In Pursuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions

ANDREW KEAY*

1. *Introduction*

One of the important tasks of a liquidator in administering the affairs of a company which is in liquidation[1] is to ascertain whether the company, prior to the beginning of the liquidation, entered into any transactions which can be challenged.[2] In undertaking this exercise the liquidator is endeavouring to recover property or money so that the company's estate is augmented and, ultimately, the general body of creditors is paid a larger dividend.

Like many jurisdictions around the world Australia has, for many years, included in legislation, provisions which have enabled liquidators to attack and avoid certain pre-liquidation transactions. In Australia, these provisions, which are now contained in Division 2 of Part 5.7B of the *Corporations Law*,[3] have often been referred to as "clawback provisions" or, as they will be referred to in this article, "avoidance provisions". Probably the most well-known provision is that which enables liquidators to challenge preferences.[4]

Over the years avoidance provisions have regularly come under the scrutiny of the courts. Yet, there is little evidence of the courts seeking to ascertain the rationale for the existence of these provisions.[5] It is submitted that the existence of such provisions in Australia is not a matter which excites any debate. There has been hardly any consideration of the underlying basis for the provisions; in fact there are few cases or articles in which the reason for the inclusion of avoidance provisions in corporations or bankruptcy legislation has been mentioned. The comment of Bennett J in the celebrated case of *Re Yagerphone Ltd*[6] that "the right to recover a sum of money from a creditor who has been preferred is conferred for the purpose of benefiting the general

* Associate Professor of Law, University of Southern Queensland, Solicitor of the Supreme Court of Queensland.

1 In this article the terms "liquidation" and "winding up" are used interchangeably. No distinction is sought to be drawn between the two terms. According to Kearney J in *The Nominal Insurer v Thomas* (unreported, Supreme Court of the Northern Territory, 15 May 1995) the two terms are synonymous.

2 O'Donovan, J, *McPherson's The Law of Company Liquidation* (3rd edn, 1987) at 5.

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

4 See s588FA of the *Corporations Law*. Also, see s122 of the *Bankruptcy Act* 1966 (Cth).

5 This is acknowledged by the Full Court of the Federal Court in *Ferrier and Knight v Civil Aviation Authority* (1995) 127 ALR 472 at 484.

6 [1935] 1 Ch 392.

body of creditors"[7] is typical of the statements which are included in judgments. Such statements are usually made only as an aside.[8]

Ascertaining the rationale behind the avoidance provisions is critical because unless the courts recognise the underlying reason(s) for such provisions they will not be able to discern the parameters of the provisions.[9] If the courts do not acknowledge the rationale there is a danger that the courts will fail to interpret the legislation which regulates pre-liquidation transactions correctly.

This article has three aims. First, it identifies and then examines the reasons which have been articulated for the existence of avoidance provisions. Second, the article assesses the reasons, especially in light of how the law has developed. Third, the article considers whether there is a case, from a policy perspective, for the inclusion of avoidance provisions in the *Corporations Law*. The significance of this article is that the avoidance provisions contained in Division 2 of Part 5.7B are relatively new and the courts will now be examining pre-liquidation transactions in a fresh light.

2. *The Background to the Provisions*

In 1988 the Australian Law Reform Commission produced a comprehensive report dealing with the law of insolvency in Australia, and commonly known as "the Harmer Report".[10] The Report, seen as the Australian equivalent of the English Cork Report[11] delivered in 1982, recommended many changes to the law of insolvency as it applied to both individuals and companies. After a substantial delay[12] the Federal legislature passed, on 17 December 1992, the *Corporate Law Reform Act* 1992 (Cth) which was to amend the provisions of the *Corporations Law*. The Act, most parts of which did not become operative until 23 June 1993 because regulations had to be drafted to complement some provisions, adopted many of the recommendations of the Harmer Report.

One of the important parts of the *Corporate Law Reform Act* 1992 (Cth), which is now Division 2 of Part 5.7B of the *Corporations Law* ("the Division"), introduced a new regime for regulating those transactions which were entered into by a company before its liquidation commenced. The new regime represents a substantial departure from the situation which formerly existed. The old scheme

---

7 Id at 396.

8 To be fair, the purposes behind the avoidance provisions and the ones dealing with preferences, in particular, are not clear (Prentice, D D, "The Effect of Insolvency on Pre-Liquidation Transactions" in Pettet, B G (ed), *Company Law in Change: Current Legal Problems* (1987) at 85).

9 See Jackson, T H, "Avoiding Powers in Bankruptcy" (1984) 36 *Stanford LR* 725 at 727. Jackson, ("Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules" (1986) 64 *Am Bankruptcy LJ* 399) has stated that the first step in any bankruptcy analysis is to concentrate on the purposes of bankruptcy.

10 Australian Law Reform Commission, *General Insolvency Inquiry* Report No 45 (1988) Australian Government Publishing Service, Canberra. The background to the production of the Report is related briefly by Ron Harmer in his article "Up and Over Down Under: Australian Corporate Insolvency Law Reforms" (1993) 2 *Int'l Insolvency R* 74.

11 Report of the Insolvency Law Review Committee, *Insolvency Law and Practice*, Cmnd. 8558 (1982) (UK) at pars 224–7, 232 (Cork Report).

12 See Harmer, above n10 at 74–5 for a discussion of the reasons for the delay.

was that section 565 of the *Corporations Law* (and its legislative forebears) assimilated the law governing antecedent transactions entered into by companies in liquidation as far as possible with that governing bankrupt individuals. Simply put, the corporations legislation incorporated, unmodified, the avoidance provisions of the bankruptcy law by reference.[13]

The new regime became operational from 23 June 1993.[14] There have been few cases heard by the courts dealing with the regime, as yet, because the regime only applies to post-23 June 1993 liquidations, and it usually takes liquidators some time in which to initiate proceedings and for them to have the proceedings heard by a court. It is envisaged that there will be a substantial number of cases involving the provisions in the forthcoming years.

There does not appear to be any standard theory which has been developed in Australia as to the reason for the existence of avoidance provisions which have been included in the corporations legislation or in the *Bankruptcy Act* 1966 (Cth), and against which the provisions can be evaluated. This means that it is difficult to determine what the role of avoidance provisions should be and to measure the effectiveness of such provisions. For so long, decisions have been made about the application and scope of the avoidance provisions without any systematic evaluation of the normative role of such provisions in the liquidation process and, more importantly, in the commercial world as a whole.[15]

The legislature had a marvellous opportunity to state the rationale(s) for the avoidance provisions when they were amended by the *Corporate Law Reform Act* 1992 (Cth). The Explanatory Memorandum stated, inter alia:

> The purpose of the provisions in this proposed Division [Division 2 of Part 5.7B] is to ensure that unsecured creditors are not prejudiced by the disposition of assets or the incurring of liabilities by a company in a period shortly before the winding up which would have the effect of favouring certain creditors or other persons, and especially related entities. This might occur where a creditor (whether or not that creditor has some connection with the company) was paid out in full rather than having to prove for a proportion of the debt in the winding up. The provisions also seek to avoid transactions where the body of unsecured creditors might be prejudiced by the company having given away assets or incurred liabilities without adequate consideration passing to the company.[16]

The Memorandum effectively restricted itself to indicating what the goal of the provisions was, rather than spelling out any policy rationale. Consequently, one is left to ascertain the policy reasons for the avoidance provisions from other sources.

---

13 See O'Donovan, above n2 at 312.

14 Commonwealth of Australia Gazette No s186, 23 June 1995.

15 The Full Court of the Federal Court in *Ferrier and Knight v Civil Aviation Authority*, above n5, acknowledged this in relation to preferences (at 484) and sought to deal with aspects of the policy behind preferences (at 484–7). With respect, the treatment was very brief and simply stated the two most common policies given for a preference law, ie, to ensure equality between creditors and to deter creditors from dismembering the insolvent company.

16 Explanatory Memorandum to the Corporate Law Reform Bill 1992 at par 1035.

3. *The Avoidance Provisions*[17]

The heart of the Division is section 588FE. It provides that certain pre-liquidation transactions are to be regarded as voidable transactions. The section states that two types of transactions are voidable: unfair loans (defined in section 588FD) and insolvent transactions (defined in section 588FC). An insolvent transaction must be, according to section 588FC, either an unfair preference, dealt with in section 588FA, or an uncommercial transaction (addressed specifically in section 588FB). In addition, to constitute an insolvent transaction, section 588FC provides that the company which is in liquidation must either have been insolvent when the transaction was entered into or became insolvent as a result of entering into the transaction.

The fact that a transaction is an insolvent transaction does not, of itself, make the transaction voidable. Only some insolvent transactions are voidable. In section 588FE(2)–(5) the legislation explains that the insolvent transactions which are voidable are those:

- entered into during the six months immediately before the relation-back day[18] or during the period between the relation-back day and the commencement of winding up (section 588FE(2));
- uncommercial transactions entered into during the two years immediately before the relation-back day (section 588FE(3));
- unfair preferences and uncommercial transactions[19] involving a related entity[20] of the company and occurring during the four years immediately preceding the relation-back day (section 588FE(4)); and
- unfair preferences and uncommercial transactions entered into during the 10 years immediately before the relation-back day where the company was a party to the transaction in order to defeat, delay or interfere with the rights of any or all of its creditors (section 588FE(5)). These types of transactions are referred to in this article as "fraudulent transactions".

Therefore, there are, essentially, four types of transactions which are able to be challenged under the avoidance provisions: unfair preferences, uncommercial transactions, unfair loans and fraudulent transactions. The last type of

---

17 For a more detailed discussion, see O'Donovan, J, "Voidable Dispositions and Undue Preferences: The Transition to the New Regime" (1994) 12 *Company and Sec LJ* 7; Singer, "Invalidation of Antecedent Transactions Under the Corporate Law Reform Act 1992 (Cth)" (1994) 2 *Insolvency LJ* 36; Keay, A, *Insolvency: Personal and Corporate Law and Practice* (2nd edn, 1994) at 313–28; Keay, A, "The Avoidance of Pre-Liquidation Transactions" (1994) 2 *Current Commercial L* 98.

18 The term "relation-back day" is defined in s9. This day will be, for most compulsory liquidations, the date when the application to wind up was filed. For most voluntary liquidations the day will be when the company's members resolve to wind up. For a discussion of the term, see Keay, A, "'Relation-Back Day' and 'Related Entity': New Key Terms in Liquidation Law" (1994) 2 *Insolvency LJ* 126 at 127–9.

19 This must be read in conjunction with s588FC. That section clearly limits insolvent transactions to unfair preferences and uncommercial transactions.

20 The term "related entity" is defined in s9. For a discussion of the term see Keay, above n18 at 129–34.

transaction is, as indicated above, a form of sub-set of unfair preferences and uncommercial transactions.

