IN THE HIGH COURT OF NEW ZEALAND
WHANGAREI REGISTRY

CIV-2013-488-485
[2014] NZHC 3391

UNDER	the Companies Act 1993
IN THE MATTER OF	an application under ss 292 and 294(5) o the Companies Act 1993
BETWEEN	PETER ESMOND FARRELL and SIMON PAUL ROGAN Applicants
AND	MAX BIRT SAWMILLS LIMITED Respondent

Hearing: 10 June 2014

Appearances: J A MacGillivray and S Jass for Applicants
L Turner for Respondent

Judgment: 22 December 2014

JUDGMENT OF ASSOCIATE JUDGE R M BELL

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*This judgment was delivered by me on **22 December 2014** at **11:30am***
Pursuant to Rule 11.5 of the High Court Rules

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Registrar/Deputy Registrar

Solicitors:
Tompkins Wake, Hamilton, for Applicants
Whaley Garnett, Auckland, for Respondent

Counsel:
Lewis Turner, Auckland, for Respondent

CONTENTS

[1] This is a voidable transaction case under ss 292-296 of the Companies Act 1993. It arises out of the way that Bay Lumber Ltd, now in liquidation, reduced its indebtedness to Max Birt Sawmills Ltd while it was insolvent during the two years before a liquidation application was made.

[2] Max Birt supplied logs to Bay Lumber for processing. Bay Lumber supplied milled timber to Max Birt. While they intended that Max Birt's supply of logs to Bay Lumber should roughly equal the value of timber supplied by Bay Lumber to Max Birt, an imbalance developed over time. At the end of June 2011 the value of logs Max Birt had supplied to Bay Lumber exceeded the value of timber delivered and payments made by Bay Lumber by $262,487.38. June 2011 is the month of peak indebtedness. The disparity did not get any higher. By November 2011 Bay Lumber had closed the gap.

[3] An order for Bay Lumber to be put into liquidation was made on 26 March 2012 on an application filed on 23 February 2012. For the two years before 23 February 2012 (the start of the specified period under s 292(5)(b) of the Companies Act), Bay Lumber was insolvent. In closing the gap between the values of logs received and timber supplied, Bay Lumber cleared its indebtedness to Max Birt. As a result, Max Birt received more than it would in the liquidation. The amount of the preference is $262,487.38. Under s 295 of the Companies Act there will be an order that Max Birt is to pay the liquidators of Bay Lumber $262,487.38 plus interest on that sum from 26 March 2012 at five per cent per annum to the date of judgment.

[4] Aspects to be noted at this stage are:

(a) Bay Lumber closed the gap by both supplying timber and making payments which exceeded in value the logs supplied by Max Birt and payments it made.

(b) The transactions relevant to reducing the debt run only from the month of peak indebtedness, not from the start of the specified period or any other earlier time.

(c) I have taken the peak at the end of the month, not part way through the month.

(d) In measuring the preference Max Birt obtained, I have gone by the respective values of logs and timber supplied and payments made, not by the face value of indebtedness recorded in the accounts.

(e) I have not found that Max Birt has any defence under s 296.

[5] Neither side sought that result. The liquidators claim $1,095,311.94. On the other hand, Max Birt contends that it should not pay anything.

[6] The differences between the parties are:

(a) The liquidators rely on the way that the parties ran their accounts under their supply agreement to say that Bay Lumber reduced its indebtedness by $1,095,311.94. They say that the reduction in indebtedness should not be measured by the difference in values of logs and timber supplied. They take the sum of $1,095,311.94 as the amount of Bay Lumber's indebtedness to Max Birt at 29 June 2011, which was entirely cleared by the date of liquidation. The indebtedness was no higher at the end of any other month. It has followed a peak indebtedness approach.

(b) Max Birt says that peak indebtedness should not be applied. When there is a continuing business relationship under s 292(4B) of the Companies Act, the court should take into account all the transactions between Bay Lumber and Max Birt within the specified period under s 292(5) of the Companies Act, not just those after the indebtedness has peaked. Max Birt says that between 23 February 2010 and the end of the continuing business relationship, any indebtedness of Bay Lumber to Max Birt increased and there was accordingly no preference under s 292(2)(b) of the Companies Act.

(c) Part of the liquidators' analysis is to treat transactions for $188,559.66 on 30 November 2011 and for $181,560.65 on 31 December 2011 as outside the continuing business relationship, but which resulted in a reduction of indebtedness. Max Birt rejects this. It says that the liquidators have mischaracterised what are essentially no more than accounting entries, which do not amount to transactions under s 292.

(d) Max Birt raises an affirmative defence under s 296(3). It acted in good faith. It did not have reasonable grounds for suspecting and a reasonable person in its position would not have suspected that Bay Lumber was or would become insolvent. It gave value by making further supplies of logs, and it altered its position in the belief that payments it had received from Bay Lumber were valid by making a major capital investment which it would not otherwise have made.

[7] These matters are not in dispute:

(a) The insolvency of Bay Lumber Ltd at the material times. The liquidators presented strong evidence to show that Bay Lumber Ltd was not able to pay its debts. Max Birt did not challenge that, although it maintained that it did not suspect insolvency.

(b) There was a continuing business relationship between Bay Lumber and Max Birt under s 292(4B) of the Companies Act, although the parties differed on how the subsection applies in this case.

(c) As a creditor, Max Birt has received more than it would in the liquidation.

[8] A large part of the case turns on an analysis of transactions between Bay Lumber and Max Birt. Mr Farrell, one of the liquidators, Mr Dobson, a forensic accountant, and Mr Chapman, an accountant with insolvency expertise instructed by Max Birt, gave evidence as to different ways in which the transactions could be analysed. At the hearing I was given an agreed 13-page schedule detailing the

transactions between Bay Lumber and Max Birt between 31 January 2010 and 10 January 2012. That schedule helpfully showed the results arising from the differences in their approaches. I express my thanks – deciding this case would have been much more difficult without it.

Background

[9] Bay Lumber carried on business at Waipapa in the Bay of Islands treating and processing logs. Its major suppliers were Taumata Plantations Ltd and White Cliffs Forests Ltd. Max Birt was Bay Lumber's major customer, buying most of its milled timber. Max Birt started buying timber from Bay Lumber in 2006. Bay Lumber had started with a small portable mill, putting through small volumes, but in 2007-2008, as a result of increased business it was doing with Max Birt, it set up a fixed mill allowing it to process significantly greater quantities.

[10] In 2009 Bay Lumber had cash-flow problems. It was not paying Taumata Plantations Ltd, which was threatening to cut off supplies. Mr Birt, Max Birt's director, was keen to ensure security of supply. He also saw Bay Lumber as a source of higher quality timber. He struck on the idea that Max Birt would pay for the supply of the logs to Bay Lumber at cost, and Bay Lumber would supply Max Birt with premium quality product in preference to any other customer. At the same time, a repayment plan would be made for Bay Lumber's debt to Taumata to be reduced.

[11] That led to two agreements – a supply agreement between Bay Lumber and Max Birt, and a repayment agreement between Taumata, Bay Lumber and Max Birt.

[12] Under the repayment agreement, Taumata undertook to continue supply to Bay Lumber in return for Bay Lumber making payments not only for current supply but also to reduce existing debt plus certain one-off payments. Bay Lumber authorised Max Birt to pay Taumata directly what it would otherwise have paid to Bay Lumber for timber. The debt to Taumata was to be repaid by January 2011, and that was apparently carried out.

[13] The supply agreement between Bay Lumber and Max Birt is more important for this case. It provided for Max Birt to order timber from Bay Lumber from time to time; Bay Lumber would use all reasonable efforts to meet all orders; Bay Lumber would make premium quality products available in preference to any other customer; and Bay Lumber was to use reasonable endeavours to fulfil all orders in a timely manner. On its side, Max Birt, in its discretion, could provide assistance to Bay Lumber by ordering logs in its name for delivery to Bay Lumber. Bay Lumber agreed to pay Max Birt for the logs supplied at cost, that is, without any mark-up.

[14] Clause 4 of the agreement said:

> 4.1 Each Party shall pay the full amount invoiced to it by the other Party by any, or a combination, of the following methods:
>
> (a) by cash payment made on the last day of the month following the date of invoice;
>
> (b) by offsetting an amount due to that Party by the other Party.

[15] Max Birt supplied logs to Bay Lumber until 9 November 2011. Bay Lumber supplied timber to Max Birt until 7 December 2011. Between 21 January 2010 and liquidation, the total value of logs Max Birt supplied to Bay Lumber was $8,510,624.17. The total value of the timber Bay Lumber delivered to Max Birt in the same period was $8,600,035.48. There were also payments going both ways. Bay Lumber paid $884,239.95 to Max Birt. Max Birt paid $961,045.43 to Bay Lumber. The net result was that Max Birt was $12,605.83 to the good. After Bay Lumber went into receivership, Max Birt refunded the overpayment to the receivers.

