## ARTICLES

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# LIQUIDATORS' AVOIDANCE OF PREFERENCES: ISSUES OF CONCERN AND A PROPOSAL FOR RADICAL REFORM

## INTRODUCTION

WHEN ascertaining what property is available to the creditors of an insolvent company that is being wound up, a liquidator will pay particular attention to transactions entered into prior to winding up in which a creditor was provided with some benefit by the company. The liquidator will examine such transactions carefully to see if they constitute preferences. If they do, the liquidator will attack the transactions and seek to recover any money or property given to the creditor.

Undoubtedly, the preference is the major type of pre-liquidation transaction which liquidators have sought to avoid over the years. The ability to avoid such transactions is usually regarded as the primary weapon in the arsenal of a liquidator in recovering property for the creditors of the company.[1] The Australian Law Reform Commission in its *General Insolvency Inquiry* (commonly known as "the Harmer Report" and referred to

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1 O'Donovan, *McPherson: The Law of Company Liquidation: Being the Law relating to Liquidation of Limited Liability Companies* (Law Book Company, Sydney, 3rd ed 1987) p314; Robertson, "Winding Up Generally" in *Australian Corporations Law,* Vol 2, (Butterworths, Sydney 1991) pp56, 241; Young, "Preferences Under The Bankruptcy Reform Act of 1978" (1980) 54 *Am Bankr LJ* 221 at 222.

here in a similar manner) noted that the evidence produced to it suggested that there was "a lively market in the recovery of preferences".[2]

After a brief examination of the origins and nature of preferences, it is argued in this article that the state of the law regulating the avoidance of preferences is unsatisfactory in a number of respects and that it would be preferable to introduce what I have called an "automatic avoidance rule", whereby all transactions entered into within a certain time zone prior to winding up will be set aside if they can be classified as preferences.

## THE ORIGINS OF PREFERENCE LAW

While the first legislation which provided for the setting aside of preferences was the *Joint Stock Companies Act* 1844 (UK),[3] preference law can be traced back at least to the time of Lord Mansfield in the eighteenth century in England. In fact, there are suggestions that the statute of 1570[4] marked the beginning of the law of preferences.[5] The statute was introduced, inter alia, to overcome the prevailing practice amongst creditors of "first come, first served," and the ensuing disorganised scramble for the assets of the insolvent, in which the most aggressive recovered all or part of their claims, while other creditors received little or nothing.[6]

Even accepting the fact that the statute of 1570 marked the beginnings of preference law in England, there was, until the time of Lord Mansfield, little development of the law. Some advance was made by the opinion given by Lord Coke in *The Case of the Bankrupts*,[7] but generally legal historians are perplexed at the lack of potency of preference law before the time of Lord Mansfield.[8]

2 Australian Law Reform Commission, *General Insolvency Inquiry* (Report No 45, 1988) para 632.

3 This was followed closely by the *Bankruptcy Act* 1869 (UK) s92 (32 & 33 Vict c71). Interestingly, Scotland had legislation on the subject as early as 1690 (*Bankruptcy (Sc) Act* 1690). A detailed history of preference law is found in Weisberg, "Commercial Morality, the Merchant Character, and the History of the Voidable Preference" (1986) 39 *Stan LR* 3; Countryman, "The Concept of a Voidable Preference in Bankruptcy" (1985) 38 *Vand LR* 713; Glenn, "The Diversities of the Preferential Transfer: A Study in Bankruptcy History" (1930) 15 *Cornell LQ* 521.

4 The Statute of Elizabeth (13 Eliz c5).

5 McPherson, "Avoiding Transactions in Insolvency" in Lessing & Corkery (eds), *Corporate Insolvency Law* (Taxation & Corporate Research Centre, Bond University, Gold Coast 1995) p187.

6 Report of the Insolvency Law Review Committee, *Insolvency Law and Practice*, Cmnd 8558 (1982) (UK) (commonly known as "the Cork Report" and similarly referred to here) at para 31.

7 (1592) 2 Co Rep 25; 76 ER 441.

8 Weisberg, "Commercial Morality, the Merchant Character, and the History of the Voidable Preference" (1986) 39 *Stan LR* 3 at 45 fn144. A critical factor in Lord Mansfield's development of the preference was, undoubtedly, his Scottish heritage. The preference was recognised in Scotland's statutes from 1690.

During Lord Mansfield's time on the bench there was a common law development of the avoidance of preferences[9] in order to give effect to the general spirit of the bankruptcy legislation.[10] An examination of the cases reveals that the law of preferences developed as a branch of the law of fraudulent transfers.[11]

In general, the Australian colonies, and later the Australian states, faithfully adhered, during the nineteenth century, to English companies legislation, which contained provisions allowing for the avoidance of preferences.[12] For instance, the *Winding-Up Act* of 1847[13] in New South Wales was in all material aspects identical with the English *Joint Stock Companies Act* 1844.[14] By 1893 all of the colonies of Australia had adopted the English *Companies Act* 1862.[15]

Ever since, until the advent of the *Corporate Law Reform Act* 1992 (Cth), companies legislation incorporated by reference the preference provision which was contained in the relevant bankruptcy statute.[16] Since 1993 the *Corporations Law*[17] has included, in Division 2 of Part 5.7B ("the Division"), a regime which specifically provided for the avoidance of preferences. Preferences which can be avoided are known as "unfair preferences".[18]

## THE NATURE OF PREFERENCES

The avoidance of preferences is designed, ostensibly, to prevent a creditor jumping to the front of the queue of the general unsecured creditors, all of whom should be paid equally, and to ensure that "an undignified scramble by creditors over available assets" is avoided.[19] This undignified scramble usually occurs, according to Cox J in *Re Feldmanis*

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9 At 44-51.

10 *Alderson v Temple* (1768) 4 Burr 2235 at 2239-2240; 98 ER 165 at 167-168. The first case in which Lord Mansfield set out the principles behind preference law was in *Worseley v Demattos* (1758) 1 Burr 467; 97 ER 407.

11 Kronman, "The Treatment of Security Interests in After-Acquired Property Under the Proposed Bankruptcy Act" (1975) 124 *U Pa L Rev* 110 at 111. Professor Farrar in "The Bankruptcy of the Law of Fraudulent Preference" ([1983] *JBL* 390 at 391) regards the body of preference law that grew up as a gloss on the law of fraudulent conveyances.

12 O'Donovan, *McPherson: The Law of Company Liquidation* p21.

13 11 Vict No 19.

14 O'Donovan, *McPherson: The Law of Company Liquidation* p21.

15 At p22.

16 For example, *Companies Act* 1981 s451; *Corporations Law* s565.

17 All references to sections in this article are to sections in the *Corporations Law* unless the contrary is indicated.

18 See s588FA. For a discussion of unfair preferences, see Keay, "An Exposition and Assessment of Unfair Preferences" (1994) 19 *MULR* 545; Keay, "An Analysis of Unfair Preferences Under the New Avoidance Regime" (1996) 24 *ABLR* 39.

19 O'Donovan, "Corporate Insolvency: Policies, Perspectives and Reform" (1990) 3 *CBLJ* 1 at 11-12.

*Finance Pty Ltd (in liq)*,[20] because creditors fear the imminent liquidation of their debtor and they wish to improve their position.

When a preference is given by a debtor company, whether motivated by kindness, a sense of duty or some fraudulent intent, the company is, in effect, "robbing Peter to pay Paul".[21] The recipient of the preference obtains an advantage over other creditors in that the preferred creditor is receiving his or her debt (or part thereof) before the other creditors, and in many cases he or she receives full payment while the members of the general body of creditors receive nothing or a small portion of their debts.

If a preference is given by the company before the commencement of its winding up the liquidator will demand that the creditor who received the preference disgorge in favour of the liquidator. The money or property returned to the liquidator will, ultimately, be distributed among the general body of creditors.[22]

It is trite law that the essence of a preference is that a creditor has received more from a company before it goes into liquidation than it would have otherwise received in a liquidation. The true test of a preference was indicated in *Robertson v Grigg*[23]: does the transaction confer a priority or advantage on a creditor in relation to past indebtedness of the company and is the advantage given at the expense of other creditors? In other words, a preference involves a transaction which discriminates in favour of one creditor and against others.[24] In *Burns v Stapleton*[25] the High Court said that there is a preference when a transaction "would dislocate the statutory order of priorities amongst creditors."[26]

Under the present law, for a transaction to be set aside, the liquidator must apply for an order under s588FF. To obtain an order it must be established that the transaction attacked was voidable pursuant to s588FE. For a preference to be voidable it must be a preferential transfer within the meaning of s588FA, it must have occurred in the six month period[27]

20 (1983) 1 ACLC 823 at 830.

21 Farrar, "The Bankruptcy of the Law of Fraudulent Preference" [1983] *JBL* 390 at 390.

22 *Re Timberland Ltd (in liq)* [1980] VR 669 at 691; (1979) ACLC 32,296 at 32,319.

23 (1932) 47 CLR 257 at 271.

24 This view of a preference is well established in other jurisdictions. For example s96(a)(1) of the *Bankruptcy Act* 1898 (US) defined a preference as a transfer "of any property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt made or suffered by such debtor while insolvent ... the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class".

25 (1959) 102 CLR 97 at 104.

26 The priorities are those found in s109 of the *Bankruptcy Act* 1966 (Cth) and s556 of the *Corporations Law*.

27 Unless a related entity was a party to the transaction. In such a case the time period is four years. "Related entity" is defined in s9. For a discussion of the term, see Keay, "'Relation-Back Day' and 'Related Entity' : New Key Terms in Liquidation Law" (1994) 2 *Insolv LJ* 126 at 129-134.

prior to the relation-back day[28] and when the company (now in liquidation) was insolvent.[29]

## ISSUES OF CONCERN

There are a number of issues relating to the present law of preferences that cause me some concern and which, I would submit, can only be addressed by significant reform.

