

Avoidance of overdraft payments due to preferential treatment

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Avoidance due to preferential treatment

The Insolvency Act provides insolvency administrators with an abundance of tools to challenge any actions committed by a debtor during a crucial period prior to the opening of insolvency proceedings. One of these tools is set out under Section 30(1) of the Insolvency Act, which stipulates that a security or payment given to a creditor after the debtor cannot pay its debts or within 60 days of filing for the commencement of insolvency proceedings is voidable if:

- the creditor has obtained a security or payment that it was not entitled to or that was not "due in that way or at that time", unless the creditor did not benefit from this transaction ahead of the other creditors (Section 30(1));
- the security or payment was given to close relatives of the debtor, unless they were unaware or should not have been aware of the debtor's intention to give them preferential treatment ahead of other creditors (Section 30(1)(2)); or
- the security or payment was given to persons other than those mentioned in Section 30(2) and they were aware or should have been aware of the debtor's intent to give them preferential treatment ahead of other creditors (Section 30(1)(3)).

However, avoidance is ruled out if the preferential treatment was given more than one year before the commencement of any insolvency proceedings (Section 30(1)(2)).

Overdraft facility and avoidance under Section 30

An overdraft facility is a form of credit agreement in which the financial institution (bank) permits an account holder to use or withdraw more money than they have in their account, without exceeding a specified maximum negative balance. Depending on the case and the specific contractual obligations, the debtor's repayment of the overdraft can be challenged by an insolvency administrator either:

- on the grounds of incongruency of the payment (Section 30(1)(1)); or
- because the creditor knew that the debtor intended to treat them preferentially (Section 30(1)(3)) (eg, where the debtor treats the bank preferentially because of its simultaneous personal liability for the overdraft and the bank is aware of this preferential treatment).

Several recent Supreme Court decisions have confirmed once again that even if an overdraft payment is congruent and thus lawful under Section 30(1)(1), the transaction can still be avoidable under Section 30(1)(3). More specifically, in cases where the bank is the creditor, the court will interpret the wording "were aware" or "should have been aware... of the preferential treatment" under Section 30(1)(3) more strictly. In any case, the burden of proof remains with the insolvency administrator.

Avoidance due to incongruence of payment

A payment or security will be considered incongruent if the creditor was not entitled to it or it was not "due in that way or at that time". Put simply, if the creditor received a substantial payment or security that was beyond the scope of its legal claim, the payment will be considered incongruent. In the case of (unsecured) overdraft facilities, a payment made to reduce the debt of a facility

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agreement account will generally constitute an avoidable transaction since the creditor's claim is unenforceable (ie, the bank possessed no material right at time of the payment).

On the other hand, incongruence can be ruled out if such a right was acquired before the critical period or if it existed at the time of payment. According to the Supreme Court's consistent judicature, this is the case if the borrower (debtor) must perform all of its money transactions through the lending bank so that the lender can be settled via offset. If the lender has similar contractual obligations, this will lead to the same result as long as they are precise in content and not a 'dead letter'. As previously stated, regardless of its congruence, the payment can still be avoided due to preferential treatment.

Avoidance due to preferential treatment intent

Apart from the general elements of avoidance under Section 30 (ie, securement or settlement of a creditor within the critical timeframe and the suitability of the avoidance to settle other non-preferential creditors), Section 30(1)(3) requires two additional elements for avoidance to succeed:

- the debtor must intend for the payment to result in preferential treatment for the receiving person; and
- the receiving person must or should have been aware of this intent.

The proof of this (conditional) intent will be considered furnished when the established facts of the case allow its deduction. This will, of course, depend on the specifics of the case. There will usually be an abundance of evidence demonstrating that a future insolvency debtor disregarded some debts but continued to settle other more important ones (eg, tax authority and health insurance funds). In this regard, the Supreme Court considers that the settlement of tedious debtors serves as an indication that the debtor intended to provide preferential treatment.

To answer the question of whether a settled debtor was or should have been aware of the preferential treatment, the creditor must or should have been aware of the suspicious circumstances. According to the judicature, slight negligence will suffice. The court will consider:

- the resources available to the creditor to acquire the information from the debtor at the time of payment; and
- whether these resources were reasonably used and properly assessed.

The emphasis lies on what the creditor should have known.

Comment

The recent court decisions summarise the existing judicature and further clarify the elements of avoidance due to preferential treatment. From the perspective of banks, which have an in-depth understanding of debtors' financial dealings, the Supreme Court has set the bar very high regarding the (un)avoidability of overdraft payments in the 12 months before the opening of insolvency proceedings.

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