[16] The relationship between Max Birt and Bay Lumber fell apart during 2011. Mr Birt's explanation is that he found that he was not getting the exclusive supply of premium quality timber contracted for. Bay Lumber was also selling quality timber to his competitors, who were undercutting him on the Australian market. He no longer wanted to subsidise his competitors. Although this was not part of his explanation, at the same time, Max Birt's accounting staff were encountering increasing difficulties in obtaining payments from Bay Lumber.

[17] The Bank of New Zealand appointed receivers of Bay Lumber on 14 February 2012. The receivers realised assets of Bay Lumber but were not able to recover enough to pay the bank's debt in full. There were no funds from the receivership available to pay the preferential claim of the Commissioner of Inland Revenue for $488,000, let alone ordinary unsecured creditors.

[18] In a report to creditors of May 2013, the liquidators advised that they had received claims of $3,921,551, of which $489,575 was preferential, $2,309,011 was claimed as secured and $1,122,965 as unsecured. Realisations until then amounted to $285,980, with a further $70,000 payable under settlement of another voidable transaction claim. So far in the liquidation there are no funds available for unsecured creditors. Mr Farrell's assessment is that unsecured creditors are unlikely to receive more than 20 cents in the dollar.

The liquidators' claim

[19] Liquidators who allege that creditors have received more than they would in the liquidation while the company was insolvent are required to identify transactions to be set aside as voidable.[1] In this case the liquidators specify three transactions under s 292 and s 294(2)(c):

(a) a running account from 29 June 2011 to 9 November 2011 when Bay Lumber reduced its indebtedness from $1,095,311.94 to $370,120.31, a net reduction of $725,191.63;

(b) a credit of $188,559.66 on 30 November 2011; and

(c) a credit of $181,560.65 on 31 December 2011.

[20] Combined, the reduction in debt comes to $1,095,311.94.

[21] In treating all the dealings between the parties between 29 June and 9 November as a single transaction, the liquidators are applying the running account

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1 Companies Act, s 294(2)(c).

provisions of s 292(4B). They say that the continuous business relationship came to an end on 8 November because that is the last day Max Birt supplied logs to Bay Lumber.[2]

[22] The other transactions were after the end of the business relationship. The parties differ on how those transactions are to be characterised. In the hearing the liquidators relied on the decisions in *Trans Otway Ltd v Shephard* to say that payment may be made be set-off.[3]

[23] There is some untidiness with the numbers. The liquidators say that they obtained the sum of $1,095,311.94 as a starting amount by taking the sum of $470,139.86 as the indebtedness at 1 June 2011 and have added on supplies of logs until 29 June 2011 amounting to $625,172.08. The liquidators have taken 29 June as the date of peak indebtedness. On 30 June, Max Birt supplied $33,843.70 of logs, Bay Lumber delivered $6,807.41 of timber, Bay Lumber paid $150,000 and a credit by set-off of $314,208.69 was recorded – resulting in a net reduction in debt. The liquidators say that the logs supply on 30 June was $31,680.24, not $33,843.70. They did not take that into account "in order to avoid any undue disadvantage" to Max Birt. A more likely explanation is that they could obtain a higher starting amount if they left the transactions of 30 June out of account.

[24] The agreed schedule shows different amounts. At 29 June the figure for Bay Lumber's debt before the transactions of 30 June is $1,090,559.92. As the experts conferred and agreed on the figures in the schedule, I prefer it. If I were to take a date of peak indebtedness, rather than the end of the month, and I were to apply the face value of the debt, I would take $1,090,559.92 as the starting figure.

How Max Birt and Bay Lumber recorded their transactions

[25] Under the supply agreement, each side invoiced the other for logs supplied or timber delivered. At the end of each month there was a reconciliation, usually by

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2 There is a minor difference between the parties whether the correct date is 8 or 9 November, but in this decision, the difference does not matter.

3 *Trans Otway Ltd v Shephard* [2005] 3 NZLR 678 (CA), [2006] 2 NZLR 289 (SC).

Max Birt's accounting staff.[4] Bay Lumber's staff invariably accepted the calculations by Max Birt. It was determined whether payment for logs supplied in the previous month would be paid by cash or set-off. When it carried out the reconciliation, Max Birt applied the total of the invoices for logs it had supplied to Bay Lumber during the month, but it did not take into account at that stage the invoices for milled timber delivered by Bay Lumber in that month. They were only taken into account in the calculation in the next month. There was a lag in the Bay Lumber timber invoices being brought into account. As an example, if Max Birt supplied Bay Lumber with $10,000 of logs in a month and Bay Lumber supplied Max Birt with $10,000 of timber in that period, the reconciliation at the end of the month would show Max Birt as a creditor of Bay Lumber for $10,000 but Bay Lumber's supply of timber would not be brought into account until the following month.

[26] This lag in bringing into account timber supplied by Bay Lumber to Max Birt can be seen in the schedule provided in the hearing. The schedule begins at 31 January 2010. In that month, Max Birt had supplied Bay Lumber with logs to the value of $381,150.90. Bay Lumber delivered timber to Max Birt worth $321,377.48. The difference in value is $59,773.42 but the liquidators' analysis has treated Bay Lumber as indebted to Max Birt in the sum of $381,150.90. The timber deliveries in January 2010 have not been taken into account.

[27] Similarly, at the start of the specified period, 23 February 2010, the difference in value between logs supplied and timber delivered since 31 January 2010 was $93,028.52 but the liquidator has treated Bay Lumber as indebted to Max Birt in the sum of $766,142.03. Supplies of logs during the month have been taken into account to reach that figure, but deliveries of timber have not. The schedule shows a set-off for 26 February 2010 for $325,627.36 which is supported by a remittance advice issued by Bay Lumber Ltd on 26 February 2010.

[28] The liquidators explain that Max Birt was not required to take into account the deliveries of timber during the month until the end of the month. Their case is that Max Birt's indebtedness for timber supplied did not arise until the end of the

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4 There is evidence that Bay Lumber did it once.

month when it was invoiced and it was therefore not necessary to take the Bay Lumber's invoices for timber into account before then. No set-off could be applied earlier.

[29] For my part I have difficulty understanding why Max Birt could debit Bay Lumber with supplies of logs during the month, but defer taking into account deliveries of timber until later. But that doubt does not matter. Max Birt did not submit that the monthly off-sets carried out did not follow the terms of the supply agreement. It would have had difficulty doing so, because there was clear and uncontradicted evidence of a consistent course of dealing in carrying out the off-sets in the way outlined above. This is a case where the parties' subsequent conduct goes to the meaning of the contract.[5] It is, alternatively, a case of estoppel by convention.[6]

[30] I accordingly hold that the indebtedness of Bay Lumber to Max Birt is to be calculated during the specified period by applying the parties' reconciliations under clause 4 of the supply agreement. Mr Farrell has applied that. I accept his approach but apply the amounts shown in the agreed schedule.

[31] At the same time it is also important to recognise that the statement of the parties' accounts at any one time does not reflect the net difference in the values of their supplies to each other at that time. The agreed schedule shows Mr Chapman's calculation of differences in values based on logs supplied, timber delivered and payments between the parties. There are significant differences between the recorded indebtedness and the actual differences in values. Under the way the parties did the accounts, Bay Lumber was always indebted to Max Birt, but for periods (most of the time between the end of March 2010 and the beginning of February 2011) the payments and deliveries Bay Lumber made to Max Birt exceeded the value of logs and payments it received.

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5 *Wholesale Distributors Ltd v Gibbons Holdings Ltd* [2007] NZSC 37, [2008] 1 NZLR 277. For this case it does not matter whether the approach of Tipping and Anderson JJ, that subsequent conduct must be that of all parties to a contract, or that of Thomas J, under which the conduct of only one party can be relevant, applies because, even on the approach of Thomas J, Max Birt is not entitled to adopt an interpretation contrary to its earlier conduct.

6 *National Westminster Finance NZ Ltd v National Bank of NZ Ltd* [1996] 1 NZLR 548 (CA).

How to measure the preference – by values of supplies or amount of debt?

[32] In almost every voidable transaction case, the direction of supply is one way. The alleged preferred creditor has made supplies (of goods, services or funds) to the company, for which it has not been paid. This case is unusual as involving supplies going both ways as part of a continuing business arrangement. Before seeing how there can be a preference in this case and how it is to be measured, it is useful to highlight two aspects of voidable transactions, one legal, the other economic.

[33] As to the legal, a starting point is Dixon J's statement in *Robertson v Grigg*:[7]

> The relationship of debtor and creditor was for long the very foundation of the provisions of bankruptcy law affecting preference, and, although exceptions have been introduced, the old rule otherwise remains and nothing can amount to a preference unless the person preferred is a creditor.

[34] In *Airservices Australia v Ferrier*, Brennan CJ said:[8]

> To be a preference a payment must discharge, pro tanto, an existing debt.