### Non-Fulfilment of Major Rationales

There are three rationales for the existence of a provision dealing with preferences.[30] It is submitted that the law as it stands fails to promote two of the rationales.

*No Equality*

Unquestionably, one of the fundamental principles of the law of liquidation is that the assets of an insolvent company are to be distributed fairly and rateably among its creditors.[31] It is an old equitable principle which is known as the *pari passu* principle.[32]

The promotion of this principle is the predominant rationale given for the existence of provisions avoiding preferences.[33] It would be impossible to achieve equality if the law

28 This day is defined in s9. For a discussion of the term, see Keay, "'Relation-Back Day' and 'Related Entity': New Key Terms in Liquidation Law" (1994) 2 *Insolv LJ* 126 at 127-129. Usually, for compulsory liquidations, the day will be the date when the application to wind up was filed. In voluntary liquidations, the date will usually be the date of the members' resolution to wind up.

29 See s588FC.

30 For a discussion of them, see Keay, "In Pursuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions" (1996) 18 *Syd LR* 55.

31 O'Donovan, *McPherson: The Law of Company Liquidation* p5; Farrar, Furey, Hannigan & Wylie, *Farrar's Company Law* (Butterworths, London, 3rd ed 1991) p709; Lipton "The Priorities Among Unsecured Creditors under the Corporate Law Reform Act 1992" (1993) 1 *Curr Com L* 24; Finch, "Directors' Duties: Insolvency and the Unsecured Creditor" in Clarke (ed), *Current Issues in Insolvency Law*, (Stevens, London 1991) p87; Warren,"Bankruptcy Policy Making In An Imperfect World" (1993) 92 *Mich L Rev* 336 at 353; Fortgang & King, "The 1978 Bankruptcy Code: Some Wrong Policy Decisions" (1981) 56 *NYULR* 1148 at 116.

32 See Farrar, "Public Policy and the Pari Passu Rule" [1980] *NZLJ* 100.

33 For example, see Levin, "An Introduction to the Trustee's Avoiding Powers" (1979) 53 *Am Bankr LJ* 173; Teofan & Creel, "The Trustee's Avoiding Powers Under the Bankruptcy Act and the New Code: A Comparative Analysis" (1979) 11 *St Mary's LJ* 311; Chiah, "Voidable Preference" (1986) 12 *NZULR* 1 at 22-23; Broome, "Payments on Long Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments" [1987] *Duke LJ* 78; Barney, "Bankruptcy Preferences and Insider Guarantees" (1991) 51 *Lou LR* 1047 at 1057; Dulchinos, "Bankruptcy Law - Determining Property Interests In Funds Recovered Pursuant to the Settlement of a Section 547 Preference Action" (1993) 15 *West New Eng L Rev* 109 at 112; Ponoroff, "Evil Intentions and an Irresolute Endorsement for

was to disregard what occurred prior to the lodging of the application to wind up a company or the date of the resolution of the members of a company whereby they resolve to wind up the company voluntarily.[34]

For a number of reasons the equality principle is not promoted by the existing law of preferences. First, while it has rarely been seen in this light, the provisions in the *Corporations Law* which permit defendants in liquidators' actions commenced under the Division to avail themselves of certain protections can be regarded as diminishing the effect of the equality principle. A creditor who has received a preference payment which would, prima facie, fall foul of the Division, and have to be disgorged, may be able to argue, pursuant to s588FA(2), that the payment was part of a running account and, therefore, the payment does not have to be repaid.[35] If the courts are willing to interpret s588FA(2) broadly[36] and, thereby, continue to apply the running account exception frequently, the efficacy of the avoidance provisions will be undermined and, consequently, the equality principle will suffer.[37]

Defendants, in actions brought by liquidators under the Division, are entitled to rely on s588FG which prescribes a number of defences.[38] For instance, if a creditor received a preference prior to the commencement of the liquidation and the preference constituted a voidable transaction for the purposes of the Division, the creditor may defend the liquidator's claim successfully if it can be proved that the creditor became a party to the transaction in good faith; had no reasonable grounds to suspect the insolvency of the company; and had provided valuable consideration or changed position relying on the

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Scientific Rationalism: Bankruptcy Preferences One More Time" [1993] *Wis L Rev* 1439 at 1488, 1516; Keay, "In Pursuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions" (1996) 18 *Syd LR* 55 at 65-74. A number of the foregoing articles do not see the equality principle as the only justification for avoidance provisions, but they all certainly regard it as the primary one.

34 See Keay, "In Pursuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions" (1996) 18 *Syd LR* 55 at 67.

35 The running account principle has been developed and applied regularly by the courts. For example, see *Richardson v Commercial Banking Company of Sydney Ltd* (1951-52) 85 CLR 110; *Rees v Bank of New South Wales* (1964) 111 CLR 210; *Queensland Bacon Pty Ltd v Rees* (1965-66) 115 CLR 266; *Petagna Nominees Pty Ltd v Ledger* (1989) 1 ACSR 547; *Spedley Securities Ltd (in liq) v Western United Ltd (in liq)* (1992) 27 NSWLR 111; 7 ACSR 271; *Airservices Australia v Ferrier* (1996) 21 ACSR 1. See also Polazzalo, "New Value and Preference Avoidance in Bankruptcy" (1991) 69 *Wash ULQ* 875 at 894-898 for a discussion of the American position.

36 The one case which has considered the issue under the regime (*Olifent v Australian Wine Industries Pty Ltd* (1996) 14 ACLC 510) indicates that courts are likely to adopt a broad approach.

37 Palazallo, "New Value and Preference Avoidance in Bankruptcy" (1991) 69 *Wash ULQ* 875 at 894-895.

38 See Keay, "Defending a Liquidator's Avoidance Action Commenced Under Part 5.7B of the Corporations Law" (1995) 5 *Aust Jnl of Corp Law* 17.

transaction.[39] Again, if this section is construed widely, to give relief to defendants, then the avoidance actions of liquidators will be less successful and the equality principle will be eroded further.[40]

Another element of the current law which contributes to the undermining of the equality principle is the fact that due to a lack of funds, preferences may not be able to be attacked by a liquidator.[41] If a preference which is clearly voidable cannot be set aside because of a lack of funds, there is no equality, because at least one creditor has received more than the others. The Harmer Report expressed concern about this issue[42] and recommended that a fund, to be known as the Insolvent (Assetless Companies) Fund, be established.[43] The government did not implement the proposal, and it has, one assumes unwittingly, contributed to the weakening of the equality principle.

Allied to this last point is the fact that those who receive the benefits of voidable transactions, particularly creditors who have received preferential transfers, are often aware of the problems related to costs which beset liquidators who wish to challenge such transactions. Potential defendants to actions initiated by liquidators may resolutely resist all demands made by liquidators and their solicitors on the basis that they know that liquidators may not have access to sufficient funds to enable them to run costly avoidance actions.[44]

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39 See s588FG(2).

40 Shanker, "The American Bankruptcy Preference Law: Perceptions of the Past, the Transition to the Present, and Ideas for the Future" in Ziegel & Cantlie (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, Oxford 1994) p331 argues that such protections are not valid if equality is the overriding goal of bankruptcy. In the United States, where the 1978 amendment of its bankruptcy legislation endeavoured to further creditor equality, it is ironic that more and more exceptions of the type discussed above were enacted (see Shanker at 343-344).

41 This was adverted to by Drummond J in *Movitor Pty Ltd v Sims* (1996) 14 ACLC 587.

42 Harmer Report at paras 337-338, 340, 343.

43 At para 346. The fund was to be established by an annual levy on all companies payable at the time of the filing of their annual returns, and the amount of the levy was to be prescribed by regulation: see para 348-350.

44 The predicament of the liquidator is likely to be relieved somewhat by the decisions in *Movitor Pty Ltd v Sims* (1996) 14 ACLC 587 and *UTSA Pty Ltd (in liq) v Ultra Tune Australia Pty Ltd* (1996) 21 ACSR 251, where the Federal Court and the Supreme Court of Victoria, respectively, recognised that a liquidator could agree to assign a portion of the proceeds of an avoidance action to an insurer which agreed to underwrite the liquidator's legal costs and expenses. Young J of the Supreme Court of NSW is of the view that the courts should as a matter of course readily approve of liquidators entering into insured litigation financial arrangements: *Re Feastys Family Restaurants Pty Ltd* (Unreported, NSW Supreme Court, 27 May 1996).

*Lack of Deterrence*

Another rationale for the existence of a law avoiding preferences is to deter creditors from dismembering debtor companies, leaving liquidation as the only result.[45] However, the present law has little, if any, deterrent effect.

First, many creditors, particularly the non-lending institutions and smaller firms, which do not regularly have substantial problems with debtors, are unaware of the avoidance provisions.[46] Creditors will apply pressure to obtain repayment just as they would normally with a recalcitrant debtor.

Second, s588FG may provide a defence to an action initiated by the liquidator for recovery of the preference. This encourages creditors not to monitor the financial position of the debtor company so that it cannot be said, if a payment is made, that they knew of the insolvency of the company. If there is no monitoring then creditors will be unaware that they are dismembering a company in distress.[47]

Third, all too frequently it appears, creditors are willing to take a preference and to assume the risk of having to disgorge it at some point in the future.[48]

The problem facing a liquidator is, as mentioned above, that he or she may have insufficient funds to launch legal proceedings and the creditors may be unwilling to give a liquidator an indemnity to permit him or her to prosecute the claim. A preferred creditor may be aware of these circumstances and this may encourage any demands by the liquidator to be steadfastly resisted.

