four invoices for its services. This sum was the value of one of those invoices. The total of the remaining three invoices was $113,551.84. Mr Hume does not explain how this payment can be reconciled with his evidence about the "cheque swap".

[16] However, after considering the inter-company correspondence in its entirety the Associate Judge was satisfied that the parties were then seeking to establish the amount owing to enable calculation of the net sum to be offset. His finding is borne out in the numerous emails exchanged in late 2010. He concluded accordingly that when Rapid received its cheque it did so:[13]

> ... believing that that was the culmination of the parties' efforts to effect an accounting transaction in terms of their arrangement. The fact that the process took so long can be viewed as evidence that the parties were giving it little priority because they were thinking in terms of a reasonably modest balancing item rather than a debt for the nominal amount of the cheque.

[17] In *Sandell v Porter*, cited by Mr Gustafson, the High Court of Australia drew a distinction between knowledge of liquidity issues and knowledge of insolvency, stating:[14]

> Insolvency is expressed in s 95 as an inability to pay debts as they fall due out of the debtor's own money. But the debtor's own moneys are not limited to his cash resources immediately available. They extend to moneys which he can procure by realisation by sale or by mortgage or pledge of his assets within a relatively short time – relative to the nature and amount of the debts and to the circumstances, including the nature of the business, of the debtor. The conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity. It is the debtor's inability, utilising such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates insolvency.

[18] We respectfully endorse that distinction. Rapid knew that Giant was experiencing cash flow difficulties following the fire. Mr Hume assumed the company's liquidity problems were temporary. As a result, Rapid agreed to assist

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12 At [10].
13 At [26].
14 *Sandell v Porter* (1966) 115 CLR 666 at 670.

Giant. Mr Hume's evidence that the arrangement throughout was one of an offsetting nature was not contradicted by the documents, by evidence called for the liquidators or, significantly, challenged in cross-examination. The Associate Judge had a proper basis for accepting it. In these circumstances the liquidators have failed to establish that the Associate Judge erred in finding that Rapid had satisfied the first limb.

(b) Suspicion of insolvency (s 296(3)(b))

[19] The second issue is whether a reasonable person in Rapid's position would not have suspected, or would not have had reasonable grounds for suspecting, that Giant was or would become insolvent. This criterion is to be assessed in accordance with prevailing business practices, the factual matrix of the case and the trading relationship between the parties.

[20] In *Meltzer v Allied Concrete Ltd* Associate Judge Abbott aptly summarised the law on this point as follows:[15]

> [13] The Courts do not look for any single factor but rather judge the matters on the basis of the contemporary knowledge of the recipient, including potentially countervailing factors, which tended to dispel suspicion at the time. While cash-flow problems can raise a suspicion of insolvency they must be viewed in context; apparent cash-flow problems may be explained simply by a habit of delay in payment. Thus, a temporary lack of liquidity is generally insufficient for a conclusion of insolvency. When approaching the question of suspicion, it is important to apply commercial reality, derived from the particular industry, to the facts of the case.

[21] Mr Coltman relies on Rapid's acknowledgement that it was aware Giant was having temporary liquidity problems. He says it necessarily follows that, no matter how temporary their problems were, that information would create a real concern on the part of a creditor. He speculates that the parties were not dealing at arm's length, submitting that Rapid has failed to place all evidence before the High Court on the basis of the unexplained payment on 4 November 2010 (discussed above at [15] and [16]).

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15 *Meltzer v Allied Concrete Ltd* [2013] NZHC 977 (footnotes omitted).

[22] However, we accept Mr Gustafson's contrary submission. The documents confirm Mr Hume's understanding throughout the relevant period between October 2010 and January 2011 that (a) Giant was awaiting payment of some large accounts (the acknowledged cash flow difficulties) and (b) the parties had yet to settle the amounts of their respective indebtedness in order to implement the cheque exchange. Giant's advice to Rapid in early January 2011 that it was now able to pay the outstanding $113,551.84 would entitle a reasonable person standing in Mr Hume's shoes to believe Giant's outstanding accounts had been settled and the cash flow problem alleviated. Payment followed without any undue delay.

[23] Moreover, Rapid's contemporaneous payment to Giant of $90,713.50 in early January 2011 is telling evidence that from Rapid's perspective the payment would substantially alleviate the financial impact of Giant's contemporaneous payment to Rapid. Viewing the correspondence as a whole, as did the Associate Judge, we are satisfied there is nothing to suggest Mr Hume would have had the requisite suspicion of insolvency as a result of Giant's cash flow problems. Looked at through the reasonableness lens, the cash flow problems appeared temporary. The possibility of an insurance recovery and Giant's expectation of payments of outstanding accounts both point against the liquidators' argument. The Associate Judge had a proper evidential basis for finding that Rapid had satisfied the second limb.

(c) Value or alteration of position (s 296(3)(c))

[24] Section 296(3)(c) contains two alternative limbs – whether "A gave value *or* altered A's position in the reasonably held belief that the transfer of the property to A was valid and would not be set aside" (emphasis added). The value ground was not apparently argued in the High Court, and the Associate Judge therefore did not squarely deal with it under s 296(3)(c). Rapid's original notice of opposition appeared to rely on both limbs – somewhat intermingling the wording of s 296(3)(c) in stating that it had *"altered its position* and *gave value* in the reasonably held belief that the payment of $113,000 was valid and would not be set aside" (our emphasis). The question was briefly addressed in written submissions in this Court but not in oral argument. In our judgment, the proper focus is on the issue of alteration of

position, which was the apparent basis on which the application of s 296(3)(c) was argued in the High Court.

