AN EXPOSITION AND ASSESSMENT OF UNFAIR PREFERENCES

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[Historically the primary legal proceedings initiated by liquidators in winding up companies has been the recovery of undue preferences which were granted by companies prior to their liquidation. The Corporate Law Reform Act 1992 (Cth) introduced a new form of preference to replace the undue preference; this is known as the unfair preference. *This article, after providing a brief discussion of the background to and the nature of preferences, considers the reasons for the introduction of the unfair preference, examines the application and scope of the section which articulates unfair preferences and identifies both the strengths and shortcomings of unfair preferences. The author submits that the introduction of the unfair preference will not dramatically change the position which applied when undue preferences were claimed by liquidators and that it is regrettable that the legislature has perpetuated some of the shortcomings which exist with undue preferences.]*

I INTRODUCTION

One of the principal functions of the liquidator of a company which is being wound up is to collect the property of the company[1] in order to distribute it, ultimately to the creditors in the form of dividends. A significant aspect of this collection function is the discovery and subsequent recovery of assets which are not held by, or under the control of, the company, but are assets to which the company is entitled. In fact the liquidator is under an obligation to recover what he or she can in order to augment the assets which will be available for distribution among the general body of creditors.[2] This obligation is predicated on one of the foremost principles of liquidation law, *viz* that the assets of a company are to be distributed fairly and rateably among its creditors.[3] This is an old equitable principle known as the *pari passu* principle.[4] The concern for *pari passu* distribution or equality among creditors has meant that the maxim 'equity is equality' is the main theme of liquidation administration.[5] It is, of course, only applied where the company is insolvent and therefore unable to pay all of its creditors in full.

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1 Bruce McPherson, *The Law of Company Liquidation* (3rd ed, 1987) 5.

2 *Re Timberland Ltd (in liq)* (1979) ACLC 32,296, 32,319.

3 McPherson, above n 1; Terry Taylor, Ian Ferrier and Anthony Hodgson, *Australian Insolvency Management Practice* (CCH Australia looseleaf service, 1994) para 43-080, 20,051; John Farrar, Nigel Furey, Brenda Hannigan and Philip Wylie, *Farrar's Company Law* (3rd ed, 1991) 709.

4 John Farrar, 'Public Policy and the Pari Passu Rule' [1980] *New Zealand Law Journal* 100.

5 Charles Seligson, 'Preferences Under the Bankruptcy Act' (1961) 15 *Vanderbilt Law Review* 115; Ian Fletcher, *The Law of Insolvency* (1990) 2; James O'Donovan, 'Undue Preferences: Some Innocents "Scape Not The Thunderbolt"' (1993) 22 *University of Western Australia Law Review* 322 turns the maxim around and states it as 'equality is equity'. O'Donovan asserts (at 337) that the maxim is not always true. This is a fair comment when one takes into account the fact that some creditors are regarded as priority creditors pursuant to the Corporations Law s 556.

While it may be said that the grand principle of *pari passu* has been eroded by judicial and legislative interventions[6] 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',[7] the principle remains at the very heart of the winding up process.[8]

It would be impossible to achieve equality if the law were to disregard what occurred prior to the winding up of an insolvent company.

As Collier stated: 'if the creditors and debtors could deal with impunity with the debtor's assets up to the date of bankruptcy [liquidation], only tag ends and remnants of unencumbered assets would too often remain.'[9]

The Cork Report put it this way:

> the 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 owing by the bankrupt, by altering the distribution of his estate it made a *pari passu* distribution among all the creditors impossible.[10]

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

The consequence of the policy of *pari passu* distribution is that transactions which effect the disposition of assets or other property before the commencement of winding up should be reviewed and avoided if they affect the principle of equal distribution. If transactions are avoided, the assets disposed of by the debtor company may be recovered and made available to meet the claims of the creditors of the company.