That is also reflected in s 292(2)(b) of the Companies Act: an insolvent transaction enables a supplier to "receive more towards satisfaction of a debt owed by the company". A supplier is a creditor when it has not been paid for supplies it has made. (There may of course be other creditors besides suppliers.) A supplier will not be a creditor if it has been pre-paid or is paid on delivery.[9] In law there is no debt. Such a transaction cannot be challenged under s 292. Ormiston JA gave a policy explanation in *V R Dye & Co v Peninsula Hotels Pty Ltd*:[10]

> So it has been accepted for many years that, as long as the company does not pay out existing creditors without obtaining an effective corresponding advantage, then it should be allowed to acquire goods and services by pre-payment or on cash on delivery terms. The rationale behind the "exception" (more precisely, the non-inclusion within the general rule) is that the company gains goods and services to an equivalent value (in broad terms) to

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7 *Robertson v Grigg* (1932) 47 CLR 257 at 271.

8 *Airservices Australia v Ferrier* (1996) 185 CLR 483 at 491 (dissenting, but not on this point).

9 *Airservices Australia v Ferrier*, above n 8, per Toohey J at 516-7 (dissenting, but not on this point); *V R Dye & Co v Peninsula Hotels Pty Ltd* [1999] 3 VR 201 (VSCA) per Ormiston JA at [29]-[31]; *Re Advocate Advertising Ltd (in liq), Burgess v Raindance Company NZ Ltd* [2013] NZHC 2738.

10 *V R Dye & Co v Peninsula Hotels Pty Ltd* , above n 9, at 34.

> that which it pays out to obtain them, so that existing creditors cannot in theory be prejudiced by the payment.

[35] That explanation goes to the economic aspect - the conferral of value by the supplier. The law as to voidable transactions is concerned with creditors (including unpaid suppliers) receiving more than they would in the liquidation. But if the supplier confers equivalent value on the company, the supplier gains no advantage and the assets available for creditors are not reduced. In *Farrell v Fences & Kerbs Ltd*, a decision as to "gave value" under s 296(3)(c), the Court of Appeal held that value given at the time the antecedent debt arose was not relevant. Value would count if it was given at the time of the alleged preferential transaction or later.[11] This notion that a contemporaneous or future conferral of value will go towards avoiding or reducing a preference also applies outside s 296(3). As Ormiston JA pointed out, it is one reason why pre-payments and payments on delivery do not involve preferences. It will also go to whether a supplier has received more than it would in the liquidation for the purpose of s 292(2)(b). The Australian courts recognised this in holding that in running account cases, further supplies made by a creditor should be taken into account in establishing whether there had been a preference. These cases are significant as they show the development of principle before the running account doctrine was enacted in statute. The decision of the majority in *Airservices Australia* shows the relevance of conferring value in a running account to establish the ultimate effect of a payment:[12]

> If a payment is part of a wider transaction or a "running account" between the debtor and the creditor, the purpose for which the payment was made and received will usually determine whether the payment has the effect of giving the creditor a preference, priority or advantage over other creditors. If the sole purpose of the payment is to discharge an existing debt, the effect of the payment is to give the creditor a preference over other creditors unless the debtor is able to pay all of his or her debts as they fall due. But if the purpose of the payment is *to induce the creditor to provide further goods or services* as well as to discharge an existing indebtedness, the payment will not be a preference *unless the payment exceeds the value of the goods or services acquired.* In such a case a court, exercising jurisdiction under s 122 of the Bankruptcy Act, looks to the ultimate effect of the transaction. Whether the payment is or is not a preference has to be "decided not by

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11 *Farrell v Fences & Kerbs Ltd* [2013] NZCA 91, [2013] 3 NZLR 82 at [86]-[93].

12 *Airservices Australia v Ferrier* (1996) 185 CLR 483 at 501-503. Other running account cases include *Richardson v Commercial Banking Company of Sydney Ltd* (1952) 85 CLR 110; *Rees v Bank of New South Wales* (1964) 111 CLR 210; and *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266.

> considering its immediate effect only but by considering what effect it ultimately produced in fact".
>
> As a consequence, a payment made during the six month period cannot be viewed in isolation from the general course of dealing between the creditor and the debtor before, during and after that period. Resort must be had to the business purpose and context of the payment to determine whether it gives the creditor a preference over other creditors. To have the effect of giving the creditor a preference, priority or advantage over other creditors, *the payment must ultimately result in a decrease in the net value of the assets* that are available to meet the competing demands of the other creditors.
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> …
>
> If at the end of a series of dealings, the creditor has supplied goods to a greater value than the payments made to it during that period, the general body of creditors are not disadvantaged by the transaction – they may even be better off. The supplying creditor, therefore, has received no preference.
>
> (Emphasis added)

[36] Referring to the running account cases, in *Trans Otway Ltd v Shephard* the Supreme Court said:[13]

> 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.

[37] Now for this case of supplies going both ways. I take again the example of Max Birt supplying logs worth $10,000 and Bay Lumber supplying timber worth $10,000 in the same month. These are contemporaneous supplies. It does not matter that on any particular day one may have supplied more than the other. The parties arranged their accounts so that supplies during any month were aggregated. In *Farrell v Fences & Kerbs Ltd* the Court of Appeal indicated that a realistic commercial approach was required on matters of timing.[14] I deal further with this timing aspect later.[15]

[38] Under the parties' course of dealing, at the end of the month when accounts were taken, Bay Lumber was indebted to Max Birt for $10,000 for logs supplied but Bay Lumber was not a creditor of Max Birt for the $10,000 of timber delivered. It

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13 *Trans Otway Ltd v Shephard*, above n 3, at [11].

14 *Farrell v Fences & Kerbs Ltd*, above n 11, at [90]. See also *Burgess v Raindance Company NZ Ltd*, above n 9, at [44].

15 Below at [69]-[71], [75].

would not become a creditor for that sum until later. The liquidators' position is that they can take that $10,000 debt to Max Birt as the amount of Bay Lumber's indebtedness and challenge later transactions that reduce that indebtedness, including the later credit to Bay Lumber for the delivery of timber, even though Bay Lumber gave equivalent value for Max Birt's supply at the same time. They would have it that Bay Lumber's timber delivery, which would become the subject of the contractual set-off under clause 4 of the supply agreement, is a preferential transaction, because it goes in reduction of a debt that had already accrued.

[39] The liquidators made this point by an argument based on insolvency set-off under s 310 of the Companies Act. It went this way. Before the time for set-off under clause 4 of the supply agreement arrived, any debt payable by Bay Lumber for logs supplied was to be dealt with separately from any debt owed by Max Birt for timber delivered. If Bay Lumber were to go into liquidation before the date for set-off had arrived, s 310 would govern whether there could be insolvency set-off. If Max Birt could not show that it did not have reason to suspect that Bay Lumber was not able to pay its debts, under s 310(2) there could not be insolvency set-off.[16] In that case, Max Birt would have to pay for any timber supplied and would have to claim separately in the liquidation, along with other unsecured creditors, for any debt for logs supplied.

[40] The basis for this argument lies in the decisions of the Court of Appeal and Supreme Court in *Trans Otway Ltd v Shephard*.[17] The Court of Appeal accepted that there could be payment by set-off, which may be a voidable transaction under s 292, if it enables a creditor to receive more than it would in the liquidation. The Supreme Court held that, while that is so, insolvency set-off under s 310 came into

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[16] Section 310(2) says:

> (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.

It is worth noting that transactions not involving indebtedness are not caught by this provision.

[17] *Trans Otway Ltd v Shephard*, above n 3.

consideration. If the set-off under s 310 would apply if the company were put into liquidation ahead of the contractual set-off, there would be no preference, but that was in turn subject to the exception under s 310(2).

[41] Sophisticated as that argument is, it deals only with the legal aspect at the expense of the economic. It ignores the fact that there has been a contemporaneous exchange of equivalent values. In economic terms, the positions of Max Birt and Bay Lumber have not changed. The value of assets available for creditors is constant. Max Birt has not gained any advantage over other creditors. In commercial terms, there are no transactions directed at discharging any existing indebtedness. In economic terms it is misleading to treat one party as having given credit to the other, whatever may be the position under the law.

[42] It is when there is a disparity in the values of contemporaneous supplies that it may be necessary to examine transactions that go to discharge indebtedness. So if Max Birt supplied $20,000 of logs in the month in which Bay Lumber delivered $10,000 of timber, later transactions to close the $10,000 gap may give a preference to Max Birt. Again, in economic terms, Max Birt is a creditor for only $10,000, not $20,000.

[43] This aspect is relevant to remedy. The purpose of orders under s 295 is to undo any preference. While a creditor should be required to disgorge all the benefits received by way of preference, it should not be ordered to give back more.[18] The discretion given under s 295 allows the court to mould orders to fit the circumstances of the case. Under the example in the last paragraph, if later transactions by Bay Lumber closed the gap, the amount by which Max Birt has benefited as a creditor is $10,000, not $20,000 as the liquidators would have it. If the transactions by which it has closed the gap are voidable under s 292, the appropriate remedy under s 295 is to order payment of $10,000, not $20,000.

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18 *Reynolds v HSE Holdings Ltd* HC Whangarei CIV-2009-488-738, 17 September 2010 at [28], *Farrell v E & E Aps* [2012] NZHC 417, (2012) 11 NZCLC 98-004 at [35], *Grant v Lotus Gardens Ltd* [2013] NZHC 1135 at [25] (overturned on appeal, but not on this point: *Grant v Lotus Gardens Ltd* [2014] NZCA 127, [2014] 2 NZLR 726).