4. *Two Categories of Voidable Transactions*

Historically, the avoidance provisions contained in the insolvency legislation of Australia (and the United Kingdom and the United States) can, it is submitted, be divided loosely into two groups of provisions. First, there are provisions, such as section 588FA,[21] which regulate the giving of preferences by the debtor, and aim at adjusting rights among the creditors *inter se*.[22] The second group, including provisions such as section 588FB and section 120 of the *Bankruptcy Act* 1966 (Cth),[23] is designed to adjust the rights of creditors as against the debtor. This latter group has its origins in fraudulent conveyance law which can be traced back in English law to the *Statute of Elizabeth* in 1570.[24]

Fraudulent conveyances involve debtors making transfers and incurring obligations with the intent to delay, hinder or defraud creditors.[25] The essence of a fraudulent conveyance is that an insolvent parts with property or money and receives nothing or little in return;[26] this action will prejudice all of the creditors of the insolvent, whereas with preferences one or more creditors are benefited vis à vis the balance of the creditors. The classic instance of a fraudulent conveyance is the transfer of property or money by a debtor to an associate or relative, thereby placing it out of the reach of creditors.[27] Provisions avoiding such conveyances are usually to be found in bankruptcy legislation[28]

---

21 See *Insolvency Act* 1986 (UK), s239 and *Bankruptcy Reform Act* 1978 (US), s547 which cover, in essence, the same material.

22 Jackson, "Avoiding Powers", above n9 at 726; Jackson, T, *The Logic and Limits of Bankruptcy Law* (1986) at 68–9.

23 See the equivalents in the United Kingdom (*Insolvency Act* 1986 (UK), s238) and the United States (*Bankruptcy Reform Act* 1978 (US), s548).

24 13 Eliz c 5. The fraudulent conveyance was recognised in Roman law (Kennedy, F R, "Involuntary Fraudulent Transfers" (1987) 9 *Cardozo LRev* 531 at 535). It may be argued that preference law has its origins in the law of fraudulent conveyances (Jackson, T and Kronman, A, "Voidable Preferences and Protection of the Expectation Interest" (1976) 60 *Minn LRev* 971 at 977; Duncan, R, "Preferential Transfers, the Floating Lien and Section 547(c)(5) of the *Bankruptcy Reform Act* of 1978" (1982) 36 *Arkansas LRev* 1 at 40; Shanker, M G, "The American Bankruptcy Preference Law: Perceptions of the Past, the Transition to the Present, and Ideas for the Future" in Ziegel, J S, (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (1994) at 323–8) but the law as it deals with preferences has developed in such a way that the essence of a fraudulent conveyance has been lost.

25 *Lloyd's Bank Ltd v Marcan* [1973] 1 WLR 1387 at 1392; *Re World Expo Park Pty Ltd* (1994) 12 ACSR 759 at 768; Baird, D, *The Elements of Bankruptcy* (1992) at 134. See s6 of the *Statute of Elizabeth*; Baird, D G and Jackson, T H, "Fraudulent Conveyance Law and its Proper Domain" (1985) 38 *Vand LRev* 829. According to *Twyne's Case* ((1601) 3 CoRep 80b; 76 ER 809) proof of actual intent was not needed if there were certain "badges of fraud" which pointed in the direction of fraudulent intent. These were objective facts which allowed the court to infer that the debtor was acting with the requisite wrongful intention when undertaking the transfer.

26 Baird, id at 136. A good illustration occurred in *Official Trustee v Marchiori* ((1983) 69 FLR 290) where a bankrupt was held to have defrauded his creditors in breach of s121 of the *Bankruptcy Act* 1966 (Cth).

27 Cullina, J A, "Recharacterising Insider Preferences as Fraudulent Conveyances: A Different View of *Levitt v Ingersoll Rand*" (1991) 77 *Va LRev* 149 at 159.

28 Clearly s121 of the *Bankruptcy Act* 1966 (Cth) deals with transactions which are akin to

and, also, in non-bankruptcy legislation.[29] The latter legislation permits creditors, and any others prejudiced, to attack fraudulent transfers that occur outside of insolvency.

As mentioned earlier, there are four primary transactions which are encompassed by the avoidance provisions which regulate pre-liquidation transactions in Australia.[30] These transactions are: unfair preferences (section 588FA), uncommercial transactions (section 588FB), unfair loans (section 588FD) and fraudulent transactions (section 588FE(5)). It is submitted that unfair preferences are clearly to be included in the first group, identified above, and the other transactions are, in general, in the mould of fraudulent conveyances, certainly as far as their purposes are concerned.

Unfair preferences are designed to adjust the benefits received by creditors, that is, a creditor who receives more from a transaction within a certain time zone before liquidation (this is, under section 588FE(2)(b), the period six months before the relation-back day and the time from the relation-back day to the beginning of the winding up) than would be received if the creditor had to prove in the winding up of the company giving the benefit.[31] Preferred creditors may be directed, pursuant to section 588FF(1)(a), to pay to the company an amount equal to the benefit received.

The other transactions referred to in the Division are designed to ensure that the debtor is unable to take action which is detrimental to all of the creditors. For example, transactions are voidable as uncommercial transactions where a person receives a benefit from a company prior to its liquidation which constitutes a gift or a bargain which is unable to be explained by normal commercial practice.[32] In such a situation, the creditor of the company will be prejudiced by the behaviour of the company as its assets will be diminished.[33]

Fraudulent conveyances do not, necessarily, involve a fraudulent element, but they do involve debtor misbehaviour resulting in loss to the creditors, and at its core fraudulent conveyance law deals with the activities of debtors which harm creditors.[34] Debtor misbehaviour is involved because invariably

---

fraudulent conveyances. See s548 of the *Bankruptcy Reform Act* 1978 (US) for an American provision of the same type.

29 See *Conveyancing Act* 1919 (NSW), s37A; *Property Law Act* 1974 (Qld), s228; *Law of Property Act* 1936 (SA), s86; *Conveyancing and Law of Property Act* 1884 (Tas), s40; *Property Law Act* 1958 (Vic), s172; *Property Law Act* 1969 (WA), s89; *Uniform Fraudulent Transfer Act* (US), s7.

30 For details concerning these transactions see the works at above n17.

31 Above n16 at par 1039.

32 Id, at par 1044. There has been a tendency over the last 100 years to regard transfers by insolvents, where the insolvent receives nothing or less than he or she should, as a fraudulent conveyance (Baird and Jackson, above n25 at 830; McCoid, J, "Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration" (1983) 62 *Texas LRev* 639 at 640–1; Westbrook, J L, "A Functional Analysis of Executory Contracts" (1989) 74 *Minn LRev* 227 at 245).

33 Prentice, above n8 at 77 applies this to transactions at an undervalue (s238 of the *Insolvency Act* 1986 (UK)) which are analogous, in many ways, to uncommercial transactions. Prentice also indicates that transactions at an undervalue are of the same line as fraudulent conveyances.

34 Above n26 at 159. Uncommercial transactions and unfair loans are examples of transactions where fraud is not a necessary element, but there is debtor misbehaviour in that the transaction disadvantages the creditors as a group.

those entering into transactions on behalf of the company are doing so in order to benefit someone other than the insolvent company or its creditors. More often than not the party benefited will be a person or entity associated or connected with the company or its directors. The company is, in effect, defeating its creditors because the creditors are unable to have access to the property transferred to non-deserving parties. It is possible for a transaction to constitute both an unfair preference and some other voidable transaction, such as an uncommercial transaction. For instance, a company could pay a bona fide debt owed to a creditor by delivering property to the creditor which is worth more than the debt[35] and this could, conceivably, constitute both an unfair preference and an uncommercial transaction.

It is likely that the reasons for the inclusion, in the *Corporations Law*, of the two groups of avoidance provisions identified will differ, to some degree, because the provisions applying to the two groups are directed at achieving different aims.[36]

Those transactions categorised as uncommercial transactions, unfair loans or fraudulent transactions all involve an attempt to adjust the rights of creditors vis à vis the debtor, and not the creditors *inter se*, as is the case with preferences. With all avoidance provisions it is possible to say that they seek to thwart the unjust enrichment of particular parties at the expense of the general body of creditors,[37] and one can argue that some purposes apply to both groups and, consequently, it is not possible to adhere to a strict dichotomy.

5. *Collectivism*

Liquidation is a procedure of an inherently collective nature[38] in that each creditor forfeits the individual right to take action to enforce the debt owed, and in lieu thereof the creditor must depend on the result of the collective proceedings,[39] that is, the primary beneficiary of the proceedings is the general group of unsecured creditors, each of whom is affected by the winding up, albeit to different degrees.[40] The procedure is compulsory,[41] in order to ensure that there is a cooperative system which is orderly.[42] When a company is being

35 This occurred, in effect, in *Re Captain Homemaker Pty Ltd (in liq)* (1984) 8 ACLR 1005.

36 Jackson, in "Avoiding Powers", above n9 at 726, takes the same view as far as the provisions contained in the *Bankruptcy Reform Act* 1978 (US). There are differences between the Australian and the American provisions, but the transactions regulated by the provisions can, when it comes to assessing aims, be placed into one of the two groups identified.

37 See Goode, R M, *Principles of Corporate Insolvency Law* (1990) at 134.

38 See *Re Western Welsh International System Buildings Ltd* [1983] 1 BCC 99, 296 at 99, 297; *Re Lines Bros Ltd* [1983] Ch 1 at 20 per Brightman LJ; Fletcher, I F, *The Law of Insolvency* (1990) at 2; Cork Report, above n11.

39 Lipton, P, "The Priorities Among Unsecured Creditors Under the Corporate Law Reform Act 1992" (1993) 1 *Curr Commercial L* 24; Jackson, "Avoiding Powers" above n9 at 758; Friedman, J, "Lender Exposure Under Sections 547 and 550: Are Outsiders Really Insiders?" (1990) 44 *Southw LJ* 985 at 993.

40 Cork Report, above n11 at par 232.

41 Prentice, above n8 at 70. In his work, "The Nature of Bankruptcy" (1940) 89 *U Pa LRev* 1 at 8, Radin, M, asserts that the central notion of bankruptcy is the coercion of creditors into a class. In *Re Lines Bros. Ltd*, above n38 at 14, Lawton LJ said that "liquidation is a form of collective enforcement of liabilities ...".

42 Jackson, *The Logic and Limits*, above n22 at 17. Warren, E, ("Bankruptcy Policymaking

wound up because of insolvency the members of the company have no interest in the assets[43] — the process involved is a collective procedure to bring about the distribution of the assets to the creditors, according to their pre-liquidation entitlements. If there was no collective procedure then creditors would enforce their debts and it would produce a "first come, first served" situation which would be disorderly. Collectivism[44] is regarded as a preferable resolution of the insolvency of the debtor as no one or two creditors receive full payment at the expense of the rest, who receive little or nothing.[45] A creditor might benefit on one occasion from a "free for all", but on other occasions he or she may receive nothing, so overall a collective regime would probably bear more fruit for everyone. If collectivism is to work then avoidance provisions are needed in order to strip a creditor of any advantage received pre-liquidation so as to bring a greater benefit to the bulk of the creditors. Not only does this balance the competing interests of creditors, it meets the public interest of ensuring an orderly and expeditious resolution of the company's demise, and so there is no unsavoury scramble by creditors for assets of the insolvent. The avoidance provisions are essential to ensure that there is a collective proceeding.[46]

Radin sees the collective process as the essence of liquidation. He has even said that there would be no reason for the commencement of liquidation unless creditors were assembled into one large group and their claims adjusted.[47] With respect, while this is an important rationale for liquidation, such a view unfairly depreciates the relevance and importance of other purposes which have been prescribed for liquidation, such as the opportunity for an investigation of the company's affairs and to put an end to the trading activities of an insolvent entity.[48] If the collectivist reason was the essential rationale for liquidation it would lead to the absurd conclusion that companies which clearly could not pay any dividend to creditors, not even those with some form of priority, such as employees, would not be subject to liquidation. Yet, it is necessary that these sorts of companies are liquidated, and, therefore, stopped from carrying on business. While the directors of such companies might be subject to actions against them, pursuant to section 588G, for insolvent trading, if their companies continue to carry on business, directors may decide to refrain from winding up their companies, and continue trading, for many reasons: they

---

In An Imperfect World" (1993) 92 *Mich LRev* 336 at 343) states that a collective process is inevitable. A collection process was employed under Roman law (Radin, M, "Fraudulent Conveyances at Roman Law" (1931) 18 *Va LRev* 109 at 110).

