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# Third party payments, voidable preferences and the Quistclose trust

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## Introduction

In preference proceedings under section 588FA, Corporations Act, or section 122 Bankruptcy Act, liquidators or trustees in bankruptcy seeking to recover alleged preferential payments made to a creditor prior to the debtor's winding up or bankruptcy, will often learn that payments to the creditor have been made by a third party as opposed to the debtor prior to the debtor's winding up or bankruptcy.

In these circumstances the creditor may be in a position to argue that the payments received from the third party arose from a Quistclose trust emanating from the dealings between the debtor and the third party making the payment. The objective of the creditor in relying on the existence of a Quistclose trust will be to deny the trustee in bankruptcy or liquidator the right to recover the payments received as unfair preferences.

Recently the Federal Court in *Rambaldi v Commissioner of Taxation* (2017) FCA 567 had occasion to consider whether third party payments in that case could be pursued by a trustee in bankruptcy under section 122 Bankruptcy Act where the payments involved were made by the third party in circumstances giving rise to a Quistclose trust.

Before reviewing the decision of the Court in this case it will be useful to reflect on the reasons why the Quistclose trust may lend itself to a creditor seeking to challenge the preference recovery proceedings being pursued by a trustee in bankruptcy or liquidator.

## Third party payments and the Quistclose trust

In commercial transactions a trust relationship may arise where A (the debtor) instructs B (the lender) from B's funds to pay C (a creditor of A) a sum of money which is not to become part of the property of A, and which is to be used exclusively for the purpose of paying C. The trust relationship arising in these circumstances is known as a Quistclose trust.

While the payment from B to C results in the extinguishment of A's debt to C the arrangement will also usually give rise to a loan agreement between A and B in respect of B's payment to C. Notwithstanding the loan agreement between A and B in these circumstances the essential intention of A and B is that the funds under B's control are held by B on trust for C and never become part of the property of A.

A possible outcome of the resulting Quistclose trust is that the payment from B to C will not constitute an unfair preferential payment

from A to C recoverable from C by a trustee in bankruptcy or liquidator in the event that A subsequently proceeds into bankruptcy or liquidation. This is the issue that arose for consideration in the *Rambaldi* case.

## Rambaldi (Trustee) v Commissioner of Taxation (2017) FCA 567, 25/5/2017

### Facts

- On 18 March 2014 the Commissioner presented a creditor's petition against the estate of Ms Alex.
- On 1 June 2014 Ms Alex entered into a Loan Agreement with Quality Australia Investments (QAI) under which QAI agreed to lend Ms Alex (and a company of which she was the sole director and shareholder) monies to satisfy Ms Alex's income tax debt, the subject of the petition.
- Clause 4 of the Loan Agreement provided that Ms Alex must only use the loan for the purpose presented to QAI, namely, the payment of Ms Alex's income tax debt and her solicitor's fees.
- Under an authority to pay executed by Ms Alex she authorized and directed QAI to pay the monies to the Commissioner by way of bank cheque.
- On 7 July 2014 the Commissioner received the bank cheque which was applied in payment of the income tax debt owed by Ms Alex.
- On 8 December a sequestration order was made against the estate of Ms Alex and the trustees were appointed.

### The issues

The only issue arising in the case was whether the loan money from QAI was property of Ms Alex, this being an express requirement under section 122, Bankruptcy Act. The trustees in bankruptcy contended that the loan money was property of Ms Alex paid by QAI at her direction. The Commissioner contended that the loan money was not property of Ms Alex but rather was held on a Quistclose trust for payment to the Commissioner. Moreover, if for any reason the payment to the Commissioner failed the funds were to be repaid to QAI.