Fourth, a creditor might reason that it is worthwhile to take a preference and then assist the company to remain afloat until the time zone prescribed for the avoidance of the

45 Orelup, "Avoidance of Preferential Transfers Under the Bankruptcy Reform Act of 1978" (1979) 65 *Iowa L Rev* 209 at 212-213; Farrar, "The Bankruptcy of the Law of Fraudulent Preference" [1983] *JBL* 390; Herbert, "The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) and (4) of the Bankruptcy Code" (1983) 17 *U Rich L Rev* 667 at 668; Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 987; Hollander, "Preferences: Section 547" (1986) 3 *Bankr Dev J* 365 at 466; *Levit v Ingersoll Rand Financial Corp* 874 F 2d 1186 at 1192-1194 (1989); *Report of the Commission on the Bankruptcy Laws of the United States*, H Doc No 137, Pt 1, 93d Cong 1st Sess 202 (1973). The Harmer Report also seems to accept this as a justification for preference law (at para 632).

46 This is implicitly acknowleged by Nimmer in "Security Interests in Bankruptcy: An Overview of Section 547 of the Code" (1980) 17 *Hous L Rev* 289 at 291.

47 See McCoid, "Bankruptcy, Preferences and Efficiency: An Expression of Doubt" (1981) 67 *Va L Rev* 249 at 263-264.

48 Creditors may not enforce a claim which is likely to be a preference if they have to incur expenses, such as litigation costs to obtain the debt. This is because, if the creditors were required to disgorge their preferences, the costs of litigation could not be claimed in a subsequent winding up.

transaction has elapsed,[49] thereby protecting the payment received. For instance, X, a creditor, receives a payment from Y Ltd on 7 May. If X can assist Y Ltd so that no winding up application is filed against Y Ltd until after 7 November, the payment received cannot be attacked as a preference (assuming X and Y Ltd are not related entities).

Fifth, typically creditors may have no idea whether a debtor is giving them a preference which is voidable because they do not know whether the company will go into liquidation.

Finally (and this is related to some of the previous reasons) there are no penalties for obtaining a preference. The worst to be expected is that the creditor will have to disgorge the payment.[50] Section 588FI provides that where a transaction is an unfair preference and the creditor disgorges so as to put the company in the same position as if the transaction had not been entered into, the creditor is entitled to prove in the winding up as if the transaction had not been entered into.[51]

The provision is included in the *Corporations Law*, inter alia, in order to encourage creditors to give up the benefit of preferences.[52] It is submitted, respectfully, that this is naïve. The attitude of creditors, often following legal advice, is one of pragmatism. They will obtain payment from a company in difficulty even if it is likely to constitute a preference, because the worst that can happen is the restoration of the status quo if he or she is required to disgorge. Liquidation may never occur; even if it does, it may be outside of the six month time zone; even if it does occur within the time zone, the liquidator may not discover it or may decide that he or she has an inadequate case against the creditor. Even if a liquidator demands the repayment of a preference, there is no certainty that he or she will initiate proceedings to recover it. The creditor's only thought will be: is the liquidator adamant about prosecuting this claim or is it a bluff? Furthest from the creditor's mind is likely to be any thought of s588FI. The creditor will, except where his or her position is hopeless, be doing all that can be done to retain the preference.

Creditors have little to lose by accepting a preference. In balancing the probability of successfully keeping the preference against the costs of failing in defending the liquidator's action, the creditor is likely to reason that at worst an amount will have to be paid in respect of the liquidator's costs and interest on any judgment sum awarded to the liquidator.[53] In such a case, the creditor will have had the benefit of the preference for some time and this may outweigh the amounts which have to be paid if the liquidator were

49 Under s588FE(2)(b)(i), this is the six months prior to the relation-back day for a preference.

50 Professor Westbrook ("Two Thoughts About Insider Preferences" (1991) 76 *Minn L Rev* 73 at 85) argues that if the receipt of preferences were penalised the deterrent effect would be much greater. See Carlson, "Security Interests in the Crucible of Voidable Preference Law" [1995] *U Ill L Rev* 211 at 216.

51 This is in the same terms as s122(5) of the *Bankruptcy Act* 1966 (Cth).

52 Explanatory Memorandum to the Corporate Law Reform Bill 1992 at para 1067.

53 The creditor will, of course, have their own legal costs to pay.

successful. Of course, in many situations the liquidator may not have the funds to challenge the preference, and in other cases the liquidator may have the funds but may refrain from proceeding to litigation because the legal advice received is that the liquidator does not have a strong case. Even in circumstances where the liquidator has a relatively strong case, he or she will usually be ready to accept an offer of compromise[54] because of the patent risks which are always involved in litigation, and because it is probable that even if successful in court the liquidator will not be entitled to recover all of his or her legal costs from the defendant.[55]

There is no stigma involved in a creditor not disgorging until proceedings have been issued. Section 588FI, in effect, encourages creditors to refrain from repaying a preference, rather than encouraging payment. Therefore, the section does not achieve its stated aim.[56] It is not very convincing to say to a creditor, in arguing that a preference should not be accepted, that the taking of a preference distorts the aim of the law to achieve equality between creditors. The creditors response to this is likely to be that there is no equality of distribution,[57] and moreover "if I do not take the money someone else will".

**Proof of Insolvency**

It has been incumbent on liquidators for many years, when seeking to attack a transaction as a preference, to establish the insolvency of the company at the time of entering into the impugned transaction. It has been generally accepted that proof of insolvency has been the most difficult of the matters which must be proved.[58] This has been due to a number of

54 This is also the case in the United States. See Herbert, "The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) and (4) of the Bankruptcy Code" (1983) 17 *U Rich L Rev* 667 at 696.

55 A court will usually order the defendant to pay a successful liquidator costs on a party-party basis and not a solicitor-client basis. The liquidator will, unless they have come to some arrangement with their solicitors, be obliged to pay their solicitors solicitor-client costs. The difference between the two scales can be substantial.

56 Explanatory Memorandum to the Corporate Law Reform Bill 1992 at para 1067.

57 See Keay, "In Pursuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions" (1996) *Syd LR* 55 at 69-74.

58 Purcell, "Banks and the Recovery of Voidable Preferences" (1990) 2 *Bond LR* 107 at 111; Wilde, "Preference Actions - The Practical Problems of Trying to Prove" (unpublished paper delivered at Insolvency Seminar conducted by the Queensland Law Society and Institute of Chartered Accountants in Brisbane on 27 October 1989). For examples, see *M & R Jones Shopfitting Co Pty Ltd (in liq) v The National Bank of Australasia Ltd* (1983) 68 FLR 282; 1 ACLC 946; *Sheahan v Vogt* (Unreported, SA Supreme Court, Bowen Pain J, 7 May 1993).

factors.[59] First, there is some uncertainty as to what liabilities[60] and what assets[61] can be taken into account when determining whether a company was insolvent at a particular point in time.

Second, the determination of whether a company was insolvent cannot be based solely on an investigation of a balance sheet:[62] demonstrating that the assets were outweighed by the liabilities. There is, however, authority for the proposition that a reconstructed balance sheet could be admitted into evidence and taken into account.[63] The process of establishing insolvency may be costly[64] and there is no guarantee that a court will accept that a company was insolvent.

Third, liquidators have encountered difficulties in obtaining the necessary evidence to prove insolvency.[65] The requisite documents and records may have been destroyed or be held by persons who are not willing to hand them over to the liquidator. Liquidators may be unable to locate officers and others in possession of such documents. If the liquidator can locate the person holding the necessary records he or she will be able to examine that person (as an examinable officer within the meaning of s596A) and the court may direct an examinee to produce, at such an examination, books which are in the examinee's possession.[66] A person who is not an examinable officer may be examined under s596B if an order of the court is secured by a liquidator. If such an order is made then the court can direct that books in the person's possession be produced at the examination.

If the person in possession of the records and books of the company and sought by the liquidator is a contributory, trustee, receiver, banker, agent or officer of the company, then

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59 See generally, Keay, "The Insolvency Factor in the Avoidance of Antecedent Transactions in Corporate Liquidations" (1995) 21 *Mon ULR* 305.

60 For example, does one take into account a debt that is due but not payable because the creditor has granted the company an extension? At 312-322.

61 For example, can a court take into account the fact that the company can obtain the money needed to cover its debts by obtaining an unsecured loan? At 322-329.

62 *Calzaturificio Zenith Pty Ltd v NSW Leather & Trading Co Pty Ltd* [1970] VR 605 at 609; *Re Pacific Projects Pty Ltd (in liq)* [1990] 2 Qd R 541 at 544; *Court v National Australia Bank* (Unreported, WA Supreme Court, Commissioner Kakulas QC, 12 November 1990). In *Sheahan v Vogt* (Unreported, SA Supreme Court, 7 May 1993) it was said that the proof of insolvency must entail more than the mere mechanical examination of financial statements.

63 *Re Action Waste Collections Pty Ltd* [1981] VR 691 at 703-704; (1980) 5 ACLR 673 at 685.

64 See *Sheahan v Air Con Serve Pty Ltd* (Unreported, SA Supreme Court, Burley J, 25 May 1994).

65 Generally, see Wilde, "Preference Actions - The Practical Problems of Trying to Prove" (unpublished paper delivered in Brisbane on 27 October 1989 at an Insolvency Seminar organised by the Queensland Law Society and the Institute of Chartered Accountants).