43 *Ayerst v C & K (Construction) Ltd* [1976] AC 167.

44 "Collectivism" is a term which has been coined by Professor Elizabeth Warren ("Bankruptcy Policy" (1987) 54 *U Chicago LRev* 775 at 776) and widely accepted, eg, see Ponoroff, L, and Knippenberg, F S, "The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy" (1991) 85 *Northw U LR* 919 at 948.

45 Jackson, *The Logic and Limits*, above n22 at 16–7.

46 *Levitt v Ingersoll Rand Financial Corp* (In *Re V N Deprizio Constuction Company*) 874 F 2d 1186 at 1194 (1989).

47 Radin, above n41 at 5. Jackson, T H, ("Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain" (1982) 91 *Yale LJ* 857) appears to agree with the approach of Radin. Jackson asserts that most of the liquidation process is concerned with questions relating to distribution to creditors (at 857).

48 See Keay, *Insolvency*, above n17 at 249. Warren (above n42 at 361) adds that liquidation forces parties dealing with the debtor to bear the burden of the failure and promotes the monitoring by creditors of a debtor's position.

might be unaware of the insolvency of the company, or if they are, they may have so convinced themselves that they can achieve financial stability eventually. Those that were aware of the company's insolvency may abscond or, themselves, be impecunious. In any of these circumstances the creditors are likely to be the losers.

The collectivist approach adverted to by Radin has been taken further in recent years by Jackson who sees liquidation as a debt collection device to handle the problem of a common pool of creditors.[49] Jackson regards liquidation predominantly as a method of distributing money to creditors. He has a "creditor-oriented justification for bankruptcy" which he calls the "creditors' bargain theory".[50] Jackson asserts that "[b]ankruptcy's rules therefore can be seen as an attempt to implement the type of collective and compulsory system that rational creditors would privately agree to if they could bargain together before the fact".[51]

According to Jackson, bankruptcy laws should be regarded as a system which mirrors this hypothetical agreement between creditors.[52] From the viewpoint of Jackson's theory, bankruptcy exists, essentially, to maximise the value of assets when faced with individual creditors scrambling to ignore the compulsory collection process and grab what they can.[53] In effect, Jackson perceives that bankruptcy is a species of debt-collection law, with the liquidator simply acting as a type of commercial agent charged with the task of enforcing a collection procedure for the benefit of all.[54]

With respect, it is submitted that liquidation takes into account a wide range of purposes and interests[55] and, certainly, the courts have rejected any notion that the liquidation process should be employed to pursue debt collection. For instance, in *Re Lympne Investments Pty Ltd*[56] Megarry J said that the English Companies Court, which heard winding up petitions, was not to be used as a debt collecting agency. This view has been approved in Australia in both the corporate[57] and bankruptcy fields.[58]

---

49 Jackson, *The Logic and Limits*, above n22 at 10, 79.

50 For example, see Jackson, above n47 at 858–60; Jackson, T H and Scott, R E, "On The Nature of Bankruptcy: Bankruptcy Sharing and the Creditors' Bargain" (1989) 75 *Va LRev* 155 at 160.

51 Jackson, above n36 at 728.

52 Jackson, above n47 at 860.

53 Jackson, above n36 at 729.

54 Jackson, *The Logic and Limits*, above n22 at 79. Ponoroff, L, ("Evil Intentions and an Irresolute Endorsement For Scientific Rationalism: Bankruptcy Preferences One More Time" (1993) *Wis LRev* 1439 at 1446–7) appears to adopt a similar view.

55 This is in accord with what Ponoroff and Knippenberg call "the Traditional view" (above n44 at 960–1). Baird, D G and Jackson, T H reject this. They see collectivism as the only element in bankruptcy policy ("Corporate Reorganizations and the Treatment of Diverse ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy" (1984) 51 *U Chicago LRev* 97 at 99–100). Conversely, Warren regards a number of issues as being integral to liquidation, including the matter of distribution (above n41).

56 [1972] 1 WLR 523 at 527.

57 For example, see *Re Bond Corporation Holdings Ltd* (1990) 8 ACLC 153 at 156.

58 For example, see *Re A Debtor* (1930) 2 ABC 164 at 166–7; *Re Hood; Ex Parte ES & A Bank Ltd* [1971] ALR 151 at 152–3.

While it is submitted that Jackson overemphasises the collection aspect of liquidation there is no doubt that it is a crucial factor in the process, for when liquidation begins, the liquidator is, in a sense, required to engage in a collective debt-collection process.

In essence, Jackson regards avoidance provisions which deal with the avoidance of preferences, as an attempt to thwart those creditors, who may foresee liquidation and seek to have their own claims satisfied to the detriment of the general body of creditors when there are not sufficient assets to meet all claims, from opting out of the collective proceeding of liquidation.[59] This is consistent with the purposes of bankruptcy law articulated by Jackson and Kronman: protecting pre-bankruptcy contractual arrangements and minimising the social costs relating to bankruptcy by distributing its effects amongst all creditors.[60]

This approach, obviously, protects the smaller, less powerful creditors. They are the ones who do not have security and are unable to negotiate things like retention of title clauses. Frequently, they have no leverage in that they cannot refuse to supply further services or goods unless they receive overdue payments, because they do not provide essential services or goods or, more likely, the goods or services can be obtained elsewhere from unsuspecting traders.

With a collective procedure the debtor's assets are administered and creditors' claims handled without any account being taken of the time when assets were acquired or debts incurred. No attention is paid to any suggestions that those owed debts for a longer period should be favoured, or that those who became creditors just prior to the commencement of liquidation should be penalised because they failed to be diligent in determining whether to extend credit to or deal with the debtor company.

Those who see the collection process as paramount in liquidation take the view that the avoidance provisions assist in the efficiency of the process and protect the advantages of such a process,[61] that is, creditors are prevented from electing to stay out of the liquidation by taking a benefit in a pre-liquidation transaction. If pre-liquidation transactions are impugned the pool of assets for the collective good is maximised.[62]

However, those who advocate a collectivist justification for avoidance provisions limit such justification to those avoidance provisions which attack preferences; it does not purport to cover avoidance provisions which have their origins in fraudulent conveyances.[63] The reason for this is that preference provisions focus on relations between creditors, which is at the heart of the collectivist approach, while fraudulent conveyances are concerned with relations between creditors and their debtor.[64]

---

59 Above n54 at 125. See Ponoroff, above n54 at 1446–7; McCoid, J C, "Bankruptcy, Preferences and Efficiency: An Expression of Doubt" (1981) 67 *Va LRev* 249 at 260.

60 Above n24 at 987–9.

61 Jackson, "Avoiding Powers", above n9 at 732.

62 Id at 763. This is stated, in effect, in *Wilmott v London Celluloid Company* (1886) 34 ChD 147 at 150; above n6 at 396; *Re An Application by Tucker and Reid Murray Developments (Qld) Pty Ltd* [1969] QdR 193 at 200.

63 Id at 726.

64 Id at 757.

Notwithstanding the essential difference between preference-like avoidance provisions and those in the mould of anti-fraudulent conveyance provisions, it is submitted that the latter type of avoidance provision can be justified, partially, on a collectivist basis. Those provisions in the *Corporations Law*, which are based on fraudulent conveyance law, and which impugn uncommercial transactions, unfair loans and fraudulent transactions are designed to protect creditors as they only apply when the company enters liquidation, and (apart from unfair loans) at the time of the transaction the company was, or was thereby rendered, insolvent.[65] If a liquidator can recover the benefit given away by the company, then assuming that the priority creditors mentioned in section 556 are fully satisfied, the creditors, as a whole, will gain as they will share in a greater distribution. There will be no discrimination between creditors who became creditors before the improper transaction was effected, and those who became creditors after the transaction. In effect, there is no distinction made between recoveries related to preferences and recoveries related to other types of avoidance provisions when distribution occurs.[66]

Two other reasons for the existence of the avoidance provisions, which are identified frequently are: to ensure that the principle of equality between creditors is preserved, and prevention of dismemberment of the company's assets. They are inextricably linked to the collectivist rationale. This is, in effect, accepted by Jackson in one of his major works in promoting his collectivist view. He recognises that to disregard pre-liquidation transactions would be to foster inequality between creditors and to encourage a race among creditors to take company assets.[67]

6. *Equality of Creditors*

A. *The Theory*

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.[68] Westbrook regards the principle as the most universal of all insolvency principles.[69] It is an old equitable principle known as the *pari passu* principle.[70] The principle is explained by Seligson, in an often cited passage:

---

65 See Explanatory Memorandum to the Corporate Law Reform Bill 1992 at par 1035. Prentice makes the same point in relation to transactions at an undervalue under s238 of the *Insolvency Act* 1986 (UK) (above n8 at 76).

66 In determining that the avoidance of preferences, and not fraudulent conveyances, serves the collectivist approach, Jackson is probably heavily influenced by the fact that fraudulent conveyance law is, in the United States, the domain of the States and is employed outside of bankruptcy (see Jackson, *The Logic and Limits*, above n22 at 147).

67 Jackson, "Avoiding Powers", above n9 at 756.

68 Above n2; Taylor, T, Ferrier, I and Hodgson, A, *Australian Insolvency Management Practice*, vol 1 (1986) at 20 051; Farrar, J, Furey, N, Hannigan R, and Wylie, P, *Farrar's Company Law* (3rd edn) (1991) at 709; Lipton, [a]above n39; Finch, V, "Directors' Duties: Insolvency and the Unsecured Creditor" in Clarke, A (ed), *Current Issues in Insolvency Law* (1991) at 87; Warren, above n42 at 353; McCoid, above n59.

69 Westbrook, above n31 at 252.

70 Farrar, "Public Policy and the Pari Passu Principle" [1980] *NZLJ* 100. Garrido ("The

> Equity is equality. That maxim is a theme of bankruptcy administration — one of the cornerstones of the bankruptcy structure. All persons similarly situated are entitled to equality in treatment in the distribution of the assets of the bankrupt estate.[71]

The notion of equality can be regarded as being linked to collectivism in that a collective procedure is necessary before there can be any equal distribution of the assets; the collective procedure is required to ensure that creditors are not prejudiced by the creditors acting unilaterally.

