



Undervalue transactions and preferences: the “good faith” defence

Brief overview

On occasion, a third party may be the ultimate recipient of a preferential payment, or a payment resulting from an undervalue transaction. A subsequently appointed Administrator or Liquidator may wish to seek recovery of this payment pursuant to his powers to challenge vulnerable transactions. The Court of Appeal recently had to consider¹ the scope of its powers to make an order for the return of such a payment from a third party. In doing so, the Court also had to consider the application of the “good faith” defence that is available to a third party recipient in these circumstances.

The facts

Prior to entering Liquidation, Sonatacus Ltd (the “**Company**”) was involved in the sale and distribution of mobile telephones and accessories. Its sole director was Paul Susca. Rahail Aslam was an acquaintance of Mr Susca’s and was a director of an entity called CIL Ltd (“**CIL**”). In September 2000, CIL agreed to lend Mr Susca £65,000 in his personal capacity, the loan being repayable by Mr Susca in February 2001. The sum of £65,000 was then advanced by CIL to the Company rather than to Mr Susca, although the obligation to repay that sum remained with Mr Susca.

In late January 2001, only three weeks before the term of the loan expired, £50,000 was repaid by the Company to CIL. This payment was found by the Court to have been made at a time when the Company was insolvent, or in circumstances such that the Company became insolvent as a result of this payment. Two months later, in late March 2001, the Company entered Creditors’ Voluntary Liquidation.

Subsequently, the Liquidators commenced proceedings against CIL alleging that the payment of £50,000 it received from the Company was a preference (under s239 Insolvency Act 1986 (“**IA 1986**”)), or alternatively, a transaction at an undervalue (under s238 IA 1986) and that accordingly, the transaction was void or voidable by the Liquidators.

Discharge of debts: the contractual setting

Prior to considering whether the payment by the Company to CIL amounted to a preference or a transaction at an undervalue, the Court of Appeal had to first determine the underlying contractual setting in which that payment was made.

The Court found that upon the initial payment of £65,000 by CIL to the Company, Mr Susca became a debtor to CIL for that amount and at the same time, the Company became a debtor to Mr Susca for that same amount. Thus, CIL itself was not a creditor of the Company.

The subsequent repayment of £50,000 by the Company to CIL then discharged, to that extent, Mr Susca's debt to CIL and the Company's debt to Mr Susca. The Court said that insofar as the payment of £50,000 discharged the Company's debt to Mr Susca, the Company gave a preference to Mr Susca within s239 IA 1986. However, the Liquidators were, understandably, pursuing CIL for recovery, as the recipient of the payment, and had not commenced proceedings against Mr Susca.

Preferential payment

Thus, given that CIL was not a creditor of the Company, the Liquidators could not argue that CIL had received a preference. Instead, the Liquidators had to rely upon s241(2) IA 1986 which allows the Court, when making an order under s239 IA 1986, to order the return of a payment received by a person, regardless of whether or not he is the person to whom the preference was given. This effectively empowers the Court to order that third party recipients of preferential payments return those payments even if the actual preferential act by the company (such as discharging Mr Susca's debt in this instance), was done in favour of some other person (such as Mr Susca).

In response, CIL sought to rely upon the defence available under s241(2) IA 1986 that it had received the payment in good faith and for value. Unsurprisingly, the Court of Appeal found that the onus of showing good faith rests with the person asserting the defence, namely CIL. Sir Martin Nourse, delivering the Court's judgment, found that CIL was unable to rely upon the good faith defence because its controller, Mr Aslam, must have known that the £50,000 payment that CIL received was actually made by the Company, rather than by Mr Susca personally, and that the payment was made at a time when the Company was insolvent.

The Court of Appeal therefore ordered that CIL return the £50,000 payment to the Liquidators.

Transaction at an undervalue?

Given the finding that CIL had to return the £50,000 as a preference, there was no need for the Court of Appeal to consider whether that payment also constituted a transaction at an undervalue. However, the transaction at an undervalue arguments were briefly discussed.

The Court below had found that the only consideration provided to the Company in respect of the £50,000 payment it made to CIL was the discharge of the debt, to the extent of £50,000, that the Company owed to Mr Susca. The Court below had reasoned (in concluding that the transaction was at an undervalue), that because the discharge by the Company of the £50,000 debt it owed to Mr Susca amounted to a preference, that same consideration could not be relied upon as valuable consideration for the purpose of considering whether the payment to CIL was a transaction at an undervalue under s238 IA 1986.

The Court of Appeal, however, preferred not to rule upon whether this reasoning was correct. They could see some logic in the argument that the transaction was not at an undervalue because in exchange for the £50,000 payment, the Company had received consideration of exactly the same value in the form of the discharge, to the extent of £50,000, of the debt it owed to Mr Susca.

Conclusion

The decision serves as a reminder for Liquidators and Administrators of the possibility of pursuing third parties who have indirectly received the benefit of undervalue transactions or preferential payments. However, such a claim may be successfully defended if the third party recipient can show that it received the payment in good faith and for value. Whether such a defence can be established will naturally depend on the circumstances, and in particular, the recipient's knowledge of the context in which a payment or benefit was received.

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