In order to safeguard the equal distribution of the assets of the company among the creditors in a liquidation, the legislature has for many years provided for the setting aside of certain transactions which have occurred before the commencement of winding up. If a liquidator was unable to avoid pre-liquidation transactions, a company could dissipate its assets in favour of whomsoever it pleased and this would result in a failure to comply with the *pari passu* principle. The provisions which allow pre-liquidation transactions to be avoided by a liquidator are now contained in Division 2 of Part 5.7B of the Corporations Law. This Division provides that certain transactions occurring within specified time zones before winding up may be avoided by the liquidator.

[6] This was the view of the 'Cork Report' in the UK: United Kingdom, Insolvency Law Review Committee, *Insolvency Law and Practice* (1982) Cmnd 8558, paras 224-7, 232.

[7] Fletcher, above n 5.

[8] James O'Donovan, 'Corporate Insolvency: Policies, Perspectives and Reform' (1990) 3 *Commercial and Business Law Journal* 1, 11, regards the principle as the linchpin of the winding up scheme. The Australian Law Reform Commission regarded the principle as fundamental: Australian Law Reform Commission, *General Insolvency Inquiry* (1988) (the 'Harmer Report').

[9] William Collier, *Collier on Bankruptcy* (Matthew Bender (publisher), looseleaf service, 14th ed, 1956) vol 3, 742.

[10] Cork Report, above n 6, para 1209.

Undoubtedly the major type of transaction which liquidators have sought to avoid is the transaction which can be classified as a preference. The ability to avoid such transactions is usually regarded as the primary weapon in the arsenal of a liquidator in recovering property for the creditors of the company.[11] The Australian Law Reform Commission in its *General Insolvency Inquiry* (1988) (usually referred to as the 'Harmer Report') noted that the evidence produced to it suggested that there was 'a lively market in the recovery of preferences.'[12] Until the advent of the Corporate Law Reform Act 1992 (Cth) ('the Act'), preferences which could be set aside by a liquidator were referred to as undue or voidable. As part of the reforms introduced by the Corporate Law Reform Act 1992 (Cth) a new preference provision was enacted and it became operative on 23 June 1993. Preferences provided for under this new enactment are known as unfair preferences. The unfair preference is articulated in s 588FA of the Law.

The primary aims of this article are, firstly, to examine the reasons for the abolition of the undue preference and its replacement by the unfair preference. Secondly, to consider the application and scope of s 588FA. Finally, to identify both the strengths and shortcomings of the unfair preference, especially in light of the situation which previously existed pursuant to s 565.

Before tackling these matters it is appropriate to examine briefly the origins and nature of the preference.

II PREFERENCES: ORIGINS AND NATURE

In medieval times, if a debtor could not pay his or her debts, there was an unregulated scramble by creditors for their assets, the rule being 'first come, first served';[13] there was no provision for a sharing of the property. This state of affairs was rectified to some degree by the bankruptcy statute of 1570,[14] which provided for the distribution of the proceeds of sale of property among the creditors rateably. It is probably not coincidental that at the same time a statute was introduced (known as 'the Statute of Elizabeth') allowing for the setting aside of fraudulent conveyances. It was stated in broad terms that all:

> feigned, covinous and fraudulent feoffments, gifts, grants, alienations, conveyances, bonds ... devised and contrived of malice, fraud, covin, collusion or guile, to the end, purpose and intent, to delay, hinder or defraud creditors and others of their just and lawful actions, suits, debts ... should henceforth be utterly void, frustrate and of no effect.[15]

The statute, in order to protect creditors, declared all dispositions and convey-

[11] McPherson, above n 1, 314; Douglas Robertson, 'Winding Up Generally' in *Australian Corporation Law* (Butterworths Looseleaf Service, 1991) vol 2 — Principles and Practice, para 5.6.0460, 56,241; Charles Young, 'Preferences Under the Bankruptcy Reform Act 1978' (1980) 54 *American Bankruptcy Law Journal* 221, 222.

[12] Harmer Report, above n 8, para 632.

[13] Cork Report, above n 6, para 31.

[14] An act touching orders for bankrupts (1570) 13 Eliz 1, c 7, s 2.