[44] Accordingly, I shall fix the remedy under s 295 as the amount required to get rid of any preference measured by economic disparity rather than legal indebtedness.

Peak indebtedness

[45] The peak indebtedness issue arises in cases under s 292(4B):

> Where—
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> (a) a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor of the company (including a relationship to which other persons are parties); and
>
> (b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship;
>
> then—
>
> (c) subsection (1) applies in relation to all the transactions forming part of the relationship as if they together constituted a single transaction; and
>
> (d) the transaction referred to in paragraph (a) may only be taken to be an insolvent transaction voidable by the liquidator if the effect of applying subsection (1) in accordance with paragraph (c) is that the single transaction referred to in paragraph (c) is taken to be an insolvent transaction voidable by the liquidator.

[46] In a continuing business relationship, a company's indebtedness to a supplier may fluctuate over time. It is necessary to establish a starting point from which all transactions (both supplies of goods and services and payments) are combined into a single transaction. Liquidators want to go for the point where the company's indebtedness is at its highest. That means that even though there may be later transactions under which the creditor gives further value to the company, they will be exceeded in value by other transactions reducing the company's indebtedness. Liquidators will therefore look to the net reduction in indebtedness as giving a preference. On the other hand, suppliers want to take an earlier date so that the hump in indebtedness is countered by earlier transactions in which the supplier gave value to the company. In this case Max Birt wants to take 23 February 2010, the beginning of the specified period under s 292(5), as the start date, whereas the liquidators go for 29 June 2011 to maximise their recovery.

[47] This peak indebtedness question arises under effects-based régimes for voidable transactions. At common law the test for setting aside transactions as preferential was the fraudulent intention of the debtor to prefer a creditor ahead of others.[19] A claim would fail if the transaction could be explained by some other matter, such as a creditor pressing for payment, because that would negative any fraudulent intent. When there was no other evidence, payments in the ordinary course of business were not held to be fraudulent. The intention test was applied in New Zealand's insolvency legislation until the company law reforms of the 1990s. Because supplies of goods and services under a continuing business relationship could be readily explained as being in the ordinary course of business, there were no cases in New Zealand on running accounts while the test for preference was based on intention. Australia's bankruptcy legislation on the other hand had an effects-based test.[20] The intention of the debtor was irrelevant. What counted was whether the effect of the transaction was to give a creditor an advantage over others. In running account cases leading up to the High Court's decision in *Airservices Australia*, the Australian courts developed an approach of not having regard to a transaction in isolation but in considering it as part of a series of transactions to see whether the ultimate effect was to prefer a creditor. In doing so, they held that a liquidator was entitled to take the date of peak indebtedness as the starting point. In *Rees v Bank of New South Wales* Barwick CJ said:[21]

> It was also said in argument for the bank that it was not permissible for the liquidator to choose a date within the period of six months and to make a comparison of the state of the overdrawn account at that date and its state at the date of the commencement of the winding up. It was submitted that the proper comparison was between the debit in the account at the commencement of the statutory period of six months and the debit at the commencement of the liquidation – a comparison which in this case would result in a materially lesser figure than that reached by taking the liquidator's comparison. In my opinion the liquidator can choose any point during the statutory period in his endeavour to show that from that point on there was a preferential payment and I see no reason why he should not choose, as he did here, the point of peak indebtedness of the account during the six months period.

[48] The Australian courts have followed that approach. The running account test was enacted in s 588FA(3) of the Corporations Act 2001 (Cth):

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19 *Grant v Lotus Gardens Ltd*, above n 18, at [36](c).
20 *S Richards & Co Ltd v Lloyd* (1933) 49 CLR 49 at 64.
21 *Rees v Bank of New South Wales*, above n 12, at 220-221.

Where:

(a) a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor of the company (including such a relationship to which other person are parties); and

(b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship;

then:

(c) subsection (1) applies in relation to all the transactions forming part of the relationship as if they together constituted a single transaction; and

(d) the transaction referred to in paragraph (a) may only be taken to be an unfair preference given by the company to the creditor if, because of subsection (1) as applying because of paragraph (c) of this subsection, the single transaction referred to in the last-mentioned paragraph is taken to be such an unfair preference.

The Australian courts have held that under that section the peak indebtedness test continues to apply.[22]

[49] The question has arisen only relatively recently in New Zealand. When the effects-based test was introduced under the reforms of the 1990s, the ordinary course of business defence was retained.[23] It was repealed under the Companies Amendment Act 2006, under which s 292(4B) was enacted. Apart from the Supreme Court's reference in *Trans Otway Ltd v Shephard*, this was the first appearance of the running account rule in New Zealand.

[50] The general trend of New Zealand decisions is not to apply the peak indebtedness approach, but to take the start of the specified period as the point from which transactions are merged into one. The significant cases rejecting peak indebtedness are: *Shephard v Steel Building Products*,[24] *Levin v Timberworld,*[25]

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22 See *Olifent v Australian Wine Industries Pty Ltd* (1996) 14 ACLC 510 (SASC) at 516-517; *Sutherland v Eurolinx Pty Ltd* [2001] NSWSC 230 at [140]; and *Sutherland v Lofthouse* [2007] VSCA 197 at [50]. See also *Beveridge v Whitton* [2001] NSWCA 6 and *McKern v Minister of Mining* [2010] VSCA 140 for general statements that the principles developed under the old law continue to apply under s 588FA.

23 See Companies Act 1993 s 292(2) as originally enacted.

24 *Shephard v Steel Building Products (Central) Ltd* [2013] NZHC 189 at [26]-[36].

25 *Levin v Timberworld* [2013] NZHC 3180.

Levin v Z Energy Ltd[26] and *Blanchett v RBI Ltd.*[27] The only significant case going the other way is *Blanchett v McEntee Hire Holdings Ltd*.[28] All are first instance decisions.

[51] The peak indebtedness issue has to be seen in the light of the purpose of an effects-based régime for setting aside preferential transactions. In *Anzani Investments v Official Assignee* the Court of Appeal said:[29]

> The purpose of s 292 is to provide a mechanism that enables a liquidator to restore valuable consideration (of various types), with which the company parted prior to liquidation, to the pool of assets available for distribution among all creditors. The object is to prevent one creditor from being given preferential treatment through payment (pre-liquidation) of an amount in excess of that which would have been received had it participated with other creditors of equal rank in the distribution of the proceeds of sale of assets on liquidation. Those general principles are qualified by limited exceptions contained in s 292.

[52] The Companies Act régime for distributions under ss 312, 313 and Schedule 7 prescribes priorities among classes of creditors, with creditors of equal ranking sharing pari passu. Section 292 is directed at recovering from those who have received preferential treatment ahead of those with higher ranking (for example, employees and certain statutory creditors) or more than those with equal ranking. As s 292(2)(b) recognises, only creditors may be required to disgorge; that excludes those pre-paid or who have obtained by payment on delivery. A creditor who confers value at the time of supply or later does not receive preferential treatment to the extent of the value conferred. That creditor is preferred only to the extent that any reduction in debt exceeds the value of the supply. It is the ultimate effect that counts.

[53] In the case of a running account that fluctuates with deliveries and payments over time, there may be periods where the value of supplies will exceed the payments made. Indebtedness will increase. When the payments exceed the values of supplies, debt will reduce. The point of peak indebtedness marks the time after

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26 *Levin v Z Energy Ltd* [2014] NZHC 688.
27 *Blanchett v RBI Ltd* [2014] NZHC 1602.
28 *Blanchett v McEntee Hire Holdings Ltd* (2010) NZCLC 764,763 (HC) at [51]-[54], [62] and [69].
29 *Anzani Investments Ltd v Official Assignee* [2008] NZCA 144 at [6].

which all payments or other reductions in debt are not matched by the values of all supplies. Those who argue against peak indebtedness say that earlier supplies, while debt was increasing, can be brought into account against later reductions in debt. Given the general purpose of the voidable transaction régime, those arguing against peak indebtedness have the onus of showing that it should not apply. In particular, the Court of Appeal's decision in *Farrell v Fences & Kerbs Ltd*, that value given at the time of the antecedent but unpaid debt is not relevant, is an important pointer not only under s 296, but also to the approach to preferential transactions generally.

[54] The effect of rejecting peak indebtedness is to make a special case for suppliers in a continuing business relationship. Their case is that they are to be treated differently from creditors of equal ranking, such as one-off suppliers, because value they gave in the past can be taken into account in assessing preference. In effect they are trying to tweak the policy explanation given by Ormiston JA in *V R Dye & Co*[30] to also cover those who gave value in the past.

