CASE REVIEW SECTION

Post-Petition Banking Transactions: the Reach of Section 127 of the Insolvency Act 1986

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Introduction

Whether or not payments into and out of a bank account constitute dispositions by a company for the purposes of section 127 of the Insolvency Act 1986 has long been a vexed question. Although the issue has been subjected to considerable judicial scrutiny the case law surrounding the provision has lacked coherence. However, the Court of Appeal has recently had the opportunity to revisit the effect of post-petition banking transactions and came down strongly in favour of the banks in relieving them from restitutionary liability.

The effect of section 129 of the Insolvency Act 1986 is to declare that winding up orders operate retrospectively. This has critical importance in relation to dispositions of company property because section 127 of the 1986 Act provides that in a winding up by the court, any disposition of the company's property, and any transfer of shares, or alteration in the status of the company's members, made after the commencement of the winding up is, unless the court otherwise orders, void. No court order is required because the sanction is applied automatically. Section 127 does not trigger to invalidate a disposition of property where it has no impact on the creditors, as would be the case where, for example, there has been a disposition by a receiver appointed under a charge of the company's property. But rather, its overall effect is designed to preserve corporate assets for the benefit of the general body of creditors by empowering the liquidator to 'claw back' company property which has been transferred by directors after a petition has been presented and liquidation is imminent.[1]

A third party dealing with a company against which a winding-up petition has been brought should apply to the court for a validation order, otherwise he runs the risk that the court will refuse to validate the transaction and he will be ordered to transfer back the property that has passed to him, unless he acquired it as a *bona fide* purchaser for value without notice.[2] The court's authorization can be sought in advance by either party to the transaction or proposed transaction. For example, in *Re A I Levy (Holdings) Ltd*,[3] the court consented to the company's proposed disposal of a lease prior to the petition hearing, and a clause in the lease which provided for its forfeiture in the event of the company being wound up did not therefore take effect.

The court's jurisdiction to grant its consent to a disposition of property is, of course, discretionary. Some guidance as to how this discretion will be exercised was provided by Buckley LJ in *Re Gray's Inn Construction Co Ltd*.[4] He observed that it was a fundamental concept of insolvency law that the free assets of the company at the commencement of the liquidation should be distributed rateably among the unsecured creditors. Buckley LJ noted, however, that there may be times when it would be beneficial, both to the company and to its unsecured creditors, that the company be permitted to dispose of some of its property after the petition has been presented but before the winding-up order has been made. This would be the case where, for example, the company has the opportunity by acting speedily to sell an asset at an exceptionally good price. However, he stressed that in considering whether to make a validating order the court should ensure that the interests of the unsecured creditors are not prejudiced. He stated that where an application is made in respect of a specific transaction this may be susceptible of positive proof. On the other hand, whether or not the company should be permitted to carry on business generally is more speculative and will depend on whether a sale of

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1 See *Coutts & Co v Stock* [2000] 1 BCLC 183, Lightman J.

2 *Re J Leslie Engineers Co Ltd* [1976] 1 WLR 292.

3 [1964] Ch 19.

4 [1980] 1 WLR 711.

the business as a going concern will be more beneficial than a break-up realization of the assets.

Buckley LJ concluded that the court will normally validate a transaction entered into in good faith where the parties are unaware that a petition has been presented unless there are grounds for believing that the disposition involves an attempt to prefer a particular creditor over and above the rest. Accordingly, although the court will be disinclined to consent to any transaction which has the effect of preferring a pre-liquidation creditor, nevertheless 'the court would be inclined to validate a transaction which would increase, or has increased, the value of the company's assets, or which would preserve, or has preserved, the value of the company's assets from harm which would result from the company's business being paralysed …'

Post-petition banking transactions

As commented above, it is in relation to the question of whether payments into and out of a bank account constitute dispositions by a company for the purposes of section 127 that the case law has for some time been in a state of flux. In *Gray's Inn* Buckley LJ accepted the concessions offered by the bank's counsel to the effect that irrespective of whether the account in question is overdrawn or in credit, (i) payments out of the company's account to third parties constituted dispositions of the company's property; and (ii) that they constituted dispositions of property which the bank was liable to make good. This reasoning has been criticized by Professor Goode.[5] He convincingly argues that there was no disposition of company property in the case. The account was at all times overdrawn so that in relation to the payments made 'the bank used its own moneys to meet the company's cheques for what were presumably payments to suppliers and other creditors in the normal course of business, so that in relation to such payments the bank became substituted as creditor for the persons to whom they were made.' But where, on the other hand, a company credits its bank account with a cash payment this will constitute a disposition of property because the bank acquires ownership of the money and the company has a corresponding right to claim against the bank. Such a claim becomes an asset of the company and this holds true whether or not the account is in credit or is overdrawn.