66 See s597(9).

the liquidator can seek an order from the court that the documents be surrendered to the liquidator.[67]

If the person in possession is not within the class of persons just mentioned then the liquidator will be unable to secure an order that the documents be delivered, as the person is regarded as outside the court's jurisdiction.[68]

Overall, this is a very unsatisfactory state of affairs as it appears to create opportunities for abuse. For example, to thwart the liquidator, officers of the company might deliver the documents to outsiders. Admittedly, since the advent of the *Corporate Law Reform Act* 1992 (Cth), liquidators have been entitled to apply to a court for a warrant to search for and seize the company's books.[69] However, it is unlikely that such warrants will be granted frequently. In *Cvitanovic v Kenna & Brown Pty Ltd*,[70] Young J of the Supreme Court of New South Wales gave every indication that courts would be reluctant to grant warrants because of the fact that people have the right to expect their homes not to be "raided".[71] His Honour said that warrants are a remedy of last resort and the courts would not encourage liquidators to apply for warrants.[72] Certainly, there have been few orders made over the years under the equivalent provision in the *Bankruptcy Act* 1966 (Cth).[73] All of this does not bode well for a liquidator who is seeking to secure the company's books.

The legislature has recognised the difficulties encountered by the liquidator and some presumptions of insolvency have been included in Division 1 of Part 5.7B in order, inter alia, to assist in the proof of insolvency.[74] The Explanatory Memorandum to the Corporate Law Reform Bill 1992 noted the observation of the Harmer Report that a liquidator:

> being a stranger to the past business operations of a company, is often confronted with considerable difficulty in affirmatively establishing that a company was insolvent at a time prior to the winding up, even though there may be every indication that this was the case.[75]

67 See s483.
68 *Evans v Bristile Ltd* (1992) 10 ACLC 1415 at 1419.
69 See s530C.
70 (1995) 18 ACSR 387.
71 At 388.
72 At 388-389. In *Morton v Robins* (1996) 14 ACLC 1197, Northrop J of the Federal Court indicated that he would adopt a less strict approach. Since that decision, Young J has affirmed the view he stated in *Cvitanovic v Kenna & Brown Pty Ltd* (*Wily v Parker* (Unreported, NSW Supreme Court, 18 July 1996)).
73 See s130.
74 The company being liquidated will be presumed to have been insolvent at a particular time before liquidation if certain circumstances existed.
75 Explanatory Memorandum to the Corporate Law Reform Bill 1992 at para 1020.

The presumptions are contained in ss588E(3), (4) and (8).[76] They apply to "recovery proceedings",[77] a term which includes an application made by the liquidator to the Court pursuant to s588FF in which an order is sought in relation to a voidable transaction.[78]

It is submitted that, overall, the presumptions are not likely to advance the position of the liquidator substantially where he or she is claiming that an unfair preference was given. The presumption which a liquidator would probably like to use most frequently, contained in s588E(4), is that if a company has breached s289(1) by failing to keep adequate accounting records, or it has breached s289(2) by failing to retain such records for a period of seven years, it is presumed to be insolvent for the period to which the inadequacy or absence of the records relates. This presumption can only be used where a related entity is a party to the transaction.[79] The fact of the matter is that the bulk of preferences do not involve related entities.

## Problems With Legal Proceedings

### *Costs*

If a liquidator takes proceedings he or she is generally entitled to be indemnified from the unsecured assets of the company[80] and the costs for which he or she is liable have, historically, a relatively high priority as part of the costs and expenses of winding up.[81] In effect, this indemnity allows the liquidator to have an equitable lien over the unsecured assets of the company.[82]

However, it is probable that if a liquidator is ordered to pay the costs of a successful opponent in a preference action, what the liquidator pays cannot be regarded as expenses properly incurred within s556(1)(a) of the *Corporations Law*. This provision is limited to expenses of the liquidator (or other administrator) and, inter alia, to the expenses in getting in the company's property. There is some doubt as to whether a costs award is capable of being classified as "expenses". Furthermore, even if an award could be so classified, one must doubt whether it could be said to involve expenses "in getting in company property."

76 For a discussion of the presumptions, see O'Donovan, "Voidable Dispositions and Undue Preferences: The Transition to the New Regime" (1994) 12 *CSLJ* 7 at 15; Keay, "The Insolvency Factor in the Avoidance of Antecedent Transactions in Corporate Liquidations" (1995) 21 *Mon ULR* 306 at 329-332.

77 Section 588E(2).

78 See s588E(1)(a).

79 Section 588E(7).

80 For example, see *Re Bonang Gold Mining Co Ltd* (1893) 14 LR (NSW) (Eq) 262; *Re Buena Vista Motors Pty Ltd (in liq)* [1971] 1 NSWLR 72; *Ferrier & Knight v Civil Aviation Authority* (Unreported, Federal Court, Lockhart J, 24 March 1994).

81 *Re Dominion of Canada Plumbago Co* (1884) 27 Ch D 33; *Re Beni-Felkai Mining Co Ltd* [1934] Ch 406 at 418-419; *Re Mesco Properties Ltd* [1979] 1 WLR 588; 1 All ER 307.

82 *Nationwide News Pty Ltd v Samalot Enterprises Pty Ltd* (1986) 5 NSWLR 227; 10 ACLR 748.

In fact, the type of situation envisaged by this discussion is where the liquidator has failed in an action to get in what he or she asserts is company property.

The wording in s556(1)(a) is similar to that contained in the relevant provisions of the *Insolvency Rules* 1987 (UK).[83] The latter provides that a priority is given to "expenses properly chargeable or incurred by the liquidator in ... getting in any of the assets of the company".[84] The disturbing fact for an Australian liquidator is that in *Re MC Bacon Ltd*,[85] Millet J held that costs incurred in prosecuting an unsuccessful preference action did not qualify as expenses within the Rules.[86] If this view is applied in Australia it would mean that liquidators would not able to recoup costs awarded against them.

Millet J held that a claim to recover a preference is not a claim to get in an asset of the company.[87] He took this view because he accepted the statement in *Re Yagerphone Ltd*,[88] that an asset recovered under a preference action does not become part of the company's assets. When the asset is received by the liquidator it is impressed with a trust in favour of the unsecured creditors.[89] Further, his Lordship said that the *Insolvency Rules* referred to existing assets and until an order under the equivalent of s588FF is made and complied with there is no such asset.[90] Millet J also noted that the expenses of getting in an asset do not include the costs of an unsuccessful attempt to recover an asset.[91] His Lordship felt that he was supported, inter alia, by the fact that expenses under the Rules were paid before the costs of the person who applied for winding up.[92] This is, of course, the same position which exists under the *Corporations Law*.[93]

If the decision in *Re MC Bacon Ltd* is applied, liquidators might look to s556(1)(dd) as the basis on which they might recoup money paid under a costs award. The provision refers to "other expenses" (except deferred expenses) properly incurred by a "relevant authority", a term which includes a liquidator.[94] It is submitted that if liquidators have legal advice that they have a fair claim under the Division and they are not guilty of misconduct, it is likely that recoupment of a costs award could be claimed under this provision. The concern which liquidators might have is that by the time expenses encompassed by s556(1)(dd) are able to be paid, the higher priority items will have exhausted the assets of the company.

83 See rule 4.218(1)(a).
84 *Insolvency Rules* 1987 (UK) rule 4.218(1)(a).
85 [1991] Ch 127.
86 See Hunt, "Avoidance of Antecedent Transactions - Who Foots the Bill?" (1992) 7 *Ins L&P* 184.
87 [1991] Ch 127 at 137.
88 [1935] Ch 392.
89 [1991] Ch 127 at 137.
90 At 138.
91 As above.
92 As above.
93 Payable under s556(1)(b).
94 Section 556(2).

If liquidators are compelled by statute to embark on a course of litigation they will not be required to pay anything over and above the costs which are met by the available assets of the company.[95] However, if liquidators initiate proceedings for the setting aside of a preference they would not be protected because there is no compulsion that the proceedings be commenced. In *Ferrier and Knight v Civil Aviation Authority*,[96] Lockhart J held the liquidators in an unsuccessful preference action were personally liable for the costs of the defendant. His Honour based this finding on the fact that the defendant should not be in jeopardy for its costs.

All of this means that liquidators should, and they usually do, seek indemnities from creditors before embarking on avoidance proceedings. If they obtain effective indemnities then it will not matter if there are insufficient assets in the company. Furthermore, even if there are sufficient assets, liquidators will not have to be concerned as to whether they can have access to them to meet any liability for costs. Of course, liquidators must ensure that those granting indemnities are persons or entities of substance.

It has become common practice for liquidators to seek the establishment of "fighting funds" by creditors.[97] These involve creditors contributing "a certain number of cents in the dollar proportionately in accordance with the admitted level of their proofs of debt."[98] The advantage of such a fund for liquidators is that it will not be incumbent on them to "chase" money if they are ordered to pay costs.

Another avenue for raising funds for litigation has recently received judicial approval. It was held in *Movitor Pty Ltd v Sims*[99] that liquidators are permitted to enter into contracts of insurance whereby an insurer agrees to provide funds for legal proceedings in exchange for a percentage of the proceeds of the action.[100]

A further concern for a liquidator, albeit of marginal importance, is that a defendant in an avoidance action may apply for an order for security for costs under s1335. It must be noted that courts will rarely make such an order against a liquidator.[101] In *Re Strand Wood*

95 Hamilton, "Aspects of Official Liquidators' Personal Liability for Costs of Litigation" (Pt 2) (1989) 7 *CSLJ* 301 at 305 and referring to *Re Buena Vista Motors Pty Ltd (in liq)* [1971] 1 NSWLR 72 at 75. See also, *Re Tokenhouse Investments Ltd* [1934] St R Qd 189.