[55] In principle, there does not seem to be a basis for making them a special case. That is because of a strong policy for creditor equality. That policy can be seen in the adoption of an effects-based approach to preferential transactions and the abolition of the ordinary course of business defence. In ss 312 and 313 and Schedule 7, Parliament set out when creditor equality should not apply by applying a ranking scheme. Suppliers who cannot bring themselves within any of the preferential creditors rank with other unsecured creditors. At that level, there is no discrimination among creditors. Creditors include anyone entitled to claim in the liquidation.[31] Under s 303 a creditor may claim for a debt or liability, present or future, certain or contingent. That extends beyond those who have supplied goods, services or funds on credit. It includes involuntary creditors, such as non-preferential statutory creditors owed, for example, income tax or accident compensation levies. (They do not give credit, it is taken.) It also includes tort victims and like claimants, who were never intended to be creditors. They must bear the burden of the company's insolvency equally.

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30 *V R Dye & Co v Peninsula Hotels Pty Ltd* , above n 10, at [34].

31 With the exception of secured creditors. See definition of "creditor" in s 240(1).

[56] The strength of the policy can be seen in the Court of Appeal's decision in *Rea v Russell*.[32] A managing director of an insolvent finance company was also the agent of a trustee. Without authority of the trustee, he paid trust funds to the finance company. The company made payments in partial restoration of the misappropriated funds. After the finance company went into liquidation, the liquidators sued to recover from the trustee the payments the finance company had made to the trustee. At first instance I considered that the trustee was a property claimant, something more than a creditor, and that a victim of a misappropriation (whose funds should never have been added to the assets of the company) should not have to pay back for the benefit of other creditors what it had received in partial restitution.[33] The Court of Appeal disagreed. It held that the trustee could only resist the claim if it could trace the funds taken from it into the repayments it received. Even though the trustee did not benefit personally and he had not breached any duty to the company or the liquidators, the Court of Appeal refused to limit his liability to the assets of the trust. The Court treated the trustee, the victim of a misappropriation, in just the same way as any other creditor.

[57] While many creditors will be able to tell hard luck stories as to how they came to be unpaid creditors in the liquidation and why they ought not to pay back any reductions in debt, the law does not differentiate among them, except to the extent the Companies Act expressly allows, as under s 296. It is against that strong policy that the arguments of those opposing peak indebtedness are to be assessed. At this stage it does not appear that in general any unfairness to suppliers who give credit on a running account basis in a continuing business relationship makes them any more deserving than any other class of unsecured creditor. It is hard to see why they should be a special case.

The text of section 292(4B)

[58] One of the arguments of those opposing peak indebtedness turns on the drafting of the subsection: "all the transactions" in s 292(4B)(c) encompasses

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[32] *Rea v Russell* [2012] NZCA 536.
[33] *Rea v Russell* [2012] NZHC 11.

transactions before and after peak indebtedness. Before dealing with that, it is necessary to note certain aspects of subsection (4B).

[59] The first is to inquire what would be the result, if the subsection had not been enacted in the Companies Amendment Act 2006. As already noted, the ordinary course of business defence was removed, reinforcing that this was an effects-based test for setting aside preferential transactions. Without the subsection, the law would be in much the same state as Australia's before s 588FA of the Corporations Act was enacted. The case law developed in Australia on running accounts based on ultimate effect would apply.[34] It may however have required a period of trial and error for New Zealand insolvency practitioners, lawyers and courts to work that out. Given the guidance of Australian case law, the peak indebtedness rule would be applied to fix the time from which any preference should be measured. Instead of leaving the matter to be worked out piecemeal in cases, Parliament addressed the matter expressly by enacting in the subsection the very words Australia had used to codify the running account rule. In adopting that, Parliament was expressly directing the courts to follow the Australian approach.

[60] Second, the Australian courts have not changed their approach in applying s 588FA. The principles established by case law continue to apply. It is business as usual with the peak indebtedness test.[35] The Australian courts have not seen any need for change based on the drafting of the subsection. Parliament's direction to follow the Australian approach entails applying peak indebtedness. Given the common statutory purpose, it would be odd for the courts in Australia and New Zealand to interpret the identical words differently.

[61] Third, as a matter of drafting, the subsection is not an exception. Instead it states a test for measuring the extent of preference, if any, in the case of a continuous business relationship. That is in contrast with the ordinary course of business defence, which was drawn as an exception in the original s 292(2). That means that the subsection is not a replacement for the ordinary course of business defence and is

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[34] The Supreme Court's decision in *Trans Otway v Shephard*, above n 3, seems to recognise this.
[35] See paragraph [48] above.

not intended to serve a similar purpose. It is not drawn so as to create a special case for one class of creditor.

[62] Fourth, there is a certain awkwardness in the insertion of the Australian subsection into s 292. This is "drop-in pitch" legislation. While the intent is plain, there are difficulties with application. That is because the surrounding context is not the same. As one example, the Australian statute has a non-exhaustive definition of "transaction".[36] The definition in s 292(3) is exhaustive. It is directed at steps taken by a company to discharge an existing debt. But "transaction" in subsection (4B) also applies to steps taken to confer value on the company: it applies to transactions going both ways. The definition in s 292(3) does not catch all the forms of transaction conferring value on the company. Examples that come to mind are supplying services or giving a licence to use intellectual property. The way round the difficulty is not to apply the definition in s 292(3), as the context requires a different meaning.[37] Another difficulty concerns the presumptions as to insolvency. Both the Australian and the New Zealand statutes have presumptions as to insolvency, but they are different.[38] Under s 292(4A) there is a rebuttable presumption as to insolvency if a transaction takes place during the restricted period under s 292(6). Outside that period, the liquidator needs to prove insolvency. Subsection (4B) requires for the purpose of subsection (1) treating a series of transactions as a single transaction. But what if that series of transactions straddles the start of the restricted period? Who has the burden of proof then? The answer may require departing from the strict application of the single transaction provision of subsection (4B). The point is that the difficulties require a purposive approach instead of applying the literal meaning of the words.

[63] With that, I come back to "all the transactions forming part of the relationship" in subsection (4B)(c). By now it is clear that the literal meaning of the words is not decisive. They must yield to the purpose. There is nothing so far that shows any legislative intent to create a special case for suppliers in a continuing business relationship. If Parliament had intended to depart from the Australian

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36 Corporations Act 2001 (Cth), s 9.
37 *Police v Thompson* [1966] NZLR 813 (CA) at 818.
38 For the Australian, see Corporations Act 2001, s 588E.

approach and not to apply peak indebtedness, it would have used different words so as to make its intention clear. In my judgment, "all the transactions" is not temporal. It serves another purpose: it shows that transactions going both ways are caught and that all sorts of transactions count, not just those defined in subsection (3). The text does not support an argument against peak indebtedness.

Farrell v Fences & Kerbs Ltd

[64] One argument opposing peak indebtedness draws support from the following passage in *Farrell v Fences & Kerbs Ltd*:[39]

> In some important respects, the Australian approach has been adopted in our s 296. In particular, the abandonment of the "ordinary course of business" test and the adoption of the "continuing business relationship" provision in our s 292(4B). These changes indicate an intention to avoid the often difficult assessment of whether a transaction is in the ordinary course of business while still recognising an ongoing business relationship. Under s 292(4B) debits and credits can be "netted off". This may occur, for example, in a running account by treating the debits and credits as a single transaction during the two year period prior to commencement of the liquidation. In this respect, the ordinary course of business test has been given at least a partial recognition to assist creditors who engage in ongoing business relationships with a company that ultimately becomes insolvent. This is likely to be a significant benefit to creditors who continue to trade in good faith. It recognises the commercial realities for many involved in business.

[65] The Court also cited parts of the explanatory note given on the introduction of the Insolvency Law Reform Bill 2006 into Parliament, the bill that led to the Companies Amendment Act 2006 (among others):[40]

> The fundamental principle that underpins insolvency law is the pari passu or "equal step" principle. In essence, insolvency law provides for equal treatment of all creditors within a particular class. This avoids wasteful races to the court. In the absence of such a principle, each creditor would have the incentive to act in their own self-interest, seeking to apply to the court first with a view to recovering everything owed to them regardless of the consequences for other creditors.
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> ...
>
> The following measures are proposed to remove the uncertainties and the inconsistencies that currently exist in the voidable transaction regime:

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39 *Farrell v Fences & Kerbs Ltd*, above n 11, at [76].

40 Insolvency Law Reform Bill 2005 (Explanatory note) at 1-19, cited in *Farrell v Fences & Kerbs Ltd* above n 11, at [45]-[47].

- replacing the "ordinary course of business" exception for setting aside a transaction with a test along the lines of the Australian "continuing business relationship". The new test will focus on the business relationship between the parties over a certain period of time. If, in the course of such a relationship, the level of the debtor's indebtedness to that creditor increases and decreases from time to time, then the relationship is to be viewed as one transaction and the net effect of those transactions together is considered in determining whether there is a preference:

- harmonising as far as desirable the personal and corporate voidable transaction provisions in the Insolvency Act 1967 and Companies Act 1993 respectively:

- adopting a defence for creditors (to avoid making a transaction void) that focuses more objectively on the knowledge of the creditor that has transacted with the debtor:

- removing the ability of a liquidator to set aside transactions by filing a notice in the Court, and extending the jurisdiction of the Associate Judges to cover all voidable transaction provisions.