[15] An act against fraudulent deeds, alienations, etc (1570) 13 Eliz 1, c 5, (Fraudulent Conveyances Act).

ances of property made with the intention of defrauding creditors to be null and void.[16] This legislation introduced the first avoidance provision, the right to avoid fraudulent conveyances, and it marked the beginnings of the law of preferences[17] although no English statute specifically provided for the avoiding of preferences until 1869.[18] Until the time of Lord Mansfield there was little development of a law of preferences. Some advance was made by the opinion given by Coke CJ in the celebrated decision of the *Case of the Bankrupts*,[19] when his Lordship 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 debts .... But if after the debtor becomes a bankrupt, he may prefer one ... and defeat and defraud many other poor men of their true debts, it would be unequal and unconscionable, and a great defect in the law.[20]

However, in general, legal historians are perplexed at the lack of potency of preference law before the time of Lord Mansfield.[21]

During Lord Mansfield's time, in the eighteenth century, there was a common law development of the avoidance of preferences[22] in order to give effect to the general spirit of the bankruptcy legislation.[23] An examination of the cases reveals that the law of preferences developed as a branch of the law of fraudulent transfers.[24] In his development of the law, Lord Mansfield emphasised the debtor's purpose in giving the alleged preference.[25] His Lordship only found a preference to exist where there was fraud, hence preferences came to be known as 'fraudulent preferences'.[26] In *Alderson v Temple*[27] Lord Mansfield said that a person may or may not give a preference on the eve of bankruptcy. If a creditor were to threaten or demand without fraud, the payment was not to be set aside.[28]

16 Henry May, *The Law of Fraudulent and Voluntary Conveyances* (3rd ed, 1908) 1.

17 Mr Justice Bruce McPherson, 'Avoiding Transactions in Insolvency', an unpublished paper presented at the Corporate Insolvency Law Conference on 6 April 1991 at Bond University.

18 Bankruptcy Act (1869) 32 and 33 Vict, c 71, s 92. Interestingly, Scotland had legislation on the subject as early as 1690 (Bankruptcy Act 1699 (Scot)). A detailed history of preference law is found in Robert Weisberg, 'Commercial Morality, the Merchant Character, and the History of the Voidable Preference' (1986) 39 *Stanford Law Review* 3; Vern Countryman, 'The Concept of a Voidable Preference in Bankruptcy' (1985) 38 *Vanderbilt Law Review* 713.

19 (1592) 2 Co Rep 25; 76 ER 441.

20 Ibid 464-73.

21 Weisberg, above n 18, 45, n 144.

22 Ibid 44-51.

23 *Alderson v Temple* (1768) 4 Burr 2235, 2239-40; 96 ER 384, 385-6 (*Alderson*).

24 Anthony Kronman, 'The Treatment of Security Interests in After Acquired Property Under the Proposed Bankruptcy Act' (1975) 124 *University of Pennsylvania Law Review* 110, 111, n 4; John Farrar, 'The Bankruptcy of the Law of Fraudulent Preference' [1983] *Journal of Business Law* 390, 391 in relation to the body of preference law that grew up as a gloss on the law of fraudulent conveyances.

25 *Alderson* (1768) 96 ER 384, 385-6 where Lord Mansfield laid down a clear set of principles.

26 Royston Goode, *The Principles of Corporate Insolvency Law* (1990) 163 has argued that this term is a misnomer.

27 *Alderson* (1768) 96 ER 384, 385.

28 Ibid.

After the government had legislated in 1869 to allow for the avoidance of preferences in bankruptcy, companies legislation specifically incorporated the provisions dealing with preferences.[29]

As far as the avoidance provisions were concerned, the Australian colonies incorporated the bankruptcy provisions by reference, just like their English equivalent. This continued to be the case after Federation with respect to all states and this practice carried over to the 'national' Corporations Law in 1991. The only substantial difference from the English position was that in England fraud had to be proved on the part of the debtor if the liquidator was to successfully set aside a transaction as a preference. Australia had adopted in its Bankruptcy Act 1924 (Cth) the concept of an undue preference where no fraudulent intent on the part of the debtor had to be proved by the liquidator.[30]

The avoidance of this type of transaction is designed, ostensibly, to prevent a creditor jumping to the front of the queue of the general unsecured creditors (all of whom should be paid equally), and to ensure that 'an undignified scramble by creditors over available assets'[31] is avoided. This undignified scramble usually occurs, according to Cox J in *Re Feldmanis Finance Pty Ltd (in liq)*,[32] because creditors fear the imminent liquidation of their debtor and they wish to improve their position.

