Going behind a bankruptcy order

Sudarshan Kanagaratnam reports on *Ramsay Health Care Australia Pty Ltd v Compton* [2017] HCA 28.

Introduction

The High Court has considered the circumstances in which a Bankruptcy Court, exercising jurisdiction under s 52 of the *Bankruptcy Act 1966* (Cth) (Act), may 'go behind' a judgment in order to be satisfied that the debt relied upon by a petitioning creditor is in fact owing. In rejecting a narrow formulation of those circumstances, the majority affirmed the approach taken by Barwick CJ in *Wren v Mahony*[1] and emphasised the need to have satisfactory proof of the petitioning creditor's debt.

Factual background

Ramsay Health Care Australia Pty Ltd (Ramsay), an operator of private hospitals, entered in to an agreement with Compton Fellers Pty Ltd, trading as Medichoice, whereby Medichoice would import medical products on Ramsay's behalf and act as a distributor of those products. Mr Compton, a director and shareholder of Medichoice, entered, in his personal capacity, into an agreement with Ramsay whereby he guaranteed to Ramsay the payment of all monies that Medichoice might become liable for in the performance of its obligations under the agreement with Ramsay (Guarantee).

Ramsay commenced proceeding in the Supreme Court of New South Wales against Mr Compton claiming for monies owed to it under the Guarantee. Mr Compton, who was legally represented at the hearing, served evidence on the quantum of the alleged debt but did not read that evidence or dispute the quantum of the alleged debt. Instead, Mr Compton relied on a non est factum defence to Ramsay's claim. That defence failed and in the absence of a challenge to quantum, Ramsay was awarded judgment in the amount of $9,810,312.33.[2] Mr Compton did not appeal from the judgment.

Mr Compton did not pay the debt and Ramsay served on him a bankruptcy notice. Mr Compton failed to comply with the bankruptcy notice in the time stipulated and so committed an act of bankruptcy by reason of s 40(1)(g) of the Act. Ramsay presented a creditor's petition in the Federal Court of Australia in reliance on Mr Compton's act of bankruptcy. Mr Compton, in opposing the creditor's petition, contended that no debt was owed because the judgment in the Supreme Court was not founded on a debt that was owed to Ramsay.

Interim application

Mr Compton filed an interim application to determine, as a separate question, whether the Federal Court should exercise its discretion to 'go behind' the Supreme Court judgment to examine the debt upon which the creditor's petition was based.

At the hearing of the interim application, Mr Compton sought to rely on a 'reconciliation' of indebtedness between the parties, which purported to show that, in fact, Ramsay owed money to Medichoice and an affidavit from one of the joint liquidators of Medichoice to the effect that it was more likely that Ramsay was indebted to Medichoice.

As to the 'reconciliation', senior counsel for Ramsay said that it was an 'open question' whether the calculation contained in it with respect to 'offsets' and 'rebates' was factually correct.

Section 52(1)(c) of the Act provides that at the hearing of a creditor's petition, the court shall require proof of 'the fact that the debt or debts on which the petitioning creditor relies is or are still owing and, if it is satisfied with the proof of those matters, may make a sequestration order against the estate of the debtor'.

The primary judge (Flick J) dismissed the interim application. He accepted the judgment as satisfactory proof of the debt and declined to undertake his own investigation into whether the debt to Ramsay was truly owed.

Mr Compton appealed to the Full Federal Court (Siopis, Katzmann and Moshinsky JJ). On the appeal, Ramsay argued that it was only in the limited circumstances identified by the High Court in *Corney v Brien*[3] namely, where 'fraud, collusion or miscarriage of justice' was made out, that a Bankruptcy Court may, or should, 'go behind' a judgment. Further, Ramsay argued that *Corney v Brien* established that a Bankruptcy Court should not 'go behind' a judgment with which follows a contested hearing where both parties were represented.

The Full Court unanimously rejected Ramsay's argument.[4] The Full Court concluded that *Corney v Brien* did not support such a narrow view of the function of a Bankruptcy Court. Instead, the Full Court applying the approach articulated by Barwick CJ (Windeyer and Owen JJ agreeing) in *Wren v Mahony* held that the primary judge erred in focussing his approach on forensic choices made in the Supreme Court proceedings rather than 'the central issue, which was whether reason was shown for questioning whether behind the judgment there was in truth and reality a debt due to the petitioning creditor.'