96 Unreported, FedCt, 24 March 1994.

97 Hamilton, "Aspects of Official Liquidators' Personal Liability for Costs of Litigation" (Pt 2) (1989) 7 *CSLJ* 301.

98 At 301.

99 (1996) 14 ACLC 587.

100 It was explicitly held by Drummond J of the Federal Court that the arrangement was not champertous. The same approach was adopted by Hansen J of the Supreme Court of Victoria in *UTSA Pty Ltd v Ultra Tune Pty Ltd* (1996) 14 ACLC 1262.

101 This is acknowledged by Lockhart J in *Ferrier & Knight v Civil Aviation Authority* (Unreported, Federal Court, 24 March 1994).

*Co,*[102] the English Court of Appeal indicated that the practice of the Court not to order security against liquidators was well established,[103] and in *Re Pavelic Investments Pty Ltd,*[104] Blackburn CJ said that the practice was so inveterate that it was almost to the point of being regarded as a rule of law. The rationale for the reluctance of courts to make security orders is, according to Blackburn CJ, that the liquidator is performing a public function on the part of the creditors and contributories.[105]

The only situation in which a security order would be made is likely to be where proceedings initiated by the liquidator are improper or meritless.[106] For instance, in *Newark Pty Ltd (in liq) v Civil and Civic Pty Ltd,*[107] Pincus J, after striking out the primary application because it had no substance and referring to the proceedings as "strange litigation",[108] said in relation to an application for security:

> There is no need to have to resort to the shadowy nature of the claim, as analysed above, in exercising discretion ... Had I not been of the view that the application should simply be struck out, I would have ordered that the proceedings be forever stayed unless there were filed within 21 days an undertaking under seal by the liquidator ... to pay any costs ordered to be paid to the respondents but not recovered from the applicant company.[109]

The problem with liquidators being personally liable for costs is that persons against whom liquidators might consider proceeding often refuse to submit to a liquidator's demand because they know that the liquidator may well lack funds to commence, let alone prosecute, an action. Moreover, because liquidators may well be personally liable for any costs awarded in the event of unsuccessful litigation, then liquidators will often be reluctant to institute proceedings at all. This could mean that many preferences go unchallenged and cause people to view the avoidance regime with contempt.

*The Margin Between Good and Bad Claims*

The rules which determine what constitutes a good preference action are rather arbitrary and this leads to the criticism that the difference between the situation which gives rise to a good claim and the situation which gives a defendant a good defence is marginal. The

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102 [1904] 2 Ch 1.
103 At 4.
104 (1983) 1 ACLC 1207.
105 At 1207-1208.
106 O'Donovan, *McPherson: The Law of Company Liquidation*, p74; Hamilton, "Aspects of Official Liquidators' Personal Liability for Costs" (Part 1) (1989) 7 *CSLJ* 262 at 270.
107 Unreported, Federal Court, 9 March 1988 and referred to by Hamilton "Aspects of Official Liquidators' Personal Liability for Costs" (Pt 1) (1989) 7 *CSLJ* 262 at 270.
108 At p8 of the judgment.
109 At p8 and cited by Hamilton, "Aspects of Official Liquidators' Personal Liability for Costs" (Part 1) (1989) 7 *CSLJ* 262 at 270.

result is that liquidators can find it difficult to ascertain whether a good case against the alleged preferred creditor exists. Consequently, there is a degree of unfairness in that there is discrimination between preferred creditors on tenuous grounds.

First, take the situation which exists in relation to running accounts. Those creditors who received payments for debts from companies (now in liquidation) during the six months before the relation-back day will not be required to disgorge the payments as preferences if they are able to prove that the payments were made pursuant to a running account.[110] Whether or not payments are held to be part of a running account is always problematical. The facts which may produce the conclusion that a running account existed and the facts which lead to the conclusion that there was no running account may be only marginally distinguishable. Courts have often been indecisive on this point. This is illustrated to some extent by the case of *Ferrier and Knight v Civil Aviation Authority*.[111] This case involved a complex set of facts surrounding payments made by Compass Airlines Pty Ltd during the six months prior to the commencement of its winding up. In a nutshell, the company made nine payments to the Civil Aviation Authority (CAA) during a time when the CAA provided various services which were critical to the continuation of the company's operations, such as air traffic control services, flight information and rescue services. The liquidators of the company claimed that the CAA had been given preferences totalling $10,351,523.90. Lockhart J of the Federal Court held, at first instance, that the liquidators' claim failed as the payments were not preferences, but were made pursuant to a running account.[112] The liquidators appealed to the Full Court which held that there was not a running account, and so the payments were preferences.[113] The CAA (subsequently re-named "Air Services Australia") then appealed to the High Court, and by a 3:2 majority its appeal succeeded.[114] In his judgment in the High Court appeal, Toohey J pointed out the lack of unanimity that there was in the courts on issues relating to the question of running accounts.[115] The *Ferrier* case illustrates the uncertainty which faces a creditor. Often it is almost impossible for a creditor to know whether dealing with a debtor (which is in bad shape financially) will result in their being required to disgorge any payments received, or whether a court would take the view that a running account existed.

110 See s588FA(2).

111 (1994) 48 FCR 163 and, on appeal to the Full Court of the Federal Court, (1995) 127 ALR 472 and, to the High Court, (1996) 21 ACSR 1.

112 (1994) 48 FCR 163. The case involved consideration of transactions which were entered into before the enactment of s588FA. The Court considered the common law principles relating to running accounts. The common law on the subject appears to have been codified in s588FA(2).

113 (1995) 127 ALR 472.

114 See *Air Services Australia v Ferrier* (1996) 21 ACSR 1. Interestingly, taking into account the three decisions delivered in the course of this litigation, a majority of judges (5:4) found in favour of the liquidator, yet the liquidator ended up losing the action.

115 At 30-32.

Second, in relation to cases where the defendant argues that the defence in s588FG can be relied on and where the defendant must establish, inter alia, that he or she had no reasonable grounds to suspect the insolvency of the company at the time of the impugned transaction, it may well be difficult for courts to decide whether a defendant did or did not have reasonable grounds. This causes uncertainty for both liquidators and creditors alike. Neither group may be able to assess to a reasonable degree whether a preference claim could be defeated successfully. In dealing with a debtor, a creditor cannot be sure that any payments will be immune from attack by a liquidator on the basis that the creditor should have suspected insolvency.

*The Protective Provision*

Since the 1933 decision in *S Richards and Co Ltd v Lloyd,*[116] it has not been necessary for liquidators in Australia to prove any mental element on the part of either the debtor or the creditor in order to establish the existence of a preference. The liquidator's only task has been to prove that a transaction covered by the legislation occurred within a certain time frame before winding up when the debtor was insolvent and the transaction favoured a creditor with the effect that the creditor received an advantage over other creditors. This objective theory means that the motive of the parties to transactions is regarded as irrelevant in determining whether a preference should be impugned.[117]

However, where creditors rely on s588FG ("the protective provision") a mental element is relevant. To gain protection creditors must establish, inter alia, that they acted in good faith. Creditors must also prove that there were no reasonable grounds for suspecting insolvency (which involves consideration of an objective standard) and unless creditors can prove that they acted in good faith, ie they did not believe that a preference was being given and did not know that the debtor was insolvent, then they cannot "pass first base" in establishing a defence. Hence, even though Australian law has eschewed any notion that the intention of the parties to the preference transaction are to be examined, and technically speaking no mental element has to be established by the liquidator to prove a preference, there is an element of culpability in preference law.

Is it fair that persons who can establish good faith (and other criteria) can escape the preference net? The fact is that if the aim of the avoidance provisions is to ensure that there is equality between creditors, then any preference which causes the estate to be

116 (1933) 49 CLR 49. For examples of cases following the same approach, see *Richardson v Commercial Banking Co of Sydney Ltd* (1952) 85 CLR 110; *Re An Application by JGA Tucker and Reid Murray Developments (Qld) Pty Ltd* [1969] Qd R 193; *Re Cummins* (1985) 62 ALR 129; *Matthews v Geraghty* (1986) 11 ACLR 229; *Ferrier and Knight v CAA* (1995) 127 ALR 472 at 485-487; *Air Services Australia v Ferrier* (1996) 21 ACSR 1.

117 This is in stark contrast with the law in England where the motive of the debtor has been significant in determining whether a voidable preference was granted to a creditor. See *Bankruptcy Act* 1914 (UK) s44 (now repealed) and *Insolvency Act* 1986 (UK) s239(5).

dissipated jeopardises that aim, no matter what was the state of mind of the creditor.[118] The distribution scheme applies to all unpaid creditors, and how creditors act before the liquidation and what they know or do not know is of no relevance in determining what will be received under the distribution.[119]

There are, in effect, good and bad preferences.[120] The law does not put it in this manner, but it does draw a critical distinction between two types of preference. Bad ones are those given in the six months before the relation-back day and where the protective provision cannot be relied upon. Good preferences are those that were given during the relevant time zone but the creditors are able to rely upon the protective provision because they acted in good faith and did not have any reason to suspect the company's insolvency: these latter preferences are not overturned.