It is trite law that the essence of a preference is that a creditor has received more from a company before it goes into liquidation than it would have otherwise received in a liquidation. The true test of a preference was indicated in *Robertson v Grigg* where it was said to be — does the transaction confer a priority or advantage on a creditor in relation to past indebtedness of the company and is the advantage given at the expense of other creditors who are owed debts at the time of transaction?[33]

When a preference is given by a debtor company, whether motivated by kindness, a sense of duty or some fraudulent intent, the company is, in effect 'robbing Peter to pay Paul';[34] the recipient of the preference obtains an advantage over other creditors in that the preferred creditor is receiving his or her debt (or part thereof) before the other creditors. In many cases he or she receives full payment while the members of the general body of creditors receive nothing or a small portion of their debts.

If a preference is given by the company before the commencement of its winding up, the liquidator will demand that the creditor who received the preference disgorge in favour of the liquidator. The money or property returned

29 Goode, above n 26, 3.

30 England has now altered its position by omitting any reference to 'fraud' in the preference provision (s 239) in its Insolvency Act 1986 (Eng).

31 O'Donovan, 'Corporate Insolvency: Policies, Perspectives and Reform' above n 8, 11-2; This also appears to be the case in the United States: see Lissa Broome, 'Payments on Long Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendments' [1987] *Duke Law Journal* 78, 82.

32 (1983) 1 ACLC 823, 830.

33 (1932) 47 CLR 257, 271.

34 Farrar, 'The Bankruptcy of the Law of Fraudulent Preference', above n 24.

to the liquidator will, ultimately, be distributed among the general body of creditors.

Hence, the law of liquidation provides procedures which are collective in nature,[35] 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 a different degree.[36] The preference reflects this principle as it allows for recovery from single creditors in order to benefit the whole group of creditors and thus there is a *pari passu* distribution of the company's property.

Besides helping to ensure an equal distribution among creditors, the law of preferences is, sometimes, said to be designed to deter a race between creditors to obtain satisfaction before the company falls into liquidation.

> Deterring parties who do see the collective proceeding on the horizon from racing to grab the debtor's assets theoretically will help the debtor stay in business and thereby increase the asset pool available for all creditors as a group.[37]

Until recently, the legislature did not provide in corporations legislation for any section which dealt with preferences. The corporations legislation simply engrafted the relevant provision from either the Bankruptcy Act 1924 (Cth) or the Bankruptcy Act 1966 (Cth). The scheme was that s 565 of the Corporations Law (and its legislative forebears[38]) assimilated, as far as possible, the law governing certain transactions entered into by companies before their liquidation with that governing individuals.[39] Sub-section 565(1) stated (prior to the enactment of the Corporate Law Reform Act 1992 (Cth)):

> A settlement, a conveyance or transfer of property, a charge on property, a payment made, or an obligation incurred, by a company that, if it had been made or incurred by a natural person, would, in the event of his or her becoming a bankrupt, be void as against the trustee in the bankruptcy, is, in the event of the company being wound up, void as against the liquidator.

Simply put, the corporations legislation incorporated, unmodified, the provisions of the bankruptcy law by reference.[40] Preferences as dealt with in s 122 of the Bankruptcy Act 1966 (Cth) were regarded as being incorporated into company law by s 565 and as a consequence the case law which has applied to preferences in bankrupt estates has been used in cases involving preference claims made by liquidators and *vice versa*.