### The decision

The Court found that the intention of the parties was to be gathered from the written Loan Agreement, and concluded that the parties intended there to be a Quistclose trust created under which Ms Alex would not hold the funds at all. The Court observed:

"The machinery adopted by the parties only serves to confirm that they did not intend that the loan money would become the property of Ms Alex … The purpose of the parties was express, namely, that the money was to be used only for the payment to the Commissioner and the solicitors." (para 46)

As a result of the loan funds being held on a Quistclose trust, the funds did not become the property of Ms Alex. It is an express requirement of a preference recovery under section 122, Bankruptcy Act that the funds received by the Commissioner were paid from Ms Alex's property. Given that this was found by the Court not to have occurred, the funds paid were not recoverable by the bankruptcy trustees as a preferential payment.

### Implications of the decision

It is apparent that this decision has significant consequences for trustees in bankruptcy seeking to avoid pre-bankruptcy preferential payments. If third party payments are implemented in circumstances similar to this case then the creditor of the bankrupt in receipt of third party payments may feel confident that the trustee in bankruptcy will have difficulty establishing that the creditor was in receipt of preferential payments within the terms of section 122 Bankruptcy Act as presently drafted.

### Does the decision in *Rambaldi* apply to unfair preference recoveries under section 588FA, Corporations Act?

As observed above *Rambaldi* is a bankruptcy case concerned with the operation of section 122, Bankruptcy Act. In the context of a company in winding up, unfair preference recoveries are pursued by the liquidator under section 588FA of the Corporations Act, which, in important respects, is expressed in terms

different to section 122, Bankruptcy Act.

In particular section 588FA when describing the elements of an unfair preference refers to a “transaction” to which “the company and the creditor are parties” and pursuant to which the creditor received from the company more than the creditor would receive in the winding up.

In view of the different terminology employed in section 588FA the question arises whether a third party payment pursuant to a Quistclose trust amounts to a “transaction” in satisfaction of section 588FA.

In Commissioner of *Taxation v Kassem* (2012) FCAFC 124 the Full Federal Court in referring to the “plain language of section 588FA(1)” clearly suggests that the requirements under section 122, Bankruptcy Act that were determinative of the decision in Rambaldi are not present in section 588FA. The Full Court observed:

“There is nothing in section 588FA(1) which expressly incorporates as a requirement for an unfair preference that the transaction must result in the diminution of the debtor’s assets.” (para’s 59-60).

Moreover at (para 56) the Full Court accepted that “in each case the court must look to the transactions between the parties in a way which accords with commercial realities … it is the objective purpose, in a business sense, of the whole transaction that must be considered.”

Similarly in the earlier case, *Re Emanuel (No 14) Pty Ltd: Macks v Blacklaw & Shadforth Pty Ltd* (1997) FCA 667 the Full Federal Court when commenting on payments to a creditor under a Quistclose trust observed that:

“All that a trust finding would do would be to change the machinery employed by the parties in extinguishing (the company’s debt to its creditor).”

In summary, the above cases involving unfair preference recoveries in a winding up clearly suggest that section 588 FA, Corporations Act is primarily concerned with whether the parties were instrumental in bringing about a transaction that generated a preferential effect. More specifically, as observed by the Court in *Re Emanuel (No 14) Pty Ltd*, a payment by a third party under a Quistclose trust at the direction of the company debtor is in reality a particular way of constituting the company and its creditor as parties to a ”transaction” in satisfaction of section 588FA.

## Concluding comments

The Rambaldi case is an important decision with respect to Quistclose trusts, third party payments and preference recoveries in the bankruptcy context. The case provides a means of ensuring that third party payments to a creditor will not in the circumstances of the case be recoverable as preferential payments in the subsequent bankruptcy of the debtor.

However, as observed above, in the context of winding up different considerations arise in view of the express terms of section 588FA, Corporations Act enabling the courts to avoid the outcomes of the Rambaldi decision.

Once again we are encountering different outcomes depending on whether the debtor is a bankrupt or a company in winding up. Such distinctions are always difficult to justify and support calls for unification of bankruptcy and corporate insolvency laws.

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