The protective provision has its roots in the law as it was developed by Lord Mansfield in the eighteenth century. It was regarded as appropriate then, but it is questionable whether that remains the case today. Unlike England, in Australia we have seen the omission of any culpability requirement on the part of a debtor before it can be said that a preference has been granted. Australia has an objective theory of preferences, that is until it comes to the question of defences. One must question why an element of culpability should be retained when it comes to considering defences to preference claims? It seems clear that any attempt to distinquish between good and bad preferences has been elusive ever since the time of Lord Mansfield.[121]

It can be argued with some force that there is no such thing as a "bad preference" and a "good preference". All preferences involve creditors receiving what they are entitled to at law. In receiving a preference the creditor is doing nothing improper.[122] Consequently, it could be submitted that it is not fair to discriminate between creditors on the basis of whether or not they knew that they were receiving a preference or had knowledge of the debtor's insolvency. Often such knowledge is not due to some careful investigation: it may well come as a result of a chance discussion or meeting with others, or as a result of

118 See Ponoroff, "Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time" [1993] *Wis L Rev* 1439 at 1449.

119 See Shanker, "The American Bankruptcy Preference Law: Perceptions of the Past, the Transition to the Present, and Ideas for the Future" in Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (Clarendon Press, Oxford 1994) pp321-322.

120 This nomenclature is employed by Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 982; Morris "Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens" (1970) 54 *Minn L Rev* 737 at 738-739.

121 Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 1035.

122 Shanker,"The American Bankruptcy Preference Law: Perceptions of the Past, the Transition to the Present, and Ideas for the Future" in Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* p332.

what is said by the debtor. Ironically, the more honest a debtor is with creditors about its financial position, the more likely that creditors will be unable to defend preference claims.

Another shortcoming follows from the manner in which the protective provision is applied. The way that the law has developed, creditors who have received payment for their debt, without placing any pressure on the debtors, have a greater chance of establishing a defence compared with creditors who exert some pressure and receive payment, even though none of them are aware of the insolvency of the debtor when the respective payments are made. Merely the fact that pressure was exerted is likely to tell against the latter creditors, as it may be sufficient for a court to infer knowledge of insolvency. This is despite the fact that the law encourages creditors to be diligent in obtaining repayment of debts.

## THE CONTEXT FOR REFORM

The existence of the concerns which have been raised in relation to the present preference law and how it is applied indicate that the law is not satisfactory. It is submitted that a better scheme than the one contained in the Division can be employed. Before considering that scheme it is important to assess the ramifications likely to result from any reform measure posited. While a particular action may achieve one improvement to the legislation, it could be deleterious to other aspects of the legislation. It is submitted that it is incumbent on any reform measure in relation to the avoidance of pre-liquidation transactions to achieve a reasonable balance between three critical elements, namely, fairness, efficiency and effectiveness. Any measure which will substantially depreciate any of the elements is unlikely to be embraced. Consequently, the reform measure that I have argued for here will be evaluated against the notions of fairness, efficiency and effectiveness.

In addition, reform proposals will be examined to see if they are congruent with the rationale for liquidations and the rationale for the existence of the preference provision. The main rationale that has been given for liquidation is to ensure that there is an equal and fair distribution of the assets of an insolvent company.[123] It has also been said that liquidation exists to provide an orderly procedure for dealing with the affairs of such companies.[124] There have been two primary rationales (discussed above) given for the existence of preference provisions: namely, equality between creditors in distribution; and

123 O'Donovan, *McPherson: The Law of Company Liquidation* p5; Farrar, Furey, Hannigan & Wylie, *Farrar's Company Law* p709; Lipton "The Priorities Among Unsecured Creditors under the Corporate Law Reform Act, 1992" (1993) 1 *Curr Com L* 24; Finch, "Directors' Duties: Insolvency and the Unsecured Creditor" in Clarke, *Current Issues in Insolvency Law* p87.

124 Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge, Harvard University Press 1986) p17; Warren, "Bankruptcy Policymaking in an Imperfect World" (1993) 92 *Mich L Rev* 336 at 343; Keay, "In Pursuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions" (1996) 18 *Syd LR* 55 at 61.

deterring dismemberment of companies. I have also argued elsewhere that a third rationale is to assist the orderly collective process for dealing with the affairs of insolvent companies.[125]

There will be an overlap in considering the elements of fairness, efficiency and effectiveness and the rationales. This is especially evident in relation to one of the rationales for winding up, that is, an orderly collective proceeding. The avoidance provisions are intended to assist the attainment of this rationale by bringing back into the estate, for distribution, property disposed of before liquidation, so that there is no advantage to creditors grabbing what they can before the commencement of winding up. In order to promote an orderly collective process, the avoidance provisions must be fair, effective and efficient, and, through legislation, provide for the automatic avoidance of all preferences within a certain time zone prior to winding up. Such an approach fixes the rights of all creditors at the beginning of the time zone, and its focus is on the principle of *pari passu* and control of the behaviour of creditors.

## AUTOMATIC AVOIDANCE

While the law dealing with preference avoidance has a long lineage and the principles relating to it have remained substantially the same for many years (certainly since the enactment of s95 of the *Bankruptcy Act* 1924 (Cth)) the rules should not necessarily be immune from radical reform.

It is argued in this section of the article that it would be beneficial if Australian corporate law were to embrace an automatic avoidance scheme in relation to preferential transfers.

### Defining Automatic Avoidance

What does an automatic avoidance scheme in relation to preferences entail? Simply, it means that there is no requirement on liquidators to establish any elements in proving their case save that a preferential transaction was entered into with a creditor at a particular time. This would require liquidators to demonstrate that a benefit was bestowed on a creditor of the company in relation to a past debt, and the effect of the transaction advantaged the creditor vis à vis the other creditors of the company. The result would be the elimination of the most technical and difficult problems of proving a claim. A person, who, it is claimed, is in receipt of a transfer during the preference time zone, should be entitled to deny that the transfer was preferential. However, there would be no need for the liquidator to establish insolvency and there would be no exceptions to avoidance. Thus,

125 Keay, "In Pursuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions" (1996) 18 *Syd LR* 55 at 61-65.

the protective provision in s588FG would be omitted from the law, as would the running account exception. This would produce a strict approach.[126]

### The Case For Automatic Avoidance

#### *The Present System Is Arbitrary*

The avoidance of preferences under the present system produces arbitrary results in that one preference in the prescribed time zone is recovered and another is not. Why should X have to disgorge a payment because he or she should have reasonably suspected the insolvency of the company, when another person, Y, who is deemed not to have suspected insolvency, is able to retain the payment he or she received? Often the distinction between the situations of creditors like X and Y is not great, and frequently those creditors who are able to rely on the protective provision do so largely by chance. An automatic avoidance rule would mean that all preferences within a designated time zone prior to winding up would be avoided, producing greater fairness as all preferred creditors would be treated equally.

#### *The Difficulty of Establishing Preferences*

As discussed at pages 169-171 above, liquidators encounter a number of difficulties in proving that preferences were given,[127] and a strict approach would mean that they would be relieved of those burdens.

An automatic avoidance regime would provide a much simpler scheme, namely, there would be no need to consider issues of insolvency, good faith and whether the defendant had a reason to suspect the insolvency of the debtor. The liquidator's investigation costs, as well as the cost associated with the gathering of evidence, would be diminished.

The majority of preference cases that go to hearing at present involve a claim by the defendant that the liquidator should not succeed because of the protective provision.[128] Determining whether a defendant is able to rely on the provision is often a difficult task for a court.[129] Even if such claims had to be litigated under an automatic avoidance regime, they would be far simpler to determine and consequently occupy less court time.

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126 Professor Tabb ("Rethinking Preferences" (1992) 43 *SCLR* 981 at 1035) refers to the situation as akin to "strict liability".

127 Pincus JA of the Court of Appeal of the Supreme Court of Queensland stated this in his submission to the Harmer Committee (at para 631).

128 Most of the balance of cases will involve a claim by the defendant that the company was not insolvent at the time of the transaction.

129 This is best seen in the problems that courts have had in deciding whether a defendant entered into a transaction in the ordinary course of business (see *Bankruptcy Act* 1966 (Cth) s122(2)). Although the "ordinary course of business" test is no longer part of the

*Promoting Equality*

A major advantage of automatic avoidance is that it would promote the principle of equality,[130] which remains the main publicised rationale both for liquidations and the existence of a preference provision, primarily as it is seen as producing an equitable resolution of the liquidation problem. The use of the automatic avoidance concept would reverse the trend of many years, which has seen the extensive weakening of the principle.[131] An automatic avoidance regime could in fact enhance the principle of equality as creditors would be prevented from relying upon exceptions to the law against preferences. Under this approach there would be true equality between unsecured creditors who have no priority rights under s556. This would undoubtedly be fairer than the present system.

*Promoting the Deterrence Policy*

The employment of automatic avoidance would have the result of promoting the policy of deterring people from obtaining benefits by dismembering insolvent companies. The fact that there would be no defences available, and the liquidator would not be required to establish insolvency in recovering preferences, might mean that some creditors would be less inclined to expend the necessary costs in obtaining payment of money owed.[132]

*An Example of Automatic Avoidance*

The suggestion of a strict approach is not as extreme as it might first seem, for the strategy is not without precedent in insolvency legislation. As far back as 1957, the United Kingdom's *Report of the Committee on Bankruptcy Law and Deeds of Arangement Law Amendment* [133] (commonly known as "the Blagden Committee") recommended an automatic avoidance time period.[134]

*The Time Zone*

What time zone should apply where automatic avoidance is to operate? The period cannot be too long as that would be unfair due to the strictness of the scheme. It has been said that companies which are wound up in insolvency are usually insolvent during the 90 days

law, it is submitted that there are problems with determining whether a defendant is able to rely on s588FG.

130 Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 1029.

131 Cork Report at para 233; Fletcher, *The Law of Insolvency* (Sweet & Maxwell, London, 2nd ed 1996) p2.

132 Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 1030.