The principle of equality has been affirmed in recent days in England[72] and Australia, with the Harmer Committee regarding it as fundamental.[73] The principle may be traced back to the English Act of 1570 (the *Statute of Elizabeth*) which stated in section 2, inter alia, that "... for true satisfaction and payment of the said creditors: That is to say, to every of the said creditors, a Portion Rate and Rate alike, according to the Quantity of their Debts".[74]

The principle was more clearly stated in the celebrated *Case of the Bankrupts*[75] in 1592 when Coke CJ said:

> So that the intent of the makers of the said Act [Act of 1570], expressed in plain words, was to relieve the debtors of the bankrupt equally, and that there should be an equal and rateable proportion observed in the distribution of the bankrupt's goods amongst the creditors, having regard to the quantity of their several debts ...[76]

The principle found favour with Lord Mansfield, who has been credited with developing the notion of the preference in English law[77] in 1758 in *Worsley v Demattos*.[78] His Lordship said, in relation to a transfer of all of the debtor's assets to a creditor immediately before and in contemplation of bankruptcy, that:

> Such preference would be a fraud upon the whole bankrupt-laws, and defeat the two main ends: of them which are,
> 1st. The right the creditors have to the management, and disposal, of the

---

Distributional Question in Insolvency: Comparative Aspects" (1995) 4 *Int'l Insolv Rev* 25 at 28–30) traces the principle back the Middle Ages in Italy when the concept of equal and rateable distribution was devised to overcome anomolies in the existing system of bankruptcy distribution.

71 Seligson, C, "Preferences Under the Bankruptcy Act" (1961) 15 *Vanderbilt LR* 115. See Jackson, above n42 at 123; Eisenberg, T, "Bankruptcy Law in Perspective" (1981) *UCLALR* 953 at 963; Countryman, V, "The Concept of a Voidable Preference in Bankruptcy" (1985) 38 *Vanderbilt LR* 713 at 738; Morris, C R, "Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens" (1974) 54 *Minnesota LRev* 737 at 738; Neider, C, "Voidable Preferences: An Analysis of the Proposed Revisions of Section 60b of the Bankruptcy Act" [1974] *Wis LRev* 481 at 482.

72 Cork Report, above n11.

73 Above n10 at pars 33 and 629. See O'Donovan in "Corporate Insolvency: Policies, Perspectives and Reform" (1990) 3 *CBLJ* 1 at 11.

74 13 Eliz c 7. McCoid states that "the equal treatment of creditors is the oldest and most frequently advanced goal of preference law" (above n59).

75 (1592) 2 Co Rep 25; 76 ER 441.

76 Id at 464–8 (ER).

77 For example, see Weisberg, R, "Commercial Morality, the Merchant Character, and the History of the Voidable Preference" (1986) 39 *Stanford LR* 3 at 46.

78 (1758) 1 Burr 467; 96 ER 1160.

bankrupt's estate, and effects.
2dly (sic) an equal distribution among them.[79]

It is trite law that the principle runs through both English and Australian legislation addressing liquidation. In *An Application by G A Tucker and Reid Murray Developments (Qld) Pty Ltd*[80] Hart J mentioned the principle of equality among creditors three times in the space of four pages of his judgment.[81] The other judges who constituted the Full Court of the Supreme Court of Queensland in this case (Lucas and Douglas JJ) dissented from the judgment of Hart J but did not disagree with what Hart J had to say about equality. Most Australian judgments and commentaries appear to accept the principle without articulating the basis of it in detail, or at all.

Some would see the fundamental justification for avoidance provisions, and particularly those setting aside preferences, as being both the promotion of the equality principle and the prohibition of the undermining of this principle.[82] Others would regard this justification as being one of two predominant justifications, the other being to discourage the dismemberment of the company and thereby hastening its financial decline.[83]

It would be impossible to achieve equality if the law 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.

The Report of the Insolvency Law Review Committee in the United Kingdom (Cork Report) put it this way:

> ... [T]he bankruptcy code, on the other hand, is directed towards achieving a *pari passu* distribution of the bankrupt's estate among his creditors. The justification for setting aside a disposition of the bankrupt's assets made shortly before his bankruptcy is that, by depleting his estate, it unfairly prejudices his creditors; and even where the disposition is in satisfaction of a debt lawfully

---

79 Id at 1164 (ER).

80 *Reid Murray Developments*, above n62.

81 Id at 200–3.

82 For example, see Levin, R, "An Introduction to the Trustee's Avoiding Powers" (1979) 53 *Am Bankr LJ* 173; Teofan, V and Creel, L, "The Trustee's Avoiding Powers Under the Bankruptcy Act and the New Code: A Comparative Analysis" (1979) 11 *St. Mary's LJ* 311; Chiah, K, "Voidable Preference" (1986) 12 *NZ Universities LR* 1 at 22–3; Barney, S, "Bankruptcy Preferences and Insider Guarantees" (1991) 51 *Lou LJ* 1047 at 1057; Giorgiannis, P, "The Small Preference Exception of Bankruptcy Code Section 547 (c)(7)" (1994) 55 *Ohio S LJ* 675 at 676; Ponoroff, above n54 at 1488 and 1516. 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.

83 For example, see Neider, above n71 at 483; Orelap, E, "Avoidance of Preferential Transfers Under the Bankruptcy Reform Act of 1978" (1979) 65 *Iowa LRev* 209 at 212–3; Farrar, J, "The Bankruptcy of the Law of Fraudulent Preference" [1983] *JBL* 390; Herbert, M, "The Trustee Versus the Trade Creditor; A Critique of Section 547(c)(1)(2) & (4) of the Bankruptcy Code" (1983) 17 *U Richmond LR* 667 at 668; Tabb, C, "Rethinking Preferences" (1992) 43 *South Carolina LRev* 981 at 987; Hollander, E, "Preferences: Section 547" (1986) 3 *Bankr Dev J* 365 at 466; above n46 at 1192–4 (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 the two justifications (above n10 at par 632).

> owing by the bankrupt, by altering the distribution of his estate it made a *pari passu* distribution among all the creditors impossible.[84]

While the Report was addressing bankruptcy the substance of what was said was applied by the Insolvency Law Review Committee to liquidation.

The avoidance provisions which allow for the challenging of preferences are, traditionally, viewed as justified on the basis of ensuring equal distribution, because preferences distort what creditors receive vis à vis one another. Yet there could be occasions when creditors receive a benefit pursuant to some other form of voidable transaction, and that will affect equality. For example, X Ltd might owe an associate, Y, $10 000. If X was to sell machinery to Y for $50 000 where the market value of the machinery was, in fact, $60 000, the liquidator of X Ltd could attack the transaction as an uncommercial transaction pursuant to section 588FB. The justification for section 588FB could be seen, in part, to be to ensure one creditor does not receive more than other creditors.

When a debtor company gives a preference it is, whether motivated by kindness, a sense of duty, or some fraudulent intent, in effect, "robbing Peter to play Paul".[85] One creditor receives more than others. If the law did not take into account, and allow for the setting aside of, pre-liquidation transactions so that the creditors and the debtor company could deal with the debtor's assets without restriction there would only remain "tag ends and remnants of unencumbered assets"[86] for the liquidator to distribute to the general body of creditors.

The underlying aim of the inclusion of avoidance provisions for reasons of equality is to produce fairness.[87] However, it appears that another aim, linked to the need for fairness, may be important. To enforce the requirement of equality means that the inevitable social and economic costs associated with liquidation are minimised.[88] When a company goes into liquidation many people and businesses may be owed substantial sums. A liquidation, particularly of large companies (and, in Australia, most notably, building companies), can precipitate financial problems for many of the company's trading partners, and can lead to a chain of failed enterprises; the so-called ripple effect. If preference payments and other voidable transactions were ignored then there is a greater chance that more creditors would not be able to survive the collapse of a debtor. The avoidance provisions mean that the impact of liquidation will be spread among all classes of creditors,[89] and there is a greater likelihood of more creditors continuing to trade. This is particularly so as far as the less powerful creditors, who might not be able to extract preference payments, are concerned.

---

84 Above n11 at par 1209.
85 Farrar, above n83 at 391.
86 Seligson, above n71.
87 Harmer Report, above n10 at par 629; McCoid, above n59 at 271; Ward, T and Shulman, J, "In Defense of the Bankruptcy Code, Radical Integration of the Preference Rules Affecting Commercial Financing" (1983) 61 *Wash U LQ* 1 at 16.
88 Jackson and Kronman, above 24.
89 Ibid.

B. *The Exceptions*

Undoubtedly, the desire for equality has been, and continues to be, regarded as one of, if not the main, justifications for the enactment of avoidance provisions.[90] However, when one examines the distribution rules under which a liquidator must proceed, together with the defences which can be invoked in relation to an action instituted by a liquidator pursuant to the Division, it is submitted that the use of the avoidance provisions does not produce equality. In fact, the concept of equality is close to meaningless in liquidation law generally[91] because of all the exceptions made to it.[92] The notion of equality among creditors has been eroded by judicial and legislative interventions[93] which have:

> ... superimposed a system of stratification of liabilities whereby certain groups of creditors are accorded preferential status and hence enjoy improved prospects of recovering full or partial payment of their debts.[94]

The unsecured creditors will, usually, bear the burden of the insolvency of a company. [95] This appears to be legislative policy. Before unsecured creditors receive any dividend a number of priority creditors will often have to be paid.

There are two types of claims that are often regarded as exceptions to the *pari passu* principle.[96] First, in a liquidation, secured creditors will be satisfied from the assets over which they have security. The *Corporations Law* implicitly, in section 554E, permits creditors to retain their security on a winding up, provided that the security is not able to be successfully attacked by the liquidator or is not invalidated or void under section 266(1) or section 588FJ. Therefore, the law protects "the hierarchical system of claims contractually created"[97] prior to liquidation by the debtor and creditors. Of course, one of the main reasons why creditors take security is to ensure that there are specific assets which they can realise for their benefit if liquidation was to intrude.[98]

---

90 In the Full Court of the Federal Court decision in *Ferrier & Knight v Civil Aviation Authority*, above n5, it appears that equality together with the discouragement of the dismemberment of the company were accepted as the rationales for provisions allowing for the avoidance of preferences (at 484).

91 Herbert, above n83 at 696.

92 Clark, R, "The Duties of the Corporate Debtor To Its Creditors" (1977) 90 *Harv LR* 505 at 516; Morris, above n71 at 738.

93 The Cork Report, above n11 at par 233. Bowers, J, ("Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economies of Failure" (1990) 88 *Mi L* 2097 at 2102–3) states that creditors are treated equally — they receive nothing.

94 Fletcher, above n38 at 2. The Cork Report, above n11 at par 233, made the point that often unsecured creditors received little or nothing.

95 Shanker, M, "The Worthier Creditors" (1975–76) 1 *Canadian Business LJ* 341 at 342.

96 Goode (above n37 at 67) regards them as false exceptions.

97 Above n88 at 990. The general law and law of liquidation, are in their basic forms, different when it comes to resolving insolvency issues. General law grants special treatment to secured creditors while the law of liquidation tries to spread the loss (See Garrido, above n70 at 30).

98 For further discussion of the rights of secured creditors and whether they should be entitled to priority in a liquidation see, eg, Buser, P, "The Who's Who in Bankruptcy: The Secured Creditor" (1973) 9 *Idaho LRev* 171; Goode, R, "Is the Law Too Favourable to Secured Creditors" (1983–84) 8 *Canadian Business LJ* 53; Jackson, T and Kronman, A, "Secured Financing and Priorities Among Creditors" (1979) 88 *Yale LJ* 1143; Drukarczyk, J, "Secured Debt Bankruptcy and the Creditors' Bargain Model" (1991) *Int'l Rev L & Econ* 203; Gronow, M, "Secured Creditors of Insolvent Companies: Do They Get Too Good A Deal?" (1993) 1 *Insolv LJ* 169.