The fact that the scheme provided for in s 565 was employed is understandable. The process of liquidation has its origins in bankruptcy. The law of liquidation arose from the application of bankruptcy laws to the corporate

[35] Fletcher, above n 5, 2; Cork Report, above n 6, paras 224-7, 232; *Re Lines Bros Ltd* [1983] 1 Ch 1, 20.

[36] Cork Report, above n 6, para 232.

[37] Charles Tabb, 'Rethinking Preferences' (1992) 43 *South Carolina Law Review* 981, 990.

[38] See, eg, Companies Act 1981 (Cth) s 451.

[39] McPherson, above n 1, 312.

[40] This process essentially imitated the system which was extant in England. See, eg, Companies Act 1948 (UK) s 317.

bodies which emerged in the nineteenth century[41] and which were the forebears of the limited liability company. Even today there remains a substantial overlap between bankruptcy and liquidation, as manifested by what Taylor, Ferrier and Hodgson say about the relationship between bankruptcy and liquidation:

> [T]he historical and functional connection between bankruptcy and liquidation is perpetuated in the similarity of many features of both bankruptcy legislation and corporations (including winding up) legislation and in a number of cases by the direct applicability of bankruptcy legislation to winding up.[42]

Despite the historical closeness there has been a tendency to greater divergence in recent years. This is particularly evident in the terms of the Corporate Law Reform Act 1992 (Cth).[43] *Inter alia*, this legislation introduced a completely new regime for regulating the avoidance of certain transactions entered into by companies prior to their liquidation. This regime is contained in Division 2 of Part 5.7B.

Preferences which can be set aside may occur where a company, shortly before liquidation:

- pays the past debts owed to related parties,[44] for example directors and their associates;
- pays a creditor in respect of past indebtedness to ensure the continuation of its business,[45] that is, the creditor refuses to supply any more goods unless past debts are satisfied;
- pays a bank or other entity to whom one or all of the directors or other related parties of the company have personally guaranteed the company's debts where the payment by the company is to reduce or totally satisfy the company's liability;[46]
- pays a sum to a creditor because the creditor has exerted some form of pressure over the company in order to obtain payment,[47] for example the serving of a statutory notice of demand under s 459E of the Corporations Law or one of its legislative forebears.[48]

In all of the above, which are merely instances where payments may be regarded as preferences, the company intends to prefer the creditor. This is not always the case. Often companies in financial difficulty, particularly where their books and records are poorly kept or where there is a lack of competent management, may pay creditors haphazardly and creditors are inadvertently

41 Taylor, Ferrier and Hodgson, above n 3, para 1-160, 2,583.

42 Ibid para 1-100, 2,553.

43 The Act was passed on 17 December 1992 and received the royal assent on 24 December 1992. Division 2 of Part 5.7B did not come into operation until 23 June 1993.

44 See, eg, *Re Clasper Group Services Ltd* [1988] BCC 673.

45 See, eg, *Re Toowong Trading Pty Ltd (in liq)* [1989] 1 Qd R 207; *Telecom Australia v Russell Kumar and Sons Pty Ltd (receivers and managers appointed) (in liq)* (1993) 10 ACSR 24.

46 See, eg, *Kyra Nominees Pty Ltd (in liq) v National Australia Bank Ltd* (1986) 4 ACLC 400; *Taylor v ANZ Banking Group Ltd* (1988) 6 ACLC 808.

47 See, eg, *Re Lee Furniture Pty Ltd (in liq)* (1983) 77 FLR 164; *Re Norfolk Plumbing Supplies Pty Ltd* (1992) 10 ACLC 158; *Re Buckleys Earthmoving Pty Ltd (No 2)* (1993) 11 ACLC 363.

48 See, eg, *Re K and R Fabrications (Qld) Pty Ltd (in liq)* [1982] Qd R 585.

granted preferences.

If a transaction is a preference under the relevant legislation it is voidable, which means that, unlike transactions which are void, it is valid until attacked.