133 Cmnd 221.

134 At para 119. The recommendation was never implemented.

prior to the liquidation commencing.[135] It is submitted that the period should be no longer than 90 days. Professor Tabb has advocated such a period,[136] but at the end of his main work on the topic, he appeared willing to accept a 45 day zone, in order to limit criticism that automatic avoidance would increase uncertainty costs.[137] It is respectfully submitted that this should not, alone, be the reason for reducing the time zone.

The Blagden Committee recommended a period of 21 days, but it was not intending to revolutionise preference avoidance as it recommended the retention of the six months zone where the trustee in bankruptcy could prove intention to prefer on the part of the debtor.[138] With respect, there are two reasons why both 21 days and 45 days are too short. First, they would permit too much opportunity for dissipation of funds, and secondly creditors might be able to extract payments and then prop up the company for such short periods so that when liquidation eventuated the payment was outside of the avoidance zone. However, 90 days is a fairly long period and 60 days may be preferable. The time period is really a side issue and should not be the sole reason for dismissing the proposal.

A point of concern in any reform of the law is the issue of related parties, such as directors and those associated with the company. Is the time zone which is to operate to apply equally in relation to preferences given to these persons and entities? It is submitted that a short time period is inappropriate. For such persons it is necessary to have a longer time, as they can often realise that liquidation is a distinct possibility before other creditors.[139] Given this advantage, it would seem to be fair to extend the automatic avoidance time period to six months[140] and retain the four year time zone which presently applies where a liquidator can establish a preference under the existing rules.[141] Does this cause a problem in that liquidators have to consider two different types of preferences? In creating two sets of rules there may be a marginal increase in costs, but that is all. Liquidators are already accustomed to considering transactions in different lights. All suspicious pre-liquidation transactions must be examined to see if they fall under one of the categories mentioned in the regime, and this proposal would merely add one more type of voidable transaction that would have to be considered. This is not onerous, particularly when one takes into account the fact that the liquidator's task as far as avoiding preferences in favour of non-related parties should be made easier.

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135 For example, the Harmer Report (at para 639); Orelup, "Avoidance of Preferential Transfers Under the Bankruptcy Reform Act 1978" (1979) 65 *Iowa L Rev* 209 at 217.

136 Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 1033.

137 At 1034.

138 Cmnd 221 at para 125.

139 Harmer Report at para 636.

140 This appears to have been advocated by Committee J of the International Bar Association in its Discussion Paper, "Statement of Common Principles of Invalid Pre-Bankruptcy Transactions," 21 September 1992 (see para 7).

141 See s588FE(4).

Is it possible, and, if so, desirable, to have an automatic avoidance period, say 60 days, followed by a longer period of up to six months during which the present rules operate? This is attractive to a degree, but there are drawbacks with such a scheme. First, the administration of the law would be made more complicated for the liquidator in that it would increase the number of time zones and proof requirements to be kept in mind. Secondly, and more importantly, it would make the scheme complex; one of the benefits of automatic avoidance would be that it would be quite simple. Thirdly, the costs for the liquidator in attacking preferences in the 60 day to six month period would be the same as they exist at the moment. This might lead to liquidators disregarding preferences during the the 60 days to six month period and concentrating on the 60 day period, as it would be easier to achieve avoidance in the latter period. If this occurred then the extra time zone would be superfluous.

*Reduction in Litigation*

The introduction of an automatic avoidance scheme would reduce the amount expended at present in costly litigation because the need for court proceedings would decrease. This is because creditors would have fewer defences and they would be aware that the burden on liquidators is far less onerous. Litigation would be necessary in some cases, but where it was the costs should be reduced for the same reasons.

## Small Preference Exemption

In an automatic avoidance scheme it would be preferable to provide an exemption for small preferences, say under $1000. There is a good argument for exempting such preferences on the basis that they are not worth recovering from a costs point of view. Such a step would enhance efficiency. The United States presently exempts any preference less than $600.[142] It has been asserted that small preferences do not have a serious impact on the goal of equality.[143]

To avoid an abuse of the exemption, the exemption would have to be limited to say a total of $1000 received by the one creditor in the avoidance period. Unless this was done, creditors could persuade debtor companies to pay their debts in parts with each payment less that $1000, and each payment would be exempt from attack.

## Examining The Case Against Automatic Avoidance

What are the principal reasons militating against the use of the strict avoidance approach?

142 *Bankruptcy Reform Act* 1978 (US) s547(c)(7).

143 US Senate Report 446, 97th Cong, Second Session 319 at 363 and referred to by Giorgianni, "The Small Preference Exception of Bankruptcy Code Section 547(c)(7)" (1994) 55 *Ohio St LJ* 675 at 681.

*Uncertainty*

It is acknowledged that with automatic avoidance there are likely to be some uncertainty costs.[144] For example, people receiving preferences may be unsure whether they can use the money received because of the risk of the company going into liquidation, and the liquidator seeking to recover it. Professor Tabb admits that it is arguable that the uncertainty which exists under the present system would be heightened because of the increased likelihood of the creditor being required to disgorge.[145] Of course, while there is an uncertainty cost with the automatic avoidance scheme, such a criticism can be levelled at any preference rule.[146] At least with what is being proposed here a creditor's uncertainty would only last for 60 days or 90 days at the maximum, while under the present law a creditor's potential waiting period is six months. In any event, Professor Tabb argues that if a creditor thinks that it is unlikely that a winding up application will be filed within the set time zone for preferences, he or she will probably proceed to commit the money elsewhere, whatever the position is with the law of preferences.[147] Hence, Tabb concludes that changing the law to automatic avoidance will not greatly affect, if at all, the decisions made by creditors.[148]

*Discouraging Diligence*

The law encourages diligent creditors. Is it possible to argue that the automatic avoidance concept is antithetical to that encouragement because it would cause creditors to be less diligent? First, while the law encourages creditors to be diligent, this is not the case during the period just prior to liquidation. The law expects creditors to temper their zeal for repayment and embrace the *pari passu* principle. Secondly, it is submitted that automatic avoidance would not precipitate less vigilance. On the contrary, it might be seen as requiring creditors to be more diligent because if they obtain payment as early as possible, there is a greater chance of them retaining the payment on the basis that payment occurred outside of the avoidance period.

*The Effect on Creditors Acting in Good Faith*

Is it right to allow preferences to be clawed back from those persons who are acting in good faith and who have no knowledge of the company's insolvency? Should creditors be protected because of their non-culpable state of mind? It is often a fine line between whether a creditor can or cannot find refuge under s588FG, the protective provision. Also, is there much difference in the end between a creditor who knew of the insolvency and one who did not? If, as many acknowledge, equality is so important in liquidation,

144 Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 1033.
145 At 1033.
146 At 1028.
147 At 1034.
148 At 1034. This discussion assumes that a creditor will consider the issue of preferences.

there can be no justification for the distinction between creditors who knew, and those who did not know, of insolvency at the time of payment. At the point of extending credit all creditors adopted the equal risk of not being paid[149] and all were lawfully entitled to what they received.[150]

It is not to be forgotten that a creditor, X, who has suspicions that one of their debtors, Y Pty Ltd, is insolvent, will be required to disgorge a payment within the relevant time zone even if they exert no pressure on Y Pty Ltd and do not join in the mad scramble to recover what is owed to them, but happen to be paid fortuitously by the company. Is such a creditor more culpable than other creditors which are required to disgorge even though they did not know that Y Pty Ltd was insolvent, but who received payment because their credit managers were very diligent and placed pressure on the company?

The fact is that where the recovery of preferences is concerned there is no moral judgment being made. Liquidation is a matter of getting in the assets of the company, including what it owned during the preference period, and distributing them to the creditors rateably and equally.[151] What a creditor knew or did not know is irrelevant when it comes to the policy of *pari passu* distribution. The fact that creditors can say that they were not aware of the debtor's insolvency and are therefore entitled to retain their preferences, is of no comfort at all to either creditors who may have known of the debtor's insolvency and have had to disgorge or creditors who received no payment at all. The latter groups of creditors will receive much less than the first group, which are allowed to keep what they were given.[152] Creditors who knew of the company's insolvency have not necessarily acted improperly and prima facie do not deserve to be penalised.

*Less Encouragement to Support Distressed Companies*

A major argument that has been mounted against automatic avoidance is that if there was an exclusion of the protective provision then it is likely that creditors would be more reluctant to support companies in difficulty.[153] This would be contrary to one of the aims of insolvency law, namely, to encourage creditors to facilitate the rescue of companies

149 Shanker, "The American Bankruptcy Preference Law: Perceptions of the Past, the Transition to the Present, and Ideas for the Future" in Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* p331.

150 At p347.

151 Orelup, "Avoidance of Preferential Transfers Under the Bankruptcy Reform Act 1978" (1979) 65 *Iowa L Rev* 209 at 216.

152 Countryman, "The Concept of a Voidable Preference in Bankruptcy" (1985) 38 *Vand LR* 713 at 729 fn 100.

153 Professor Ponoroff argues that a rule of strict liability moderated by specific exceptions which enable troubled companies to gain support is the most optimal way of ensuring that there is substantial equality and providing every chance that the company will not enter liquidation. See Ponoroff, "Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time" [1993] *Wis L Rev* 1439 at 1516.

suffering financial stress. There are a number of responses to this, all of which are predicated on the notion that the existence of a protective provision does not create any incentive for creditors to assist debtors. First, it is unlikely that the state of preference law will be determinative, or even mildly influential, in a creditor's decision whether or not to deal with a debtor.[154] It is more likely the case that creditors are as ready to cast debtors loose under the present system as they would under an automatic avoidance scheme because they are reluctant to extend credit to those in trouble. More often than not, creditors will turn to a cash-on-delivery system whenever dealing with a debtor in financial straits and it will matter little what preference law provides.[155] Usually, the creditor is not thinking about specific issues like liquidation and preferences, but about the main issue - "will I get paid?"[156]

Secondly, creditors may decide, even under the current regime, not to extend credit to a debtor because they reason, quite correctly, that another might get paid in preference to them.[157] Therefore, the presence of the exceptions to the preference rule would have no effect on the creditor's decision.