It is unlikely, despite the criticisms of some distinguished commentators and judges,[99] that the present priority of the secured creditor will change.[100]

Second, the decision of the English Court of Appeal in *Aluminium Industrie Vaasser BV v Romalpa Aluminium Ltd*[101] has been regarded as an attack on the concept of equality of creditors. In this case the Court held that a clause, preventing the passing of property (retention of title) in respect of goods until the purchase price was paid, was effective. While there are many traps for suppliers who wish to rely on retention of title clauses,[102] there is no doubt that these clauses have, indirectly, reduced the dividends likely to be received by unsecured creditors. Now clauses which provide that title to the goods is retained until the purchaser has paid, not only for the price of those goods but all other indebtedness outstanding to the supplier, have been sanctioned by the courts.[103] Retention of title clauses are an opportunity for suppliers to opt out of the collective proceedings of liquidation. Perhaps the main argument against the subordination of the rights of unsecured creditors to the interest of an unpaid seller claiming under a retention of title clause is that the unsecured creditors had no way of ascertaining whether goods have been supplied subject to such clauses.[104]

Even if it can be said that these elements have eroded equality, they have not, in the past, affected the reasons for the existence of the avoidance provisions, because secured creditors and those having rights under retention of title clauses would have retained their priority whether or not avoidance provisions existed.

It is possible that under the present avoidance provisions some secured creditors may be able to claim benefits which will cause a further reduction in the amount received by unsecured creditors. In relation to the avoidance provisions which are contained in the *Bankruptcy Act*, and which were applied to liquidations by section 565 of the *Corporations Law*, prior to the advent of the regime found in the Division, there is a substantial amount of authority for the

---

99 See, eg, Goode, R, in "The Death of Insolvency Law" (1980) 1 *Company Law* 123; "Is the Law Too Favourable to Secured Creditors" (1983–84) 8 *Canadian Business LJ* 53. In *Salomon v Salomon* [1897] AC 22 at 53 Lord MacNaughton said, "Everybody knows that where there is a winding-up debenture-holders generally step in and sweep off everything; and a great scandal it is."

100 The Harmer Report stated that the equality principle should not intrude upon the law as far as it affects security rights (above n10 at par 713).

101 [1976] 1 WLR 676.

102 For example, see generally Collier, B, *Romalpa Clauses: Reservation of Title in Sale of Goods* (1987); Gageler, S, "Retention of Title Clauses" (1989) 2 *J Cont L* 34; Palmer, N, "Reservation of Title" (1992) 5 *JCL* 175; Christensen, S, "Reservation of Title in Goods Attached to Personalty or Realty" (1993) 4 *JBFLP* 264; Everett, D, "Romalpa Clauses: The Fundamental Flaw" (1994) 68 *ALJ* 404 at 407–13; Connock, M, "Retention of Title: Divining the Principles, Drafting a Clause and Some Practical Issues" (1994) 22 *ABLR* 37.

103 *Armour v Thyssen Edelstahlwerke AG* [1991] 2 AC 339; *Puma Australia Ltd v Sportsman's Australia Ltd* [1994] 2 QdR 149 at 157; *Chattis Nominees Pty Ltd* v *Norman Ross Homeworks Pty Ltd* (*in liq*) (1992) 28 NSWLR 338 at 345.

104 This is one of the best arguments in favour of requiring the registration of the interests of suppliers which are based on Romalpa clauses. The Australian Law Reform Commission in its (interim) Report No 64 on *Personal Property Securities* has proposed a single national register of personal property security interests and has recommended the inclusion of retention of title devices (at par 5.10). The Harmer Report had earlier called for a system of registration (above n10 at par 753).

proposition that any money recovered by a liquidator, pursuant to the avoidance provisions, was to benefit the unsecured creditors; secured creditors who held floating charges were not entitled to claim the recovered money.[105] This was because the provisions provided, in effect, that transactions which could be impugned were void as against the liquidator; the recovered money was held in trust by the liquidator for the unsecured creditors.[106] The money did not become part of the company's property.[107]

However, now the *Corporations Law* provides in section 588FF(1) that if a court finds that the company entered into a voidable transaction prior to the commencement of the winding up, and it decides to direct a person (usually this will be the defendant to the proceedings initiated by the liquidator) to pay money constituting the benefits received under the transaction, the money is to be paid to the company. This may now mean that a secured creditor who held a floating charge over the company's assets prior to liquidation can argue that he or she is entitled to the money which is paid under the order. If creditors do seek to put such a view, and are successful, the upshot will be that the priority afforded to secured creditors and which has impacted substantially on the size of distributions to unsecured creditors in liquidations in general will, also, impact on the size of the distributions to unsecured creditors where a liquidator successfully attacks pre-liquidation transactions under the avoidance provisions. The ultimate result is that the priority of secured creditors will undermine the principle of equal distribution further.

Another factor which has eroded the principle of equality in liquidations in general, and affects the principle where a liquidator recovers the benefit of a pre-liquidation transaction, is that the legislature has sanctioned the view that certain unsecured creditors should be paid in priority to other unsecured creditors. While section 555 of the *Corporations Law* incorporates the equality principle, the section also provides that the principle will not apply if another provision of the *Corporations Law* states otherwise. In section 556 the *Corporations Law* establishes a complicated priority regime whereby certain persons, such as employees of the company, are entitled to be paid for their services before the unsecured creditors receive anything. In effect, section 556 represents a conscious decision of the legislature to provide major exceptions to the principle of equality.

The rationale for the existence of the priorities in section 556 is that the legislature believes that certain persons warrant some form of protection, and should be insulated from the company's failure.[108] For instance, it is a policy

---

105 *Re Zucco; Ex parte Cooper* (1875) LR 10 Ch App 510 at 511 and 512; *Wilmott v London Celluloid Company*, above n62 at 150; *Sanguinetti v Stuckey's Banking Company* [1895] 1 Ch 176 at 180; *Re Yagerphone Ltd*, above n6 at 396; *Re Quality Camera Co Pty Ltd* (1965) 83 WN (Pt 1) (NSW) 226 at 229; *N A Kratzmann Pty Ltd (in liq) v Tucker (no2)* (1968) 123 CLR 295 at 300; *Campbell v Michael Mount PPB* (1995) 13 ACLC 506 at 509. If the liquidator recovered property *in specie*, it was included in the assets of the company, and if a secured creditor had a charge over the assets then he or she was entitled to the benefit of the recovery (*Bank of New Zealand v Essington Developments Pty Ltd* (1991) 5 ACSR 86 at 89–90).

106 *Re Yagerphone Ltd*, above n6 at 396; *Re Quality Camera Co Pty Ltd*, ibid.

107 *Starkey v Deputy Federal Commissioner of Taxation* (1993) 11 ACLC 558.

108 The Cork Report was of the opinion that creditors should not receive priority under statute

decision that an employee should not be out-of-pocket because his or her company has gone into liquidation. An employee relies upon his or her wages, and should be paid before a creditor who, if it does not receive any or all of what it is owed by the company, will simply be required to endure a reduction in its profits. Hence, the employee priority is to "ease the financial hardship caused to a relatively poor and defenceless section of the community by the insolvency of their employer".[109] The Harmer Report questioned whether this rationale was still valid.[110] The Report felt that the development of a sophisticated social welfare system had changed things. Also, unsecured creditors who are small traders may be dependent upon payment to maintain the solvency of their businesses. These persons are, according to the Report, in an employee-like relationship with the insolvent. However, the Report did accept that there was strong community support for retaining the employee priorities.[111]

Often the payments made pursuant to the priorities enumerated in section 556 will exhaust the total funds collected by the liquidator from the sale of assets and from the recovery of property disposed of under voidable pre-liquidation transactions and, as a consequence, the ordinary unsecured creditors receive nothing. Certainly, if the unsecured creditors do receive a dividend it will be less than that received by the priority creditors mentioned in section 556.

Besides the priorities in section 556, there are other persons, while not being regular claimants in liquidations, who will receive preferential treatment when compared with the general body of unsecured creditors. For instance, section 562 enables a creditor of a company because of a claim for which the company is insured, to be paid out of the insurance moneys received by the liquidator, in priority to other unsecured creditors. Under section 564 the Court may order, where property has been recovered by a liquidator after a creditor has given an indemnity for litigation costs, that the creditor be granted some advantages over other creditors because of the risk it assumed.

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 section 588FA(2), that the payment was part of a running account and, therefore, the payment does not have to be repaid.[112] If the courts are willing to interpret section 588FA(2)

---

unless there was general public acceptance of the fairness and equity of granting such priority (above n11 at par 1398). The legislature has connected social policy with loss allocation (Nimmer, R, "Negotiated Bankruptcy Reorganisation Plans: Absolute Priority and New Value Contributions" (1987) 36 *Emory LJ* 1009 at 1024–5). It is common for insolvency legislation across the world to provide priority status to certain classes of creditors (Cantlie, S, "Preferred Priority in Bankruptcy" in Ziegel, J (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (1994) at 413).

109 Cork Report, above n11 at par 1428.

110 Above n10 at par 722.

111 Id at par 726. Cantlie (above n108 at 422–3) argues that employees are non-consensual creditors who have not consciously and voluntarily accepted the risk of default and, therefore, should receive priority.

112 The running account principle has been developed and applied regularly by the courts (see

broadly 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.[113]

Defendants, in actions brought by liquidators under the Division, are entitled to rely on section 588FG, which prescribes defences.[114] For instance, if a creditor received a preference prior to the commencement of the liquidation and the preference constitutes 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. 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.[115]

Another element which contributes to the emasculation 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. 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[116] and recommended that a fund, to be known as the Insolvent (Assetless Companies) Fund, be established.[117] 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 have received 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.

Richardson v Commercial Banking Company of Sydney (1951–52) 85 CLR 110; *Rees v Bank of New South Wales* (1964) 111 CLR 210; *Queensland Bacon Pty Ltd v Rees* (1966) 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 721). See Polazzalo, T, "New Value and Preference Avoidance in Bankruptcy" (1991) 69 *Wash U LQ* 875 at 894–8 for a discussion of the American position.

113 Polazallo, id at 894–5.

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

115 Shanker (above n23 at 331) 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 (Shanker at 343–4).

116 Above n10 at pars 337–8, 340, 343.

117 Id at par 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 par 348–50.

C. *Summary*

The many exceptions to the equality principle, which appear to be enshrined in the law, mean that the principle is substantially circumscribed. It is submitted that it cannot be asserted that the justification for the avoidance provisions is the desire for equality, because the law has effected a compromise between the ideal of equality at the point of distribution, the interests of the credit economy[118] and the social values of the community. The latter can be seen by the priorities granted to employees under section 556(1)(g) and section 556 (1)(h).