[66] The explanatory note does not expressly address peak indebtedness. Its outline of the purpose of the amendments based on the pari passu principle is consistent with the purpose I have identified, as is the adoption of the Australian approach to running account cases. None of that counts against peak indebtedness. If anything, it supports it. The statement that the continuing business relationship provisions are to replace the ordinary course of business defence only records what is to occur – it does not mean that the new test is to do the work of the old.

[67] The Court of Appeal seems to have gone by the explanatory note in its passage, but it may have inferred a purpose when none was intended. The passage from the judgment needs to be read in context. The case concerned the time for giving value under s 296(3)(c). The Court did not have to decide peak indebtedness. The passage is not part of what the court had to decide, but was no more than a description of some points of similarity between the Australian statute and New Zealand's. It is followed by a discussion of differences in the area the court did have to decide. Given that the court did not have to decide peak indebtedness, it is reading too much into that passage to say that it goes against it.

Airservices Australia v Ferrier

[68] It is also claimed that the majority judgment in *Airservices Australia v Ferrier*[41] can be read as holding that peak indebtedness does not always apply. Passages such as those cited in paragraph [33] above are cited.[42] It was a continuing business relationship case, but it was not about peak indebtedness. Section 588FA of the Corporations Act did not apply to the transactions in issue.

[69] The Australian Civil Aviation Authority had provided air navigation services to an airline company until the commencement of winding up. Under the Australian statute, the specified period was six months before the start of winding up. At the start of the six months, the airline owed $4,301,071.74. At the end of the period the debt was $10,413,598.90, after crediting a payment of $1,700,703.16 made on the last day. During those six months, the airline paid the Authority a total of $10,351,523.90 but the Authority provided services to a value of $19,035,873.91 and charged penalties of $719,580.49 for late payments, a total of $20,475,034.89.[43] In short, the value of services exceeded the payments. The liquidators sued to recover $10,351,523.90 as preferential payments, saying that the services provided in that last six months were not provided on a running account basis. They succeeded at first instance and in the intermediate appellate court. The majority in the High Court held that the Authority should pay back only the last payment of $1,700,703.16, even though the Authority did provide further services on the last day.[44] The payment exceeded the value of the services on that day.

[70] The contest was whether the Authority could claim a deduction for the value of services it provided in that last six months. The majority held that it could because of the continuing business relationship, even if it could not be characterised as a running account and even though the Authority considered that there was a public interest in continuing to provide services, notwithstanding delays in payment. What counted was the ultimate effect, not taking transactions in isolation. As the

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41 *Airservices Australia v Ferrier*, above n 8.

42 *Shephard v Steel Building Products (Central) Ltd*, above n 24, *Levin v Timberworld*, above n 25 at [52], *Levin v Z Energy Ltd*, above n 26, at [19]-[21].

43 These figures are taken from the judgment of the majority at 500-501. Toohey J used different figures, see 512-3 and 523-4, but for this case the differences are not relevant.

44 *Airservices Australia v Ferrier*, above n 8, at 510.

company's indebtedness increased throughout the six months until the last payment, it is not surprising that the peak indebtedness rule was not discussed in any of the judgments. But the result, requiring repayment of the last payment, which reduced net debt, is consistent with applying peak indebtedness. The case cannot be read as rejecting peak indebtedness or supporting another approach.

Debt spike

[71] This objection is that the peak indebtedness rule does not accommodate debt spikes and is subject to arbitrary choices by liquidators. As an example, a supplier may deal with a company under a running account subject to credit limits. The customer persuades the supplier to make an exception for a one-off order, the customer pays promptly for that delivery and thereafter keeps within the credit limit. The liquidator ought not to be able to use the increase in the debt caused by that one-off order to measure the preference. Barwick CJ's formulation of the peak indebtedness test might suggest that the court should defer to the liquidator's choice, but I doubt that he intended an unprincipled approach. In my view there is a rational basis for applying peak indebtedness. It does not allow a liquidator to run rampant. In some cases it may be possible to adjust for debt spikes while applying peak indebtedness. If the supplier were to insist on cash on delivery for any supplies above the credit limit, the value of that supply ought not to count if payment is made immediately. There is no increased indebtedness in respect of that supply and no element of preference can arise. Therefore the liquidator should not be able to use that supply to assert an overall increase in indebtedness. It is only if credit is given or taken for that supply, so that the exchange of values is not contemporaneous, that the debt spike will be counted in establishing the peak indebtedness.

[72] One explanation for not including such one-off transactions is that they are not an integral part of the continuing business relationship under s 292(4B)(a). Another is that in economic terms, they do not involve any element of preference.

[73] How soon must the payment be, to be contemporaneous? In *McKern v Minister of Mining*, Nettle JA addressed the suggestion that on a literal construction,

s 588FA would apply to transactions which had never been considered voidable transactions. He gave as examples:[45]

> … if a company ordered parts COD on terms that title and risk should pass upon dispatch and paid for the parts upon delivery, the payment would be susceptible to being set aside as a voidable transaction even though the company received the parts in good order in return for payment. Similarly, if a commercial traveller with authority to purchase petrol on behalf of his corporate employer drove one the company's vehicles into a service station and filled the car with petrol costing $100.00, and then walked from the forecourt to the attendant to pay $100.00 of the company's money for the petrol, the payment would be susceptible to being set aside as a voidable transaction even though the company received a full $100.00 worth of petrol in return for the payment.

[74] In response to a suggestion made in *Ford's Principles of Corporations Law*[46] that such transactions might be excepted on the basis that, because payment is made against delivery, there is never a point at which a debt exists, he said:[47]

> Perhaps, even that idea suffers from the logical defect that a debt arises upon delivery and exists, albeit *in scintilla temporis*, until discharged by payment. But perhaps such fine theoretical distinctions should not be allowed to stand in the way of the rational operation of regime which is intended to be essentially practical.

[75] The last sentence is obviously right. As the Court of Appeal said in *Farrell v Fences & Kerbs Ltd*, a realistic commercial approach is required to make the legislation work.[48] The assessment is whether, in commercial terms, any credit is given or taken. That will depend on the circumstances of each case, including practices within the particular trade or industry and how the parties dealt with each other.

[76] Barring those cases where supply and payment are commercially contemporaneous, debt spikes do not provide a ground for rejecting peak indebtedness.

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45 *McKern v Minister of Mining*, above n 22, at [20].

46 R P Austin and J M Ramsay *Ford's Principles of Corporations Law*, (13th ed, LexisNexis, Australia, 2007) at [28.340].

47 *McKern v Minister of Mining*, above n 22, at [24].

48 *Farrell v Fences & Kerbs Ltd*, above n 11, at [90].

Summary on peak indebtedness

[77] In *Farrell v Fences & Kerbs Ltd*, the Court of Appeal declined to follow the Australian approach to "gave value" in s 296(3)(c) because of crucial differences with the Australian statute. But in the case of a continuing business relationship in which debt levels fluctuate with supplies and payments, where the identical words in the Australian statute have been inserted into s 292, it would be perverse for the meaning of the statute to change according to the side of the Tasman it is applied on. Peak indebtedness does provide a rational basis for establishing a point from which any preferential reductions in debt can be measured. Taking an earlier point entails allowing an earlier transfer of value to be brought into account in working out whether there is a preference: that is inconsistent with the general approach in an effects-based régime for preferential transactions. There is nothing in the text or the purpose of the Act for making a special case for suppliers in a continuing business relationship to require them to be treated more favourably than other creditors. Aside from debt spikes for commercially simultaneous supplies and payments, the peak debt is to be used in measuring the extent of preference under s 292(4B). For these reasons, I regretfully decline to follow other cases which have not applied peak indebtedness.

Calculating the preference

[78] At the start of June 2011, the value of Max Birt's supplies of logs and payments exceeded Bay Lumber's payments and deliveries of timber by $175,584.64. By 22 June the difference had grown to $479,229.66. At the end of the month, once further supplies on both sides were taken into account and Bay Lumber had paid $150,000, the difference was $262,487.38.

[79] Throughout their dealings over the specified period, transactions were almost daily. In June 2011, there were nine days when there were no deliveries by either side. The parties might have checked the ongoing differences in supplies on a daily basis or weekly, but instead they did it monthly. No account was taken whether a particular supply was made at the beginning or the end of the month. For them, all supplies going either way in a month were aggregated. They treated them as having

taken place within the same period. As a matter of commercial practice, all supplies during the month were contemporaneous. It would be anomalous to take any particular day during a month in isolation. In terms of these parties' dealings, it was the difference at the end of the month that counted. The end-of-month figure, $262,487.38, is the peak indebtedness.

[80] After June 2011 the supplies and payments going both ways resulted in a balance in favour of Bay Lumber of $33,680.34 at 7 December 2011, the date of Bay Lumber's last delivery to Max Birt. Max Birt in turn paid Bay Lumber $21,074.51 on 10 January 2012. It paid the remaining $12,605.83 to the receivers later. No point was taken over the receivers receiving the refund, rather than the liquidators. The amount of the preference is $262,487.38.