Professor Tabb offers another response, that is that the preference issue only arises if liquidation occurs and if it does arise then the ultimate object of the incentive argument (keeping the company out of liquidation) has not been achieved.[158] With respect, this point is not sound because at the time of extending credit the creditor has no way of knowing whether liquidation would ensue. In fact, the giving of credit could help rescue the company.

The running account principle is also said to provide incentives to creditors to continue dealing with a debtor. It is submitted that the points made in response to the argument that omission of the protective provision will mean creditors will be less keen to support troubled companies are equally valid here.

It is frequently argued that it would be unfair not to except a running account creditor from preference avoidance because the creditor has poured money and/or goods into the company and this will indirectly benefit the general body of creditors on a winding up. This is the result where any creditor has extended credit in some way to a company. For example, a timber supplier allows a building company to have a quantity of timber for the construction of a house on credit. If the company enters liquidation and the supplier has not been paid, then the creditors of the company will benefit when the house which has been built using the supplier's timber is sold.

154 Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 1023.
155 At 1024. For an example where this occurred, see *Re Toowong Trading Pty Ltd* [1989] 1 Qd R 207.
156 Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 1023.
157 At 1024.
158 At 1023.

*No Fixed Time Zone*

The scheme that I have proposed in this article involves the use of a fixed avoidance period of 60 or 90 days. It may be argued that the use of a fixed time period has drawbacks. First, it is arbitrary and, consequently, a matter of sheer chance whether a transaction occurs within the time zone. It is seemingly unfair that a transaction entered into on, say, 18 February is not subject to avoidance, yet a transaction entered into on 19 February is avoided totally. The two transactions could be exactly the same as far as content and format, yet the one day makes all the difference. And there is no period where there is a phasing in of the effect of avoidance; a transaction either completely escapes any attack from the liquidator or is completely caught.

Secondly, a creditor dealing with any company cannot ever be really sure, until the elapse of the time zone, that a payment for an outstanding debt will not be attacked as a preference at some time in the future. The creditor often will have no idea what the fate of the company will be at the time of payment. Many creditors are surprised when they receive letters of demand, many months (or even years) later from a liquidator. While a fixed time period appears to give certainty, that certainty is illusory as it is after the fact.[159]

The existence of a set time period can have an undesired effect. Creditors, in fear that they have received a preference, may be moved to keep the receipt of payment secret from other creditors, even assisting the company financially so that it can remain out of liquidation (if the payment received was sizeable) and then abandoning the company summarily once the time period has elapsed.[160]

Instead of a fixed time applying, it has been suggested that transactions entered into after the company becomes insolvent (on a cash flow basis) are those that should be set aside.[161] It has been argued that this approach produces greater certainty as creditors can ascertain informally or through trade publications whether a company is insolvent.[162] Therefore, creditors are on notice that it is not going to be profitable to seek payment from a debtor which is insolvent.[163] With this scheme it does not matter how much time elapses after payment of a preference: if the company enters liquidation then the payment may be challenged.

159 Weisberg, "Commercial Morality, the Merchant Character, and the History of the Voidable Preference" (1986) 39 *Stan LR* 3 at 135.

160 Note, "Preferential Transfers and the Value of the Insolvent Firm" (1978) 87 *Yale LJ* 1449 at 1457.

161 At 1459. This view is favourably reviewed by Weisberg, "Commercial Morality, the Merchant Character, and the History of the Voidable Preference" (1986) 39 *Stan LR* 3 at 135-136.

162 At 1461.

163 As above.

This approach is flawed in three respects. First, creditors will not be deterred from taking a payment because the company is insolvent. As always, the creditor will take it and hope: hope that the company does not enter liquidation; hope that if it does, the liquidator will not discover the payment; hope that if the payment is discovered, the liquidator will not have sufficient funds to pursue recovery; hope that if the liquidator has sufficient funds the liquidator will receive advice that the case against the creditor is not overly strong; and hope that if all else fails the creditor can successfully fight the action in court. There is, as we have seen, no penalty imposed on the creditor if, ultimately, the payment has to be disgorged.

A second problem is that, while it is acknowledged that there is greater chance of ascertaining the preference period because the period starts when insolvency occurs and is not determined at some time in the future, determining whether a company is definitely insolvent or not is far from easy. It has proved, on occasions, hard enough for a liquidator or a court seized of all the details about the company to decide on the insolvency question, let alone creditors, who will have, in many instances, inadequate information to be able to make that assessment.[164] It is clearly not reasonable to expect creditors to carefully monitor the financial positions of all their debtors, not least of all because of the cost.[165]

The third concern is that, contrary to the argument that certainty is enhanced where the period of preference vulnerability is determined by insolvency rather than by a fixed period, uncertainty is in fact increased.[166] This is because it deprives creditors of the assurance that after a set period of time has lapsed the payment received is no longer vulnerable to attack by a liquidator.[167]

Making insolvency the point that marks the beginning of a relation-back time produces a relatively open-ended rule, and the time for relation-back could be quite long: the company could limp on in an insolvent state for some time.[168] It does not seem fair that the "sword of Damocles" should hang over the head of a creditor for a long period. Equity and commercial certainty demand that a relation-back period should be a relatively short one.

164 Of course, in some cases creditors who deal frequently with the company will be the first ones to know that it is insolvent (or very likely to be) because the company will be defaulting regularly.

165 Ponoroff, "Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time" [1993] *Wis L Rev* 1439 at 1486 fn 134. Weisberg only supports the idea of insolvency determining when the preference avoidance period is to begin if insolvency can be discerned readily, after and before the fact: Weisberg, "Commercial Morality, the Merchant Character, and the History of the Voidable Preference" (1986) 39 *Stan LR* 3 at 136.

166 Ponoroff, "Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time" [1993] *Wis L Rev* 1439 at 1486.

167 At 1515.

168 This time could be lengthened if the company was to enter voluntary administration and even a deed of company arrangement before it was eventually wound up.

Also, with an open-ended rule it is possible that it could precipitate more litigation,[169] as the time zone to which a liquidator would have reference (the period following the onset of insolvency) could be longer than the fixed period which presently applies. A rise in the amount of litigation is likely to be detrimental to the winding up of companies and increase the cost of giving credit.

While the arguments concerning the arbitrariness of a set period for a preference avoidance zone generally have merit, it is submitted that after weighing all interests involved, a fixed time is preferable, particularly if the time is short. Unfortunately, there appears no way of ruling out luck; some transactions will escape the preference net by a day while others will be captured by one day.

## CONCLUSION

It has been submitted in this article that the present regime for the avoidance of preferences in corporate law has many shortcomings, many of which are identified here. It has been argued that it would be beneficial if the preference system which has remained, in essence, the same for many years, was overhauled substantially and a scheme introduced where all transfers that are preferential are avoided. The liquidator would only be required to establish that the transfer was preferential and occurred within the specified time zone. Unlike under the present regime, liquidators would not be called on to prove the insolvency of the company at the time of the alleged preference and defendants would have no right to rely on defences, such as those presently found in s588FG. While suffering from some drawbacks, this scheme, which I have referred to as the automatic avoidance scheme, deals in the best way possible, it is submitted, with all of the competing issues which exist.

If one evaluates automatic avoidance against the three elements of fairness, effectiveness and efficiency, it is submitted that it comes through quite well. As far as fairness is concerned, the scheme means that all preferences are avoided during the relevant time zone and, therefore, there is no discrimination between those creditors who are deemed to have known of the company's insolvency and those who did not. Such a distinction is rarely clear-cut. Creditors, other than those who are related to the company, benefit from the scheme because they can retain preferences given to them during the period of 60 (or 90) days to six months before the relation-back day. This is a fairer outcome as the further one moves away from the date of the commencement of winding up, the less likely that a payment will have contributed to the onset of liquidation. Also, the number of transactions which are vulnerable will be reduced[170] and this would not impede, as much as the present law does, diligent credit managers.

169 Orelup, "Avoidance of the Preferential Transfers Under the Bankruptcy Act of 1978" (1979) 65 *Iowa L Rev* 209 at 218.

170 Tabb, "Rethinking Preferences" (1992) 43 *SCLR* 981 at 1032.

Rules must be easily administered. If they are not, then the people who have to administer them, liquidators and their staff, will incur more costs and will become frustrated with them. This can lead to the rules being ignored for the sake of expediency. Automatic avoidance is efficient in that it would be easy to apply, would reduce the costs of liquidators and would be likely to require the consumption of less court time.

The scheme would be more effective in that it would be easier for a liquidator to claim preferences, as fewer matters have to be established, and there would be little in the way of defences available.

It is submitted that automatic avoidance would further the achievement of the rationales behind the avoidance of preferences. The orderly collective rationale is enhanced in that scrambling for the payment of debts is deterred, and if a winding up application is filed and succeeds there is a greater certainty that any payments already made to creditors will be recovered. Automatic avoidance complements and enhances the effectiveness of the *pari passu* principle. It is likely that, under an automatic avoidance regime, a greater number of creditors would receive more than they do at present, and there is more of a chance of there being something like an equal distribution to the general body of creditors.