It is submitted that it is far more accurate to say that the rationale for the avoidance provisions is to ensure that the assets of the company are distributed according to what is viewed by government as a socially and economically responsible scheme ordained by statute (encapsulated, primarily, in sections 555 and 556 of the *Corporations Law*) that is, a debtor should not be permitted to subvert the scheme by entering into transactions shortly before liquidation.[119] *This was adverted to by the High Court in Burns v Stapleton.*[120] *In a joint judgment, Dixon CJ, Kitto and Windyer JJ, said that what section 95(1) of the Bankruptcy Act* 1924 (Cth) (the precursor of section 122(1) of the *Bankruptcy Act* 1966 (Cth) and regularly applied to liquidations by sections like section 565 of the *Corporations Law*) "clearly intends to make void, where it applies, is the change which, if allowed to be effectual, would dislocate the statutory order of priorities amongst creditors".[121]

7. *Deterring Dismemberment*

A. *The Principle*

Mr Justice Cox of the Supreme Court of Tasmania in *Re Feldmanis Finance Pty Ltd (in liq)*[122] said, in relation to the transaction which was the subject of the litigation before him, that "... [it] has all the hallmarks of an anxious scramble by creditors fearing the imminent bankruptcy or liquidation of their debtor to protect their position as best they could".[123]

The scramble referred to by Justice Cox, and often called "the race of diligence",[124] particularly in the United States, is another reason which has been identified for the avoidance provisions.

---

118 Neider, above n71 at 491; Ponoroff, above n54 at 1516.

119 See Morris, above n71 at 738; Nutovic, I, "The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1) and 546(a)(1)" (1985) 41 *Bus L* 175 at 186; Countryman, above n71 at 748; Fletchner, H, "Preference, Post-Petition Transfers, and Transactions Involving a Debtor's Downstream Affiliate" (1987) 5 *Bankr Dev J* 1 at 8; Rodenberg, J, "Indirect Preferences: Recovery Under Sections 547 and 550 of the Bankruptcy Code" (1990) 55 *Miss LRev* 328 at 332.

120 (1959) 102 CLR 97. Also, see *Re RHD Power Services Pty Ltd (in liq)* (1991) 9 ACLC 27 at 29.

121 Id at 104.

122 (1982) 1 ACLC 823.

123 Id at 830.

124 For example, see Fletcher, above n38 at 1; Ward and Shulman, above n87 at 17; Nutovic, above n119 at 185; Westbrook, J, "Two Thoughts About Insider Preferences" (1991) 76 *Minn LR* 73 at 77; Farrar (above n83 at 390), Prentice (above n8 at 78) and Chiah (above n82 at 1) refer to it as "the race for the swiftest".

The law has been concerned that if a scramble is not prevented, creditors who participated and succeeded in a scramble would improve their position at the expense of other creditors,[125] so that there would be little remaining for distribution in a subsequent liquidation,[126] which may well be caused, ultimately, by the rush of creditors demanding payment. Hence, the avoidance provisions are viewed as a means of deterring creditors from engaging in the scramble, and securing benefits.

If there were no avoidance provisions the creditors would have every incentive to grab what they could, and as quickly as they could. If this occurred the costs incurred by creditors would escalate, as they would need to be more diligent in their monitoring of their debtors' financial affairs, and it could precipitate the premature termination of the businesses of some debtors because of the pressure placed on them;[127] one cannot expect creditors to refrain from exerting pressure in a hope that the debtor will survive, when all the creditors around them are endeavouring to obtain what they can.[128]

Consequently, it is often asserted that the existence of avoidance provisions, primarily those prohibiting the giving of preferences, should encourage creditors to respond positively to calls from debtors for support,[129] and generally to refrain from dismembering debtors. The avoidance provisions, in effect, remove the incentive of "first come, first served".

In *Union Bank v Wolas*,[130] the United States Supreme Court referred to the House of Representatives' Committee Report delivered in 1977[131] in which it stated that one of the two purposes (the other being equality) of the preference section was to discourage creditors "from racing to the courthouse to dismember the debtor during his slide into bankruptcy".[132] The Full Court of the Federal Court of Australia in *Ferrier and Knight v Civil Aviation Authority*[133] cited the purposes given by the House Committee, but did not specifically approve of them.

Besides the House Committee, there are a number of commentators who have accepted that the deterring of dismemberment is a joint reason, with the need to ensure equality between creditors, for the avoidance provisions.[134] While the deterrence justification is a modern idea, when compared with the notion of equal distribution,[135] Easterbrook J, who handed down the decision

---

125 Chiah, above n82 at 1; Friedman, J, "Lender Exposure Under Sections 547 and 550: Are Outsiders Really Insiders?" (1990) 44 *Southwestern LJ* 985 at 989; Ponoroff, above n53 at 1451.

126 Friedman, id at 994.

127 Jackson, above n47 at 862; Barney, above n82 at 1047; Nutovic, above n119.

128 Ponoroff, above n54 at 1447, 1448–8.

129 Id at 1499.

130 112 S Ct 527 at 532–3 (1991).

131 Report No 595, 95th Long, 1st Sess 177–8 (1977).

132 Ibid. The House Report said that the deterrence policy furthers the goal of equality of distribution.

133 Above n5 at 484.

134 For example, see Herbert, above n83 at 668; Orelap, above n83 at 212; Westbrook, above n124 at 76; Ponoroff, above n82 at 1452; Giorgianni, P, "The Small Preference Exception of Bankruptcy Code Section 547(c)(7)" (1994) 55 *Ohio State LJ* 675 at 676. The Court in *Union Bank v Wolas*, above 130 at 572 refused to regard either purpose as pre-eminent.

135 Westbrook, above n124 at 76.

in the very important American bankruptcy case, *Levit v Ingersoll Rand Financial Corp*,[136] emphasised the former justification as the more important in current preference law.[137]

Westbrook clearly agrees with this view.[138] This is probably because there is, today, a greater emphasis on endeavouring to achieve a rescue of a company before it is in such a state that liquidation is the only avenue for it to take. The Harmer Report noted, in 1988, that in Australia, historically, there had been little encouragement given to a constructive approach to corporate insolvency whereby the focus was on the rescuing of the business.[139] As a result the Report recommended the introduction of a new voluntary procedure for insolvent companies.[140] The recommendation was adopted by the legislature and led to the enactment of Part 5.3A of the *Corporations Law*, which deals with voluntary administrations and deeds of company arrangement. Voluntary administration was inserted because there was concern that Australia's corporate insolvency laws were inflexible and that they too often led to the liquidation of companies.[141]

While the deterrence justification may be regarded by some as the primary purpose for avoidance provisions, there seems to be little doubt that this purpose is inextricably tied to the equality principle. If the legislature focuses on preventing a scramble by creditors during the period before the beginning of liquidation this should, as a consequence, lead to creditors being treated equally.[142]

The idea of creditors rushing to seize what benefits they can when a company is in financial straits is antithetical to the concept of collectivism, and the very notion that liquidation is a collective procedure. As Jackson states, in relation to creditors seeking advantages, rather than being prejudiced by passively waiting for a resolution, "creates a race to use individualistic remedies, even though it is not in the creditors' collective interest to use them at all".[143]

If avoidance provisions have been enacted in order to deter dismemberment of companies this purpose will assist the collection procedure in that creditors know that a liquidator will be able to set aside preferences received, and they will be distributed to the general body of creditors.

---

136 Above n46.

137 Id at 1194.

138 Above n34 at 76–7. While not necessarily agreeing with the situation Tabb, above n83 at 995 regards deterrence as being given primacy over equality.

139 Above n10 at par 52.

140 Id at par 54 ff.

141 Above n16 at par 448.

142 *Union Bank v Wolas*, above n130 at 533; Chiah, above n82 at 23; Baird, above n25 at 155; Lurey, M, Rosenberg, R and Bosse, R, "Recovery Property of the Estate: Avoidance of Preferences and Fraudulent Transfers" in *Basics of Bankruptcy and Reorganisations*, vol 2, (1992) at 142.

143 Jackson, above n47 at 862. Also see note, "Preferential Transfers and the Value of the Insolvent Firm" (1978) 87 *Yale LJ* 1449 at 1459; Tabb, above n83 at 990; McCoid, above n74 at 263.

B. An Assessment

The deterrence policy is, in essence, that the avoidance provisions will cause the creditors to realise, when a debtor is floundering, that it is not worth obtaining a preference because if liquidation eventuates they will be required to disgorge it. Consequently, so the argument goes, creditors should determine to assist the debtor to stay in business and, hopefully, it will be able to repay its debts in full, or at least to an extent where it is more profitable for creditors than sharing in a winding up.

It is submitted that if the deterrence of creditors in dismembering companies is the justification for the avoidance provisions then the avoidance provisions are an unqualified failure. By and large they have little deterrent effect. The Harmer Report indicated that the evidence produced to it suggested that there was "a lively market in the recovery of preferences".[144]

There are, it is submitted, a number of reasons why the avoidance provisions have little deterrent effect. First, provisions which are intended to deter are only effective if people are aware of them, and the fact is that 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.[145] Creditors will apply pressure to obtain repayment and they tend to feel that if they can extract the payment of their debts they are very fortunate. This is, to express it colloquially, a "take the money and run approach".

Second, section 588FG provides, inter alia, that if a creditor had no reasonable grounds for suspecting that the company was insolvent when it gave the creditor a preference, the creditor has (provided that good faith and valuable consideration can be established), prima facie, a defence to an action initiated by the liquidator for recovery of the preference. This encourages debtors not to monitor the financial position of the debtor company so that it cannot be said that they knew of the insolvency of the company, if a payment is made. If there is no monitoring then creditors will be unaware that they are dismembering a company in distress.[146] Simply, where there is no knowledge of insolvency there can be no deterrence.

Third, it appears, all too frequently, that creditors are willing to take a preference and to assume the risk of having to disgorge it at some point in the future. The attitude of creditors, often as a result of legal advice, is one of pragmatism. They will obtain payment from a company in difficult 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.[147] Section 588FI of the *Corporations Law* permits the recipient of a preference to prove in the winding up once the preference has been disgorged. Creditors usually reason that they will grab what they can and resist a liquidator's demand to the point where they think that they are likely to lose. If that point is reached they

---

144 Above n10 at par 632.

145 This is acknowleged by Nimmer, R in "Security Interests in Bankruptcy: An Overview of Section 547 of the Code" (1980) 17 *Houston LR* 289 at 291.

146 Above n59 at 263–4.

147 Id at 264; Countryman, above n71 at 748.

will disgorge and claim in the winding up for the amount they are owed — in effect, they have lost nothing except, perhaps, some legal costs. Potentially such costs can be substantial so creditors must monitor the amount they may have to pay if they are not successful.

Furthermore, creditors in taking what they can from an insolvent company may reason that liquidation may never occur; even if it did, it may be outside of the time zone in which preferences can be attacked (this is, according to section 588FE(2)(b), six months prior to the relation-back day and from the relation-back day until the beginning of the winding up), and even if it did occur within the time zone, the liquidator may not discover it or may decide that he or she does not have a strong 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 he or she bluffing?

The problem facing a liquidator of which a creditor is often aware, is 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. At worst a creditor, against whom the liquidator is seeking a preference, will often have to pay only a small amount in respect of a liquidator's costs if the liquidator commences proceedings and the creditor, because his or her case is not strong, disgorges soon after such commencement. In such a case, the creditor usually will have had the benefit of the preference for some time and this may outweigh the fact that he or she has to pay the liquidator's costs and interest. There is no stigma involved in a creditor not disgorging until proceedings have been issued.