[81] If I am wrong on peak indebtedness and the preference is to be calculated from the start of the specified period, I would apply $74,044.11, being the difference in values at 28 February 2010, as the start amount and also the measure of preference.

Max Birt's challenge to the liquidators' second and third transactions

[82] Max Birt takes issue with the liquidators' characterisation of the last two transactions to discharge the indebtedness. They are dated 30 November and 31 December 2011. On those dates Max Birt made accounting entries in its records to show reductions in Bay Lumber's debt. By 8 November 2011 the continuing business relationship had, on the liquidators' case, come to an end, as Max Birt had made its last supply of logs. After 8 November 2011 Bay Lumber made a few more deliveries of timber. Max Birt says that there could not be any payment by set-off under clause 4 of the supply agreement, once it had stopped supplying logs. Its case, as I understand it, is that when a creditor makes entries in its accounts, that is not a transaction under s 292(3). There needs to be something moving from the company to the creditor to reduce debt and falling within one of the heads under s 292(3). As there is no transaction under s 292(3), there is nothing to be set aside. It cited this from *Harlock v Commissioner of Inland Revenue*:[49]

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[49] *Harlock v Commissioner of Inland Revenue* [2013] NZHC 3389 at [41].

> … s 292 refers to transactions "by the company". That would suggest that the expression does not extend to the point where it embraces actions or decisions of third parties which are unilateral in nature and which the company did not participate in.

[83] It is necessary to see what the liquidators are targeting in their notice under s 294 and their application. Is it a transaction under s 292 or is it something else? What does their notice mean? Max Birt seems to be saying that the notice has misfired because it refers to accounting entries it made, which are not themselves transactions by Bay Lumber under s 292. While it did not cite the case, its approach is akin to that of Lord Goff in *Mannai Investments Co Ltd v Eagle Star Life Assurance Co Ltd*:[50]

> The simple fact is that the tenant has failed to use the right key which alone is capable of turning the lock.

Lord Goff was however in the minority. In that case on interpretation of a notice given under a lease, the majority held that errors in language were not necessarily fatal, so long as the meaning could be ascertained when the notice was read in context.[51]

[84] The liquidators' notice under s 294 identifies the last two transactions:

2	30/11/2011	$188,559.66
3	30/12/2011	$181,560.65

[85] While these were accounting entries, they recorded actual reductions in debt brought about by Bay Lumber, admittedly on the lagging basis set out above. In the case of the November entry there was a netting-off, as under a payment by set-off, because both log supplies by Max Birt and timber deliveries by Bay Lumber were brought into account. The December entry recorded only deliveries by Bay Lumber, so there was no payment by set-off. But that does not matter. The relevance of those entries is that they recorded reductions in debt by Bay Lumber that had been brought about by transactions under s 292(3). In the November entry that was the payment by set-off arising out of deliveries (transfers of property) going both ways and by

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50 *Mannai Investments Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749 (HL) at 754.

51 See in particular the speech of Lord Hoffmann.

payments. The December entry, made after log supplies had stopped, recorded the effect of timber deliveries as transfers of property under s 292(3)(a), in reducing debt. Read in context, the liquidators' notice did identify transactions under s 292. Max Birt is too pedantic in taking issue with a notice that records the net reduction in debt over a period but does not specifically state the particular dealings between the parties that led to that discharge of debt.

[86] Max Birt gave an extensive written notice of objection under s 294 that set out a number of grounds. They go to the substance of the case. Some of those grounds are given under the heading: "Section 292(4b)." One ground under that heading says:

> MBS therefore also objects to the characterisation of the "transactions" referred to as '2' and '3' in the Notice, which ignores the set-off arrangement between the parties.

That does not put the matter the way counsel developed the argument in the hearing, but it does show that Max Birt was alive to the effect of the second and third transactions (as does the rest of the objection notice). It knew that they were about debt reduction as a result of the parties' dealings. It was not misled. I find that, as required by s 294(2)(c), the liquidators' notice specified transactions under s 292.

Setting aside the transactions

[87] In *Trans Otway v Shephard* the Court of Appeal held that the liquidator could choose which transactions to challenge as voidable under s 292, as when the transaction might fall under more than one head in the definition in s 292(3).[52] The transactions in the liquidators' notice and in the application, recorded at paragraph [19], all took place during the specified period, while Bay Lumber was insolvent. It is beside the point that those reductions in Bay Lumber's indebtedness might be characterised as falling under other heads of s 292(3). As the assets that might be available for unsecured creditors are much less, those transactions enabled Max Birt to receive more than it would in the liquidation. They are to be set aside under s 294. The extent of relief to redress the preference is decided separately under s 295.

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52 *Trans Otway v Shephard* (CA), above n 3, at [36].

Max Birt's defence under s 296(3)

[88] Section 296(3) says:

> (3) 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 enactment, or in law or in equity, if the person from whom recovery is sought (**A**) proves that when A received the property—
>
> (a) A acted in good faith; and
>
> (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.

[89] Max Birt is required to make out all three grounds under subsection (3). If it does, the court must not order payment under s 295 – the court has no discretion under s 296(3).

[90] As to the defence, Max Birt says that from 2008 it moved from being a niche low-grade supplier to providing a full range of timbers to the domestic market, selling low-grade timbers in the Pacific and high-grade timbers in Australia. It needed to assure itself of a reliable source of good quality timber and that led to the relationship with Bay Lumber. Its supply agreement with Bay Lumber was not for the supply of logs (on which it made no profit) but the purchase of timber. It was with that object that it had gone into the repayment agreement with Taumata Plantations Ltd and Bay Lumber. It was aware of Bay Lumber's cash-flow difficulties at that time, but believed that part of Bay Lumber's difficulties lay with its director. It was aware that Bay Lumber repaid its debt to Taumata. Max Birt had its own small mill at Kerikeri. It was aware of the costs of processing and considered that in light of the margins Bay Lumber should be operating profitably. There was a downturn in the industry and a number had cash-flow difficulties, but Mr Birt said that those who had good volumes of work survived. He put Bay Lumber in this category. In 2010 he approached the director and his father with a view to buying Bay Lumber's business, but they declined his offer. They were not

interested in selling and gave him to understand that the business was in a sound financial position. His impression was that Bay Lumber was doing relatively well, as shown by signs of significant capital investment and discretionary spending. In 2011 there were problems with delays in payment by Bay Lumber, but that was not uncommon in the industry. The director had an acrimonious marriage break-up which Mr Birt took as an explanation for some of the difficulties. The director did say on occasions that Bay Lumber could not survive on the prices Max Birt was paying but Mr Birt put that down to the usual posturing that goes with negotiations between suppliers and customers. The breakdown in the relationship in 2011 came when Mr Birt found that Bay Lumber was supplying good quality timber to Max Birt's competitors who were undercutting it in Australia. Max Birt did not want to continue an arrangement under which it was subsidising its competitors. It continued to order timber from Bay Lumber at the end of 2011, even though it stopped supplying logs, because it had customers it needed to service.

[91] As to reliance, in August 2012 Max Birt bought a timber milling business for $2.35m, which was entirely funded by external borrowing. It says that it would not have made that purchase if it had known that it would have to refund payments received from Bay Lumber.

Good faith

[92] In *Levin v Market Square Trust* the Court of Appeal said:[53]

> The first matter the trust must establish, therefore, is that it "received the property in good faith". The test of "good faith" has been clearly established by this court. The recipient of the property or money must show that he or she honestly believed that the transaction would not involve any element of undue preference either to himself or herself or to any guarantor [*Re Orbit Electronics Auckland (In Liq*) approved in *Re Number One Men Ltd (In Liq)*].[54] The cases show that a creditor is likely to fail this test where he or she has actual or implied knowledge of the company's financial

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53 *Levin v Market Square Trust* [2007] NZCA 135, [2007] 3 NZLR 591 at [54]. The case was decided under the version of s 296(3) in force between 1 July 1994 and 31 October 2007. That version of s 296(3) gave the court a discretion to decline relief in full or in part if the court considered it inequitable to order recovery in full and if "the person from whom property is sought received the property in good faith and has altered his or her position in the reasonably held belief that the transfer to that person was validly made and would not be set aside".

54 *Re Orbit Electronics Auckland (In Liq)* (1989) 4NZCLC 65.170 (CA); *Re Numer One Men Ltd 9In Liq(* (2001) 9 NZCLC 262,671 (CA).

> difficulties, due to the company's cheques being dishonoured, its failure to pay its debts on time, or of the circumstances indicating serious cash-flow problems.