The Full Court held that focussing on the pertinent issue revealed substantial reasons for questioning whether the debt was owed, considered afresh whether to 'go behind' the judgment and concluded that the Bankruptcy Court should do so to determine whether there was in fact any debt owing to Ramsay.

High Court

Ramsay sought special leave to appeal to the High Court. By majority (Kiefel CJ, Keane and Nettle JJ, Edelman J agreeing in separate reasons, Gageler J dissenting), the High Court upheld the judgment of the Full Court, holding that there was a substantial question as to whether the debt that Ramsay was relying on to found the creditor's petition was owing and the Bankruptcy Court should investigate this question in order to decide whether it was open to it to make a sequestration order. Central to the High Court's reasoning were the judgments in *Corney v Brien* and *Wren v Mahony*.

In *Corney v Brien*, Fullagar J said, in a judgment that concurred with that of Dixon CJ, Williams, Webb and Kitto JJ:[5]

> No precise rule exists as to what circumstances call for an exercise of the power, but certain things are, I think, clear enough. If the judgment in question followed a full investigation at trial in which both parties appeared, the court will not reopen the matter unless a prima facie case of fraud or collusion or miscarriage of justice is made out.

Ramsay relied on the above passage in submitting that *Corney v Brien* established that a Bankruptcy Court's discretion to go behind a judgment after a contested hearing was limited to circumstances of 'fraud, collusion or miscarriage of justice'.

Observing that by s 52 of the Act, a 'Bankruptcy Court must be satisfied with the proof of 'the fact that the debt ... on which the petitioning creditor relies is ... still owing', if the court's power to make a sequestration order is to be enlivened', Kiefel CJ, Keane and Nettle JJ held that *Corney v Brien* was not authority for the proposition that a Bankruptcy Court must treat a judgment as satisfactory proof of the petitioning creditor's debt, save in cases

of fraud, collusion or miscarriage of justice. Rather, their Honours held that while a Bankruptcy Court has 'undoubted jurisdiction' to go behind a judgment in circumstances of fraud, collusion or miscarriage of justice 'to say that the court may do a thing in certain circumstances is not to say it may do that thing only in those circumstances.'[6]
In *Wren v Mahony*, Barwick CJ (Windeyer and Owen JJ agreeing) said:[7]

> The judgment is never conclusive in bankruptcy. It does not always represent itself as the relevant debt of the petitioning creditor, even though under the general law, the prior existing debt has merged in a judgment. But the Bankruptcy Court may accept the judgment as satisfactory proof of the petitioning creditor's debt. In that sense, that court has a discretion. It may or may not so accept the judgment. But it has been made quite clear by the decisions of the past that where reason is shown for questioning whether behind the judgment or as it is said, as the consideration for it, there was in truth and reality a debt due to the petitioning creditor, the Court of Bankruptcy can no longer accept the judgment as such satisfactory proof. It must then exercise its power, or if you will, its discretion to look at what is behind the judgment: to what is its consideration.