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 transactions has elapsed, thereby protecting the payment received. For instance, X, a creditor, receives a payment from Y Ltd on 7 February 1995. If X can assist Y Ltd so that no winding up application is filed against Y Ltd until after 7 August 1995, the payment received cannot be attacked as a preference (assuming X and Y Ltd are not related entities). Fifth, 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. If they refrain from accepting payment they may be hurting their own businesses.

Finally, and this is related to some of the previous reasons, there are no penalties for obtaining a preference. The worst to be expected, unless litigation is commenced by a liquidator, is that the creditor will have to disgorge the payment.[148]

In fact, rather than deterring dismemberment so that the company can survive, the existence of avoidance provisions might encourage creditors to seek the winding up of the company. For instance, an action can only be initiated under section 588FB for the recovery of the benefits given by the company pursuant to an uncommercial transaction, where the company is in liquidation.

148 Westbrook (above n124 at 85) argues that if the receipt of preferences were penalised the deterrent effect would be much greater.

If a creditor is aware of an uncommercial transaction having been entered into by the company he or she might think it to be advantageous if the company was wound up so that a liquidator could challenge the uncommercial transaction. This would not occur frequently as creditors would have little knowledge of the company's transactions unless they were associated with the company.

It is rather ironic that the deterrence policy could precipitate laziness on the part of creditors. Generally, the law encourages creditors to be vigilant in their dealings with debtors. However, a creditor who has pursued a debt efficiently and assiduously, and been paid, is penalised.[149] In reality the creditors who are able to exert pressure tend to be the lending institutions and large companies, and not the major body of creditors who often have no levers which they can use to extract payment. Furthermore, preference payments are often paid indiscriminately by insolvent companies whose books are unkept and whose general procedures are inefficient. As a result, creditors who have not been diligent may receive payment and in many instances have as much chance of payment as the vigilant and efficient creditors.

Because there is no real equal payment of creditors any longer, creditors may feel more inclined to obtain what they can pre-liquidation. Consequently, there may well be a conflict between the aim of ensuring that debts are paid in accordance with the statutory scheme, and the aim of deterring dismemberment. While the latter seeks to discourage creditors from dismembering a company, the existence of the former tends to encourage it, as creditors may be aware that they are likely to receive little or nothing as a member of the general body of unsecured creditors.[150]

In fostering the notion of deterrence, the American legislature has allowed certain transactions to be excepted from the avoidance provisions, for example, transactions in the ordinary course of business[151] to encourage doing business with distressed companies. An Australian example of the same kind of exception is the running account principle which protects creditors, in certain circumstances, when they deal with creditors. This causes a conflict between the equality and deterrence justifications because any exception in relation to the payment of a pre-liquidation debt (within the relevant time zone) tends to favour the payee at the expense of the other creditors, who cannot enjoy the benefit of equality.[152]

It is submitted that deterrence cannot realistically be regarded as the reason for the avoidance provisions as there are overwhelming indications that deterrence is meaningless in the context of creditors taking benefits prior to liquidation.

---

149 Lord Mansfield, who is credited with developing the law of preferences, did not criticise or penalise creditors who pressed their claims against the debtor (*Rust v Cooper* (1777) 2 Cowp 629 at 634; 96 ER 1277 at 1280).

150 This appears to be at odds with the statement of the US House of Representatives' Committee Report which regarded the deterrence policy as furthering the goal of equality of distribution (*House of Representatives Committee Report*, Report no 595 (1977) 95th Congress 1st Sess at 177–9).

151 *Bankruptcy Reform Act* 1978 (US), s547(c)(2).

152 *Union Bank v Wolas*, above n130 at 533 per Stevens J. Ponoroff regards the deterrence policy as potentially antinomous to the equality principle (Ponoroff, above n54 at 1481).

8. *Prevention of Commercial Impropriety*

The equality and deterrence policies focus upon those avoidance provisions which provide for the setting aside of preferences. The avoidance provisions which are derived from fraudulent conveyances require a different justification as they are included, principally, to arrest debtor misbehaviour, and not creditor misbehaviour (the aim of preferences).[153] With fraudulent conveyances, the debtor manipulates its affairs so as to dissipate its assets in favour of persons or entities who are not deserving of the benefits bestowed on them. It is avoidance provisions, such as uncommercial transactions, fraudulent transactions and unfair loans, which are derived indirectly from the fraudulent conveyance, to which we now turn.

Initially, it is to be noted that there has been little consideration of the purposes of the type of avoidance provisions which are derived from fraudulent conveyances.[154] While both preferences and fraudulent conveyances deplete the estate of the debtor company, thereby prejudicing creditors, provisions attacking the former are concerned with re-ordering the distribution of what are, prima facie, legitimate payments, and provisions dealing with transactions like fraudulent conveyances are concerned with recovering payments which are totally unwarranted. It is submitted that while both the setting aside of preferences and fraudulent conveyance is founded on fairness, the recovery of preferences is intended to achieve some degree of equality among equals,[155] while the recovery of fraudulent conveyances is permitted because to allow them would offend against good conscience.

There is a different sense of commercial morality at work with preferences in comparison with fraudulent conveyances. The law says that it is wrong, in commercial terms, to give a preference when a company is insolvent[156] because other creditors suffer. Consequently, it can be said that the focus of preference law is equality (subject to certain statutory priorities) and not the punishment of opprobrious conduct.[157] As Morris stated, "After all, the parties to a preference have usually done nothing dishonourable. The debtor paid a debt; the creditor accepted his due."[158] With respect to fraudulent conveyances, the law is concerned with something which strikes at the heart of commercial morality; not only do such transfers hurt the creditors, but persons are given benefits which they do not deserve. This is generally unacceptable behaviour and it is contrary to the principle of insolvency law. Debtors have a

---

153 Above n22 at 146; above n8 at 77; above n36 at 777 and 786; Friedman, above n125 at 1007.

154 See Clark, "The Duties of the Corporate Debtor to its Creditors" (1977) 90 *Harv LR* 505 at 560.

155 The Cork Report asserts that the avoidance of preferences is not provided for because they defeat or defraud the creditors who remain unpaid; it does not permit an equal distribution (above n11 at par 1220).

156 Farrar states that it is arguably morally wrong to give a preference (above n83 at 390). He was addressing the fraudulent preference which applied in England under s44 of the *Bankruptcy Act* 1914 (UK) This section required proof of intention, as opposed to the equivalent Australian sections (see *Bankruptcy Act* 1924 (Cth), s95; *Bankruptcy Act* 1966 (Cth), s122) which majored on effect. It had to be established in England that the debtor gave the benefit with a view to giving the creditor a preference.

157 Ponoroff, above n54 at 1470.

158 Morris, above n 71 at 738.

moral duty to ensure that they fulfil legitimate claims on their assets before meeting their own interests or the interests of the recipients of benefits under other transactions, for example, family members or associates.[159]

The dichotomy which has been drawn above, between those receiving preferences and those receiving benefits under other avoidance provisions, does not depend on moral culpability. Under Australian preference law it makes no difference whether a debtor intended to give a preference.[160] If the effect of a transaction is that it gives a preference to a creditor, and the necessary conditions stipulated have been fulfilled then a court will hold that the preference is voidable.[161] Likewise, under many of the provisions which are in the mould of fraudulent conveyances, there is no requirement to establish any intention on the part of the company. For instance, to establish that a pre-liquidation transaction is an uncommercial transaction under section 588FB a liquidator need only establish that a reasonable person in the company's position would not have entered into the transaction and this occurred when the company was insolvent or was rendered insolvent as a result of the transaction. Of course, it may be inferred that the company, in entering into an uncommercial transaction, intended to benefit the other party to the transaction, and to do so to the detriment of the creditors of the company.

Avoidance provisions like section 588FB effectively spell out what amounts to disreputable commercial behaviour. It is not commercially moral to dispose of assets in a manner which benefits one party (perhaps an associate) at the expense of the company and hence, the creditors.

The prevention of commercial impropriety, as a justification for avoidance provisions of the fraudulent conveyance type can be supported by the fact that one of the purposes of the law of insolvency is to provide for the investigation of the conduct of the debtor, and this, in corporate insolvency, requires an examination of the conduct of the company's controllers.[162] This purpose exists to meet the demands of commercial morality.[163] The public interest demands that those responsible for conducting the affairs of companies behave in accordance with proper commercial behaviour.[164] In implementing this public interest, and permitting certain transactions to be attacked, the legislature is, also, protecting creditors. It is ensuring that undeserving third parties do not benefit at the expense of creditors in general.

If a company sold equipment worth $100 000 to a director for $40 000, a liquidator would seek to attack the transaction as an uncommercial transaction

---

159 Above n154. Clark refers to this as the "ideal of Respect" at 511. Also, see McCoid, above n32 at 656.

160 *S Richards and Co Ltd v Lloyd* (1933) 49 CLR 49; *Richardson v Commercial Banking Co. of Sydney*, above n112; *Re Cummins* (1985) 62 ALR 129; *Matthews v Geraghty* (1986) 11 ACLR 229. The same position exists, in effect, in the United States (see *Buckley v Jeld-Wen Inc.* 986 F 2d 228 at 232 (1993) and cited in Ponoroff, above n54 at 1484).

161 *S Richards and Co Ltd. v Lloyd*, id at 62. Starke J clearly stated that the legislation said nothing about the intention or state of mind of the debtor at 62.

162 Cork Report, above n11 at pars 198, 238 and 239. See *Spedley Securities Ltd (in liq) v Bond Corporation Holdings Ltd.* (1990) 1 ACSR 726 at 738 per Rogers CJ (Comm Div). It appears to be implicit in the Harmer Report (above n10 at par 33). Also, above n8 at 71.

163 Cork Report, above n11 at par 235.

164 Above n8 at 71.

on the basis that no reasonable person would sell the equipment for such a reduced sum. It is improper that the director receives a windfall and the creditors' share of the company's assets is reduced. A court would have a discretion, under section 588FF, as to what order it made. It is likely that it would either order the return of the equipment and the repayment of the $40 000 to the director, or order the director to pay the balance of what would be a fair price, that is, $60 000.

Support for the propriety rationale can be found in the explanatory memorandum to the Corporate Law Reform Bill 1992, where it was said that the purpose of the avoidance provisions in the division was, inter alia, to ensure that the unsecured creditors were not prejudiced by the company, during the time shortly before liquidation, disposing of assets or incurring liabilities so as to favour other persons.[165]

9. *Avoidance Provisions — Can They Be Justified?*

It is appropriate, in the course of examining the policy reasons which have been given for the presence of avoidance provisions, to inquire whether, in fact, such provisions can be justified, that is, would it be preferable for them to be omitted, despite the apparent justifications which have been identified. In other words, would the liquidation process be better served by the abolition of avoidance provisions? This is all the more relevant given the problems existing with the equality and deterrence principles which have been propounded as the principal reasons for the avoidance provisions.