[93] The good faith requirement in (a) goes to the recipient's honesty in believing that it would not be preferred. In *Royal Brunei Airlines Sdn Bhd v Tan*,[55] Lord Nicholls famously explained dishonesty in the context of accessory liability for breach of trust. He noted that acting dishonestly is not acting as an honest person would in the circumstances, and that that was an objective standard. He said:[56]

> Honesty, indeed, does have a strong subjective element in that it is a description of a type of conduct assessed in the light of what a person actually knew at the time, as distinct from what a reasonable person would have known or appreciated. Further, honesty and its counterpart dishonesty are mostly concerned with advertent conduct not inadvertent conduct. Carelessness is not dishonesty. Thus for the most part dishonesty is to be equated with a conscious impropriety. However, these subjective characteristics of honesty do not mean that individuals are free to set their own standards of honesty in particular circumstances. The standard of what constitutes honest conduct is not subjective. Honesty is not an optional scale, with higher or lower values according to the moral standards of each individual. ...

[94] That offers helpful guidance when considering "good faith" under s 296(3). Because carelessness is not a component of dishonesty, it is important to guard against imputing absence of good faith to a recipient on the basis of what they ought to have known, rather than what they actually knew.

[95] Under the test in the Court of Appeal's decision in *Levin v Market Square Trust*, to hold that Max Birt did not act in good faith requires the court not to be satisfied that it honestly believed that the payments would not involve any element of undue preference to itself.

[96] The relevant period when Max Birt received its preferences was from June to November 2011. On 23 November the disparity in values came to an end. From that time on, the credit swung in favour of Bay Lumber. During the period of preference, the main way that Bay Lumber reduced its debt to Max Birt was to deliver timber. The fact that Max Birt continued to order timber and take deliveries after the preference had been cleared suggests that its real motivation was to obtain timber for

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55 *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378 (PC).
56 At 389.

its business. Against that, there were also some payments to reduce debt. There was also a reference in an email to one delivery of timber that Max Birt did not really require. But these are not enough for me to say that Max Birt has not shown that it acted in good faith. Max Birt has satisfied the first limb.

Reasonable suspicion of insolvency

[97] In this context, it is standard to refer to the dicta of Kitto J in *Queensland Bacon Pty Ltd v Rees*:[57]

> A suspicion that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of apprehension or mistrust, amounting to "a slight opinion, but without sufficient evidence" as *Chambers' Dictionary* expresses it. Consequently a reason to suspect 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 subsection 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. ...

[98] Kitto J warned against too ready an assumption of insolvency:[58]

> In many situations, of course, the dishonour of a cheque, unless otherwise explained, carries a strong suggestion of insolvency; but in others it may indicate, to those who are constantly dealing with the drawer and know the general course he is pursuing in his business, no more than a policy of wringing the last ounce of credit out of everyone who can be fobbed off with promises.

[99] Kitto J found on the facts of that case that the dishonour of a number of cheques did not create the requisite feeling of apprehension or mistrust.

[100] In *Hamilton v Commonwealth Bank of Australia* Hodgson J said:[59]

> 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…

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57 *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 at 303.
58 At 302.
59 *Hamilton v Commonwealth Bank of Australia* (1992) 9 ACSR 90 (NSWSC) at 113.

[101] Max Birt relies on the same factors that it relied on to show good faith. However, whereas the test in *Levin v Market Square Trust* goes to the belief that the transaction does not involve any element of undue preference, here the matter goes to suspicion of insolvency. The test is not one of dishonesty but whether the information available to the creditor would have created Kitto J's feeling of actual apprehension or mistrust.

[102] The information now available to the liquidators shows the company to have been in a much worse position than Max Birt makes out. It is important not to make a hindsight judgment. The matter is to be assessed on the basis of the information available to the creditor at the time, not what others have found out later. The liquidators ran this part of the case on the basis of information available to Max Birt. While the matter is to be assessed on the totality of the information available, some of it was peripheral. The facts that the country was in a downturn and that others in the industry were failing are not by themselves enough to create the requisite suspicion. Speculation by Mr Farrell as to what Mr Birt would have known did not advance matters.

[103] The repayment agreement with Taumata clearly made Max Birt aware of Bay Lumber's financial difficulties at the time of that agreement. As time passed and as Bay Lumber cleared that debt (with the help of Max Birt through the agreement), that became less important, but it cannot be dismissed as irrelevant.

[104] More to the point is the way the parties' supply agreement operated in 2011. The original intention was to keep supplies of logs and timber more or less even, but over time Bay Lumber's deliveries of timber were not keeping up with the supplies of logs and it was struggling to match that with payments. If it was operating profitably, sales to other customers would have provided the funds to close the gap. Max Birt experienced difficulties and delays in obtaining payment. On one occasion a cheque bounced. On others Bay Lumber had to find funds for payment from a number of sources. Max Birt's staff had to press for payment a number of times. Its administration manager recorded that in an email to Bay Lumber on 10 January 2012:

> I would like to remind you of the issues and problems we have had with receiving your payments over the last 12 months (that I have been here and am aware of). I have often had to email and telephone chasing payment from you. Payments have been extremely late and you haven't adhered to payment arrangements on several occasions and we have continued to work with you and support you.

[105] Mr Birt's reaction was to regard these as no more than temporary cash-flow difficulties. I accept that he personally did not suspect insolvency. That can be seen in his continuing to deal with Bay Lumber. I accept his explanation that he severed relations only when he found out about the sales to his competitors. The liquidators try to make out something more sinister. In their eyes the supply agreement was designed to protect him against Bay Lumber's insolvency and he must have been aware all along. I do not accept that. If Max Birt had planned from the outset to protect itself from Bay Lumber's insolvency, it could have done better by purchasing logs and engaging Bay Lumber on contract to process them, while retaining title throughout.

[106] But Mr Birt's lack of suspicion is not determinative. A reasonable person, who in this case would have the knowledge and skill of someone experienced in the industry, would have suspected that given the information available to both Mr Birt and others in his company dealing with Bay Lumber, it was insolvent during the second half of 2011. Bay Lumber's ongoing inability during 2011 to make timely payments, when it could not match timber deliveries with log supplies, would lead to a suspicion that the company's position was chronic rather than a matter of temporary cash-flow difficulty. While Mr Birt was apparently confident that there was nothing amiss because Bay Lumber was processing significant volumes at reasonable margins, that optimism should not have survived the continuing payment problems.

Alteration of position

[107] Max Birt does not say that it gave value for the payments it received. The decision of the Court of Appeal in *Farrell v Fences and Kerbs Ltd*[60] stands in the

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[60] *Farrell v Fences and Kerbs Ltd*, above n 11.

way of such a submission. Instead, it says that it altered its position in the reasonably held belief that the payments would not be set aside.

[108] In *Re Bee Jay Builders Ltd (In Liq)*,[61] Fisher J said:

> The essence of an alteration of position for present purposes seems to me to be a deliberate course of conduct, be it act or omission, following receipt of the impugned payment which course of conduct the recipient would not have undertaken but for receipt of the payment and belief in its validity.

[109] Fisher J identified the injustice at which s 293(6) is directed in *Baker Timber Supplies Ltd v Apollo Building Associates (Tauranga) Soc Ltd (In Liq)*:[62]

> The main purpose ... is 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 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.

[110] In the same case, Fisher J made the point that simply applying payments received from an insolvent company in the general running of the company business is not a relevant change of position:[63]

> I do not think it sufficient for a creditor simply to rely upon its injection of the relevant funds into its working capital, with or without a reduction of its outstanding overdraft. In this case there is no satisfactory evidence of any conscious or deliberate decision to embark upon a course of action or refrain from an action in reliance upon the payment. There is no suggestion that because of the payment the applicant would now be unfairly denied the opportunity to take up a course which, without payment, would not have been pursued or would have been available as the case may be.

[111] In this case, this part of the defence under s 296(3) fails because of lack of persuasive evidence. Mr Birt's evidence is no more than general assertion in two paragraphs of his affidavit. It is little more than a pleading. The agreement to buy the timber mill has not been put in evidence, nor any financial data to show that it was critical to that investment that any past receipts not be disturbed. There is no significant evidence on which the reliance assertion can be assessed.

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

62 *Baker Timber Supplies Ltd v Apollo Building Associates (Tauranga) Soc Ltd (In Liq)* (1990) 5 NZCLC 66,791 (HC) at 66,793.

63 At 66,794..

[112] The defence under s 296(3) fails under both the suspicion and the reliance limbs.

Outcome

[113] Under the transactions in the liquidators' notice under s 294, Max Birt received more in reduction of the debt Bay Lumber owed it than it would in the liquidation. Given the parties' continuing business relationship on a running account basis, the preference is to be measured from the month of peak indebtedness, not the start of the specified period under s 292. The amount of the preference is not the face value of the debt, but is calculated by reference to the net difference in the values of supplies. That is required to ensure that the liquidators' claim is not inflated by taking into account transactions under which value was conferred contemporaneously with supplies going the other way. Max Birt's defence under s 292 fails because it has not proved absence of suspicion under subsection (3)(b) and reliance under (3)(c).

[114] I make these orders:

(a) The transactions in the liquidators' notice of 20 September 2013 are set aside.

(b) Max Birt shall pay the liquidators $262,487.38 and interest on that sum at five per cent per annum from 26 March 2012 to the date of judgment.

(c) Max Birt shall pay the liquidators' costs and disbursements.

[115] If the parties cannot agree costs, memoranda may be filed.

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Associate Judge R M Bell