III The Unfair Preference: Its Place in the New Regime

Having established the long lineage of preferences and their general character and role, it is appropriate to turn to the new concept of the unfair preference. Division 2 of Part 5.7B encompasses a number of transactions which are potentially voidable by the liquidator. The unfair preference, defined in s 588FA, is but one of those transactions. This section of the article considers the place of the unfair preference in Division 2 of Part 5.7B.

While borrowing aspects of concepts previously employed in the Bankruptcy Act 1966 (Cth) and incorporated into the Corporations Law, such as 'preference', Division 2 of Part 5.7B essentially introduces a completely new regime which includes fresh concepts, for example the unfair loan,[49] and which represents a form of avoidance code in relation to certain types of pre-liquidation transactions. Unlike the previous scheme of avoidance, which required reference to other legislation, the new scheme is contained wholly within the Corporations Law.

It is not within the scope of this article to examine the impact of Division 2 of Part 5.7B in detail. Suffice it to say that, in effect, the avoidance provisions reflect the acknowledgment by the Harmer Report that insolvency law has adopted for many years the policy of avoiding transactions by which an insolvent company disposed of property within a certain time zone prior to the commencement of a formal insolvency administration, in circumstances where the dispositions are unfair to the general body of unsecured creditors.[50]

Division 2 specifies the transactions which are capable of being avoided by a liquidator, in which circumstances, and fixes the time zones within which the transactions must have been effected if they are to be set aside.[51]

As Division 2 is concerned with which transactions are voidable it is submitted that the starting point, in examining the Division, is s 588FE. This section defines, in broad terms, which transactions can be set aside.

Section 588FE provides that two classes of transactions are voidable. Firstly, insolvent transactions which meet certain other criteria and occur within specified time periods;[52] and secondly, unfair loans.[53] Importantly, for the purposes of this article, s 588FE(2) provides that a transaction is voidable if:

> (a) it is an insolvent transaction of the company; and
> (b) it was entered into, or an act was done for the purpose of giving effect to it:

[49] Section 588FD.

[50] Harmer Report, above n 8, para 629.

[51] See Zolly Singer, 'Invalidation of Antecedent Transactions Under The Corporate Law Reform Act 1992' (1994) 2 *Insolvency Law Journal* 36.

[52] Sections 588FE(2)-(5).

[53] Section 588FE(6). 'Unfair loans' are defined in s 588FD.

(i) during the 6 months ending on the relation-back day; or
(ii) after that day but on or before the day when the winding up began.

Section 588FC articulates the meaning of 'insolvent transactions'. The section is a drafting device[54] designed to act as a stepping stone between the broad definition of voidable transactions in s 588FE and the specific instances of voidable transactions elsewhere in Division 2. There are three classes of insolvent transaction, one of which is an unfair preference.[55] An unfair preference is regarded as an insolvent transaction only if it was effected when the debtor company was insolvent or where it became insolvent as a consequence of such a transaction.

It needs to be added that Division 2 does more than articulate the meaning of 'voidable transaction' and set out instances of such a transaction. The Division provides a system for dealing with all aspects of voidable transactions, such as stating which transactions are protected[56] and which orders can be made by a court where a voidable transaction has been entered into.[57]

IV THE RATIONALE FOR THE CHANGE FROM UNDUE TO UNFAIR PREFERENCES.

While, in many ways, the provisions contained in Division 2 of Part 5.7B are closely related to those which they have replaced, Division 2 represents somewhat of a radical departure from the previous state of affairs where, as discussed earlier, the avoidance provisions contained in the Bankruptcy Act 1966 (Cth) were incorporated into the Corporations Law by reference. In order to achieve one of its prime aims of providing separate provisions regulating antecedent transactions in bankruptcy and companies legislation,[58] the legislature could have introduced Division 2 by merely reproducing s 122 of the Bankruptcy Act as the new s 588FA. However, it chose not to do that. Rather, it revamped the provisions dealing with, and related to, preferences and gave them a new description. Why did the legislature do so?