Academic criticism aside, the decision in *Gray's Inn* has not been universally welcomed by the judges and subsequent case law has adopted an inconsistent approach to the issue of post-petition banking transactions. For example, in *Re Barn Crown Ltd*,[6] Judge Rich QC, sitting as a High Court judge, held that where a company deposits a cheque into its bank account which is in credit, no disposition of property arises because the bank collects it as the company's agent and it therefore acquires no interest of its own in the cheque. On similar reasoning, Anglo-Commonwealth jurisdictions take the view that when a bank pays a cheque drawn by a company in favour of a third party payee, a disposition of company property arises as against the payee but this does not constitute a disposition as far as the bank is concerned because it is acting merely as an intermediary or agent in the transaction.[7]

The confused state of the UK authorities was further compounded by the decision of Lightman J in *Coutts & Co v Stock*,[8] in which the judge doubted, albeit correctly, the Court of Appeal's reasoning in *Re Gray's Inn*. The case is of particular interest because he sought to lay down fundamental principles that would serve to inject some coherence into the law governing the impact of section 127 on payments into and out of company bank accounts. It also presaged the more recent Court of Appeal's view on the effect of section 127 on payments out of a company's bank account which was taken in *Hollicourt (Contracts) Ltd v Bank of Ireland*.[9] The facts in *Coutts* were that the bank had granted a GBP200,000 overdraft facility to L Ltd, which was secured by a personal guarantee given by S, a director of the company. Shortly thereafter a winding up petition was brought against the company. At this time its account was GBP500 in credit. However, at the time the petition was advertized the account was GBP121,875 in the red and by the time the winding up order was granted its overdraft had increased to some GBP190,000. These increases were due to the bank having honoured cheques in favour of third parties, although most of the payments were in fact made to three companies either owned or controlled by S. Coutts sought to enforce S's guarantee. S responded by arguing that section 127 disentitled the bank from debiting L Ltd's account by honouring cheques after the presentation of the petition and that therefore the bank could not recover from him the amounts it had paid out.

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5 See R. M. Goode *Principles of Corporate Insolvency Law* (Sweet and Maxwell, London, 1997).

6 [1994] BCLC 186.

7 See, for example, *Re Mal Bower's Macquarie Electrical Centre Pty Ltd* [1974] 1 NSWLR 254; and *Re Loteka Pty Ltd* (1989) 7 ACLC 998.

8 [2000] 1 BCLC 183.

9 [2001] 1 BCLC 233, discussed below.

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Lightman J stated that two issues arose on the facts. First, whether the retrospective effect of section 127 operated to disentitle the bank from debiting the account after the petition had been presented (absent any validation order) and therefore prevented it from recovering the sums from S, as guarantor. Secondly, if the answer to the first question was in the affirmative, whether the guarantee agreement resulted in S being liable as principal debtor.

The judge noted that the invalidation under section 127 is limited to dispositions of property. It does not invalidate a company's assumption of liabilities and so the provision does not preclude, for example, a company incurring liabilities for such things as utilities or employees' wages. Thus, an increase in a company's overdraft during the period between the presentation of the petition and the court's winding-up order is outside section 127. Further, the provision does not impact upon a company's use or exhaustion of its assets. More particularly, the presentation of a winding up petition does not invalidate the bank's mandate to honour the cheques of the company and the subsequent winding up order does not operate to invalidate the loan made by the bank to the company through continuing to honour its cheques drawn on the overdrawn account. Significantly, Lightman J concluded:

> On principle ... the acts of the bank in honouring cheques drawn on a company's overdrawn account constitute (i) loans of the sums in question by the bank to the company and (ii) payment by the bank as agent of the company of the sums loaned as moneys of the company to the party in whose favour the cheques are drawn. On this analysis, the loan by the bank to the company is not a disposition of the company's property (it is a disposition of the bank's money to the company) and is therefore outside s 127; but the payment by the bank as agent for the company does constitute a disposition to the payee by the company within s 127 and is recoverable by the liquidator from the payee [citing Millett J in *Agip (Africa) Ltd v Jackson* [1990] Ch 265].

Preferring the Commonwealth approach and endorsing Professor Goode's criticisms (see above), the judge therefore held that the bank was entitled to the sum claimed by way of a debt from the guarantor and that section 127 had no impact on his liability.

It was against this uncertain state of the case law, the hallmark of which was described by Lightman J as 'confused', that the Court of Appeal in *Hollicourt (Contracts) Ltd v Bank of Ireland*[10] had to decide whether the impact of section 127 operated to make the bank liable, on the application of the liquidator, to make restitution to the company of the amounts it had paid out to third parties. The decision arose out of an appeal against the decision of Blackburne J who had held, applying *Gray's Inn*, that the bank's honouring of company cheques after the date of the petition constituted dispositions of the moneys standing to the credit of the company so that, therefore, the bank could not debit the account. The Court of Appeal, allowing the appeal, held that only the payees were liable to make restitution on the amount of the cheques to the company, not the bank. Mummery LJ observed that for section 127 to trigger, a disposition amounting to an alienation of the company's property had to be made. The bank in honouring the cheques obeyed as agent the order of its principal to pay out of the principal's money in its hands the amount drawn in favour of the payee. The beneficial ownership of the property represented by the cheque was never transferred to the bank, to which no alienation of the company's property was made. Accordingly, the company could not recover the amounts from the bank, which had only acted in accordance with its instruction as the company's agent to make payments to the payees out of the bank account. Section 127 only avoided 'dispositions' of the company's property; it did not avoid all or any related transactions. Mummery LJ observed that this result carried the practical advantage of avoiding what in some cases could be complex analysis of whether payments were made out of an account which was in debit or in credit.

From the perspective of company liquidators this decision will be unwelcome. The third parties that benefit from the dispositions are generally diffuse and difficult to trace. Banks, on the other hand, were a readily identifiable target to proceed against and will no doubt now be breathing a sigh of relief.

Notes

10 Ibid.

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