[25] A creditor's alteration of position following receipt of a payment must be a conscious one;[16] it must show that it would not have undertaken that course but for receipt and a belief in the payment's validity.[17] The Associate Judge made two central findings on this limb: first, that a contemporaneous alteration of position was sufficient;[18] and, second, that Rapid altered its position by foregoing an opportunity to have a set-off applied on Giant's liquidation under s 310 of the Act.[19]

[26] As for the Associate Judge's first finding, we accept that a contemporaneous alteration of position is sufficient, provided the decision is a conscious one to act in reliance on the payment.[20] On the contemporaneity of the action taken, as this Court held in *Farrell v Fences & Kerbs Ltd*:[21]

> [86] ... with one exception, proof of all three elements of s 296(3) of the Companies Act 1993 is to be established at the time the payment or other company property is received. Specifically, in relation to s 296(3)(c), the giving of value must be proved to have occurred at that time and does not include value given to the company at the time the antecedent debt was created. ...
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> [87] The exception to this general approach arises in the second part of s 296(3)(c) relating to alteration of position in the reasonably held belief that the transfer of the property was valid and would not be set aside. *Although in some cases the alteration of position might occur contemporaneously with receipt of the property, it would typically occur after receipt. The legislation necessarily allows for that possibility.*

[27] The inquiry under this limb is essentially one of causation. Would Rapid have contemporaneously paid Giant $90,713.50 in discharge of its debt if Giant's payment to Rapid had not been made? Mr Hume's evidence, which as noted was unchallenged, is that Rapid discharged its debt in reliance on the validity of Giant's

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16 *Harte v Wood* [2004] 1 NZLR 526 (CA) and *Re Access Homes Ltd, Berry v Hastings Ready Mix Concrete Ltd* (1991) 5 NZCLC 67,481 (HC).

17 *Re Bee Jay Builders Ltd (in liq)* [1991] 3 NZLR 560 (HC) at 566.

18 At [46].

19 At [48]. Section 310 of the Companies Act 1993 deals with mutual credit and set-off (covering mutual credits, mutual debts, or other mutual dealings between the now insolvent company and the claiming party).

20 *Baker Timber Supplies v Apollo Building Associates (Tauranga) Society Ltd (in liq)* (1990) 5 NZCLC 66,791 (HC) at 66,794.

21 *Farrell v Fences & Kerbs Ltd* [2013] NZCA 91, [2013] 3 NZLR 82 (footnotes omitted, emphasis added).

payment. This was an element of the parties' arrangement, rather than an isolated transaction as Mr Coltman contends.

[28] We are satisfied that Rapid made a conscious decision which it would not otherwise have made. That was because under the arrangement the payment was always going to occur when both parties were in a position to repay each other. Accordingly both parties were acting in reliance on the other. The Associate Judge's reasoning that, without payment from Giant, Rapid would have retained the sum it paid and applied for a set-off on Giant's eventual liquidation follows logically.

[29] Turning to the Associate Judge's second finding – on the belief in the validity of the transaction – unless there is good reason to suspect otherwise, a creditor receiving a payment in the ordinary course of business is entitled to assume that the payment has been made validly. A positive finding of good faith under s 296(3)(a) assists the creditor in establishing this requirement is met.[22]

[30] In assessing whether there is an alteration of position under s 296(3)(c) the question is whether a creditor has acted to his or her detriment. In *Baker Timber Supplies v Apollo Building Associates (Tauranga) Society Ltd (in liq)* Fisher J properly described the main purpose of s 311A(7) (now s 296(3)) as:[23]

> to assist a creditor if he has deliberately gone down one path in the reasonable expectation that he has received a valid payment, only to find that he is not only required to repay the money but that in the meantime he has also lost a valuable alternative opportunity. In other words, he must have acted to his detriment on the strength of the insolvent company's payment.

[31] The same factors relevant to the good faith limb therefore answer this element of s 296(3)(c): while Mr Hume had some knowledge of Giant's cash flow difficulties, Rapid was able to establish in the High Court that that understanding was merely that (a) the cash flow difficulties were temporary; (b) insurance would likely cover much of Giant's losses; (c) Giant had continued to trade with Rapid with seemingly no delays in payment; and (d) the financial effect on Giant of the payment

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22 *MacMillan Builders Ltd (in liq) v Morningside Industries Ltd*, above n 6, at 17.

23 *Baker Timber Supplies v Apollo Building Associates (Tauranga) Society Ltd (in liq)*, above n 20, at 66,793. Applied in *Harte v Wood*, above n 16, at [39].

received would be relieved in circumstances where Rapid also made a contemporaneous payment to Giant in order to discharge its debt to Giant.

Result

[32] The liquidators have failed to identify any error in the Associate Judge's carefully reasoned assessment of the evidence in applying the elements of s 296. The appeal is dismissed.

[33] Costs should follow the event. Accordingly, the liquidators must pay Rapid costs for a standard appeal on a band A basis together with usual disbursements.

Solicitors:
Fortune Manning, Auckland for Appellants