There has been some consideration given from time to time, to abolishing avoidance provisions which set aside preferences. McCoid accepted that equality and deterrence are the goals of preference laws,[166] yet he is of the opinion that such laws are not effective in achieving these goals, citing two principal reasons for this. First, liquidators have limited success in setting aside preferences, such that the result is "hit and miss",[167] giving rise to inequality among creditors.[168]

Second, the costs associated with recovering preferences militates against the inclusion of an avoidance rule.[169] There will be some administrative costs even if the preferred creditor does not contest the liquidator's demand for the return of the payment. At the very least the liquidator will need to send a carefully prepared written letter of demand, and may, in some cases need to instruct a solicitor to prepare and deliver such a demand as well as seeking some preliminary legal advice. If the creditor decides to contest the demand, costs associated with the ensuing litigation will often be substantial and they will have to come out of the estate. With litigation comes the risk of failure and the prospect of more costs.

These reasons, together with the fact that preference law is perceived as being unfair, as it retroactively amends the rules for creditors, make the abolition

---

165 Above n16 at par 1035.
166 Above n59 at 260–1.
167 Id at 265.
168 Id at 266.
169 Id at 266–7.

of preference law attractive to McCoid.[170] It is true that the focus of creditors in non-insolvency situations is to seek and obtain priority over other creditors; there is no thought given to equality[171] and creditors are not penalised for seeking priority. The period prior to liquidation sees a change to the rules. If liquidation intervenes, the race for priority is replaced with the notion of equality. However, when extending credit to a company a creditor knows, or should know, that if liquidation was to ensue, and he or she received a payment during the six months prior to the relation-back day, it could be attacked as a preference. The creditor's transaction with the debtor is voluntary. The spectre of insolvency and liquidation is not unforeseeable; it is always something which a creditor must take into account, and it is one reason why unsecured credit can precipitate higher yields.

In a submission to the Harmer Committee, Pincus J, then of the Federal Court of Australia, and now of the Court of Appeal of Queensland, was of the view that while preference laws were founded on good policy they were of doubtful practical benefit because "of the difficulty in legislating for a simple means of adjustment".[172] He focussed, inter alia, on the costs involved in litigating claims.[173] With respect, it is submitted that rather than saying the law is not workable and, therefore, should be abolished, one should consider whether the avoidance of preferences is desirable from a policy perspective and, if so, examine what can be done to construct a fair and efficient law.

It has been argued that preferences should not be regarded as inherently bad as all creditors have "an equal shot at winning the race of diligence".[174] Why shouldn't the more diligent creditors be rewarded? The response to this is that all creditors do not have an equal opportunity in recovering payments. Some creditors will have better information concerning the plight of the debtor company. Others will be able to take action more promptly to recover funds. While others, who are relied upon to supply essential goods or services, can use the threat of no further supplies unless they are paid.[175] There is little doubt that stronger creditors, such as lending institutions and large companies, will fare much better than the weaker ones. For example, a major bank will start "the race" a number of grid positions ahead of a small supplier, and, taking the analogy further, the bank's car will have a much larger and faster engine in order to win the race.

Furthermore, a debtor company is more likely to pay creditors who are associated with it,[176] or who may be of assistance in the future to those who control the company, perhaps when they begin a new business.

---

170 Id at 270.

171 Tabb, above n83 at 988, points out that the main characteristic of collection law outside of liquidation is "first in time is first in right". Also, see Jackson, T and Kronman, A, "Secured Financing and Priorities Among Creditors" (1979) 88 *Yale LJ* 1143 at 1162. The expression used by Tabb is akin to the Australian colloquialism, "first in, best dressed".

172 Harmer Report, above n10 at par 631 (Submission 115).

173 Ibid.

174 Tabb, above n83 at 988.

175 For example, see *Re Toowong Trading Pty Ltd(in liq)* [1985] 1 QdR 207; *Telecom Australia v Russell Kumar & Sons Pty Ltd (in liq)* (1993) 10 ACSR 24.

176 For example, *Re Captain Homemaker Pty Ltd (in liq)*, above n35; *Re Clasper Group Services Ltd.* [1989] BCLC 143.

While accepting the equality principle in liquidation, it has been said that the principle should not apply in the pre-liquidation period.[177] It could be said that when a creditor exacts payment from a debtor prior to liquidation there is nothing "unlawful" about it but, the fact that there is a subsequent liquidation makes the creditor's action "unlawful".[178] Yet the simple answer to that is, as Seligson recognised many years ago, there may well only be "tag ends and remnants"[179] left when the liquidator comes to collecting the assets of the company if the pre-liquidation period is ignored. In addition, allowing creditors to grab what they can, could precipitate the final demise of the company. Such a result not only penalises creditors in general, but has wider ramifications, for example, the loss of employment for workers.

Undoubtedly, the abolitionist view has some attractions, however, it is too extreme[180] as it offends notions of fairness and equality, which are at the very foundation of the law of liquidation.[181] It is submitted that there are not sufficient reasons yet, to ignore this foundation. It would encourage the use of aggressive collection procedures at times when businesses are failing. This would favour the strong and it would be likely to precipitate more corporate collapses.[182] Furthermore, it may mean that creditors are less disposed to consider arrangements which could keep the company afloat.

It is interesting to observe that there appears to be no call for the abolition of avoidance provisions other than preferences. It is submitted that the reason is that other avoidance provisions, derived from fraudulent conveyance laws, cannot be ignored because of the need for commercial propriety. In his submission to the Harmer Committee calling for an abolition of preferences, Pincus J affirmed the need for the avoidance of payments made by a debtor to a creditor in a conspiratorial fashion.[183] Such payments would offend the principle of commercial propriety. Unlike the recipient of a preference, who is entitled to payment, the recipient of benefits pursuant to transactions, such as those covered by section 588FB (uncommercial transactions), is not so entitled. In fact the recipient is being unjustly enriched.

10. Conclusion

The failure of the Australian legislature and courts to identify and articulate clearly the reason(s) for the existence of the avoidance provisions is one of the major faults characterising the law in this field. Unless the reason(s) is carefully defined then interpretations can be made in relation to the avoidance provisions which are not congruent with the real purpose behind the law; courts will not be aware when they are departing from the purposes of the law and this may produce results which are, in fact, contrary to the policy behind the existence of the avoidance provisions.

---

177 See Nutovic, above n19 at 180.
178 Shanker, above n24 at 313.
179 Seligson, above n71 at 115.
180 Ponoroff, above n54 at 1488.
181 See the Harmer Report, above n10 at par 632.
182 Warren, E, "Bankruptcy Policy" (1987) 54 *U Chi LRev* 775 at 791.
183 Above n10 at par 631.

It is submitted that there are a number of reasons which can be identified for the inclusion of avoidance provisions in insolvency legislation, but these reasons are not separate and distinct; they tend to overlap, and even merge.[184] Clearly, all of the policy goals articulated for the avoidance provisions are not complementary and may almost be in conflict.[185] There is little doubt that the avoidance provisions have been included in the *Corporations Law* to foster a general purpose of liquidation law, that is, to provide an orderly process for dealing with the affairs of insolvent companies.[186] The provisions seek to assist the bringing of orderliness to the disorder which often marks an insolvent's relationship with creditors, in that they endeavour to resolve the creditor-debtor conflict[187] by enabling the insolvent (through the agency of the liquidator) to work out the situation through co-operation with all creditors.[188] In this working out a liquidator will be required to balance the need for an orderly and fair resolution of the estate with the private interests of creditors.

The avoidance provisions are an important factor in liquidation's policy of providing for a collective process, that is, transactions entered into by the company within certain periods before liquidation are set aside so that the property or money involved can be collected and distributed to the creditors. It has been argued that both preference provisions and provisions derived from fraudulent conveyances are intended to contribute to this policy. Preference provisions ensure that a creditor is not benefited to the detriment of the other creditors. Any benefit received must be disgorged and distributed among all of the creditors. Those provisions similar to fraudulent conveyance provisions will, also, lead to benefits being recovered which are available for distribution among creditors. All avoidance provisions are in existence to protect the unsecured creditors.[189]

Often regarded as allied to the collective policy are the policies of equal sharing between creditors in liquidations and deterring the dismemberment of companies on the basis that they contribute to furthering the collective process. Although not expressly approving of them, the Full Court of the Federal Court in *Ferrier & Knight v Civil Aviation Authority*[190] referred to them as if they had authority. However, it has been argued in this article that these policies are tantamount to meaningless. It has been demonstrated that there is not equality among creditors. It sounds good but it is, in fact, illusory. Even in the United States, where the policy has been discussed frequently, and supported by a

---

184 For an example, see Tabb, above n83 at 989–90.

185 Ponoroff, above n54 at 1495. This was recognised in *Union Bank v Wolas*, above n130 at 533.

186 Harmer Report, above n10 at par 33; above n16 at par 1035. This is consistent with the approach adopted in the United States. See Report of the Commission on the Bankruptcy Laws of the United States, HR Doc No 137 pt 1 93rd Congress, 1st Sess, 19 at 71 (1973) cited by Ponoroff, above n54 at 1474; Orelap, above n83 at 210–1.

187 Neider, above n71 at 491.

188 Broome, L, "Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments" (1987) *Duke LJ* 78 at 115.

189 Above n16 at par 1035.

190 Above n5 at 484.

report of the legislature,[191] there is general acceptance that it does not apply in practice.[192] This latter view is replicated in England[193] and Australia.[194]

The legislature has, by varying the equality principle, apparently, sought to accommodate conflicting aims; it has balanced the ideal of equality with the interests of the credit economy[195] and the general welfare of the community.[196] Whatever the result, one cannot say that the equality principle applies. The policy appears to be that avoidance provisions exist to ensure that the distributional scheme prescribed by statute occurs.[197] The policy of deterrence just does not work out in practice. It has been argued in this article that many factors prove that people are not deterred from accepting preferences because of the existence of the avoidance provisions.

It has been submitted that a further policy reason for the existence of provisions derived from fraudulent conveyance law is that to permit pre-liquidation transactions covered by these provisions would be to condone a breach of general commercial morality. It would be decidedly unconscionable to refrain from prohibiting the disposal of property by insolvent companies (which have since gone into liquidation) to persons who are not entitled to the benefits received under the transactions. The fact that there is commercial impropriety in disposing of assets in such cases is supported by the fact that all Australian jurisdictions have enacted provisions which entitle creditors to challenge the disposal of assets in non-insolvency situations where the intention is to defraud creditors.

While avoidance provisions should be retained, and not abolished, if the traditional principles of equality and deterrence are, in fact, the policy reasons for the avoidance provisions then the provisions clearly do not implement these policies. For these policies to work the legislature would need, inter alia, to amend the *Corporations Law* to abolish priority creditors and therefore, foster equality, and it would need to attach some form of penalty to those who benefit from pre-liquidation transactions. These actions are very unlikely to occur. First, as discussed in this article the legislature has decided that certain persons such as employees deserve some priority. Second, the imposition of a penalty could affect those who may have acted in good faith but are deemed, on reasonable grounds, to have suspected the insolvency of the debtor company. This would probably be unpalatable to the legislature.

---

191 *Report of the Commission on the Bankruptcy Laws of the United States*, above n186.

192 For example, Countryman, above n71 at 748. Bowers (above n93 at 2102) suggests that this results from the fact that creditors are not in fact equal and he wonders why the United States Congress would want unequal people to be treated equally.

193 Cork Report, above n11; Fletcher, above n38.

194 Harmer Report, above n10.

195 Neider, above n71 at 491.

196 Radin, above n41 at 9.

197 See *Burns v Stapleton* (1959) 102 CLR 97 at 104; *Re RHD Power Services Pty Ltd. (in liq)*, above n120 at 29.