Ramsay sought to distinguish *Wren v Mahony* on the basis that it involved a default judgment and submitted that the Full Court took too broad a view of *Wren v Mahony*. Ramsay argued that a judgment obtained in the absence of fraud or collusion after a contested hearing precludes the possibility of sufficient reasons for questioning whether behind that judgment there was, in truth and reality, a debt due to the petitioner.
However, Kiefel CJ, Keane and Nettle JJ held that Barwick CJ's statement 'should not be given the artificially narrow application urged on behalf of Ramsay'.[8] Their Honours observed that *Wren v Mahony* held that a Bankruptcy Court may go behind a judgment, notwithstanding that the judgment was obtained after a contested hearing. Their Honours said that 'fraud, collusion or miscarriage of justice' are the most frequent examples of the exercise of a Bankruptcy Court's jurisdiction to go behind a judgment, however the overarching obligation imposed by s 52(1) of the Act 'requires a Bankruptcy Court to be satisfied that there is, in truth and reality, a debt'.[9]
Their Honours held that Ramsay's reliance on *Commonwealth Bank of Australia v Jeans*[10] did not assist it because, in *Jeans*, Hely J explicitly applied the approach in *Wren v Mahony* though, on the facts of *Jeans* no question was raised in the Bankruptcy Court as to whether the underlying debt was owed. In contrast, in the present case there was no suggestion of a lack of good faith in Mr Compton's application and while the evidence disputing the debt may ultimately have been unreliable, absent an investigation, that conclusion could not have been reached.[11]
Ramsay further argued that miscarriage of justice in this context was confined to the kind of miscarriage of justice which would impeach the obtaining of the judgment. In rejecting that argument, Kiefel CJ, Keane and Nettle JJ identified the importance of protecting third party creditors. Their Honours held[12] that 'in point of principle, scrutiny by a Bankruptcy Court of the debt propounded by a judgment creditor seeking a sequestration order in no sense involves an attempt to impeach the judgment'. The function of the Bankruptcy Court is to fulfil its statutory duty to be satisfied as to the existence of the debt founding the application for a sequestration order. The purpose of the scrutiny is not only because 'a creditor should not be able to make a person bankrupt on a debt which is not provable' but also to protect the interests of third parties and, in particular, other creditors of the debtor who were not parties to the proceeding resulting in the judgment debt and who should not be prejudiced by the making of a sequestration order which does not reflect the truth and reality of the debt.
Further, their Honours held[13] that there was no suggestion in the cases that 'merger of a debt in a judgment limits the power of a Bankruptcy Court to go behind a judgment so that it is confined to circumstances in which the judgment itself might be set aside'. That a prior existing debt is taken, at general law, to merge in the judgment does not operate 'to relieve a Bankruptcy Court of the paramount need to have satisfactory proof of the petitioning creditor's debt'.
Ramsay's final argument, that a narrow formulation of the circumstances in which the discretion was to be exercised was consistent with the principle of finality in litigation also was rejected. Kiefel CJ, Keane and Nettle JJ held that while Ramsay's concession that it was an open question whether the calculation in the 'reconciliation' was factually correct was 'no more than an acknowledgment of the existence of evidence which might tend towards a different result from that reflected in the Judgment',[14] that concession meant that there was evidence before the primary judge, which, if left unanswered, supported a conclusion that Mr Compton was not indebted to Ramsay at all.
Their Honours said that while the failure of Mr Compton to rely upon such evidence was unexplained, there was, prima facie, a real question as to whether Mr Compton had failed to present his case on its merits at the trial in the Supreme Court. It was no answer to this to say that Mr Compton was bound by the conduct of his case. That is because the Bankruptcy Court is concerned to protect the interests of third parties to the litigation leading to the judgment debt and those third parties (creditors in the bankruptcy) should not be prejudiced by a failure on the part of Mr Compton to present his case on the merits such that a sequestration order is made while that question remains unresolved.[15]
Edelman J, in his concurring reasons, agreed that 'neither precedent nor principle' imposed a constraint on the power of a Bankruptcy Court acting under s 52(1)(c) of the Act to 'go behind' a judgment obtained after a contested hearing.[16]
Gageler J dissented. His Honour identified the question to be whether Mr Compton had shown a prima facie case for the exercise of the discretion to go behind the Supreme Court judgment.[17] Gageler J considered[18] that Fullagar J's reasoning in *Corney v Brien* had repeatedly been interpreted and applied and should continue be treated as a 'guiding principle'. His Honour distinguished *Wren v Mahony* on the basis that the creditor there chose to rely on the antecedent debt as opposed to the judgment debt which was not entered after a trial on the merits.
His Honour held further[19] that creditors of a bankrupt are not to be protected 'by an exercise of judicial discretion from what might be shown in retrospect to have been poor forensic choices which the debtor made in the course of contested proceedings which have resulted in a judgment on the merits against the debtor.' Accordingly, Gageler J held that the Full Court's identification of the central issue was incorrect and the focus of the primary judge on whether there had been a failure of legal process was correct in principle.

ENDNOTE

1 (1972) 126 CLR 212.
2 *Ramsay Health Care Australia Pty Ltd v Compton* [2015] NSWSC 163.
3 (1951) 84 CLR 343.
4 *Ramsay Health Care Australia Pty Ltd v Compton* (2016) 246 FCR 508.
5 (1951) 84 CLR 343 at 357-357.
6 *Ramsay Health Care Australia Pty Ltd v Compton* [2017] HCA 28 at [39].
7 (1972) 126 CLR 212 at 224.
8 [2017] HCA 28 at [43].
9 [2017] HCA 28 at [49].
10 [2005] FCA 978.
11 [2017] HCA 28 at [52].
12 [2017] HCA 28 at [54], [55].
13 [2017] HCA 28 at [58].
14 [2017] HCA 28 at [66].
15 [2017] HCA 28 at [71].
16 [2017] HCA 28 at [97]-[98].
17 [2017] HCA 28 at [79].
18 [2017] HCA 28 at [81] to [88], [90] and [91].
19 [2017] HCA 28 at [92], [94].