It is clear that the legislature, in introducing Division 2, was seeking to provide a set of provisions which are peculiar to companies. While the major purposes and broad mechanisms of bankruptcy and winding up are very similar, it is submitted that the legislature has come to recognise the fact that the law governing the liquidation of companies has been developing along its own unique lines for some years.[59] This is manifested by the fact that bankruptcy and winding up as forms of administration have different procedural rules and until

54 Explanatory Memorandum to the Corporate Law Reform Bill 1992, para 1046.
55 Others are uncommercial transactions (s 588FB) and fraudulent transactions (s 588FE(5)).
56 Section 588FG.
57 Section 588FF.
58 Explanatory Memorandum, above n 54, para 1033.
59 Fletcher, above n 5, 10.

recently different courts have overseen their respective administrations.[60]

At times s 565 and its predecessors, together with the bankruptcy provisions, failed to provide workable and certain situations for liquidators. For example, s 120 of the Bankruptcy Act 1966 (Cth), which provides for the avoidance of certain types of settlements, is totally unsuited to corporations, and for years there was substantial uncertainty as to whether the section applied to corporations.

Accepting all of this, why did the legislature feel that it was necessary to introduce a totally fresh form of preference?

It is submitted that the reason was that the legislature used the revamping of the avoidance provisions to overcome the many problems of interpretation and application which had arisen over the years in relation to undue preferences under s 122 of the Bankruptcy Act 1966 (Cth).[61]

V THE CHANGES TO THE PREFERENCE PROVISIONS

For a liquidator to be able to avoid a transaction as an undue preference it was incumbent on him or her to establish the five conditions prescribed in s 122(1). They are:

- that the transaction was within one of the classes mentioned in s 122(1), for example conveyance, payment, etc;
- that at the time of the transaction the company was insolvent, that is, unable to pay its debts as they became due from its own money;
- that the one favoured by the transaction was a creditor of the company;
- that the effect of the transaction was to give the creditor, who was a party to the transaction, a preference over the other creditors; and
- that the transaction occurred within the six months immediately preceding the commencement of the winding up (usually the filing of an application to wind up the company).[62]

It is submitted that, with minor exceptions, a liquidator is still obliged, under the new preference provisions, to prove these conditions.

If a liquidator was able to establish *all* of the above conditions, the defendant creditor may have been able to avail himself or herself of protective provisions in s 122(2). A creditor would not be required to disgorge an alleged preference if he or she was able to prove that the benefit of the transaction under attack was taken:

[60] Historically, while the State Supreme Courts have had the power to hear bankruptcy cases, these matters have, for the most part, been left to special bankruptcy courts, eg Federal Court of Bankruptcy. The State Supreme Courts have judicially administered liquidation matters. In recent years bankruptcy has been, generally, the domain of the Federal Court of Australia. Ironically, now that there is greater divergence between bankruptcy and liquidation law, the Federal Court is hearing an increasing number of liquidation cases because it is granted jurisdiction by the Corporations Law (see the definition of 'Court' in s 9).

[61] It is probably fair to say that this comment could be applied equally to both voidable settlements and fraudulent dispositions under s 120 and s 121 of the Bankruptcy Act 1966 (Cth) respectively.

[62] McPherson, above n 1, 314-20; Arndell Lewis, *Australian Bankruptcy Law* (9th ed, 1990) 164-71; Andrew Keay, *Bankruptcy Proceedings Handbook* (2nd ed, 1992) 111-5. The conditions are very similar to those prevailing in the United States: see Bankruptcy Reform Act 1978 (US) s 547(b).

- in good faith;
- for valuable consideration; and
- in the ordinary course of business.[63]

A *Insolvency of the Debtor*

It is generally accepted that the most arduous of the five conditions which a liquidator had to establish in proving an undue preference was that the company gave the alleged preference when it was insolvent.[64] The determination of whether a company was insolvent could not be based solely on an investigation of a balance sheet,[65] that is demonstrating that the assets were outweighed by the liabilities, although there is authority for the proposition that a reconstructed balance sheet could be admitted into evidence and taken into account.[66]

The definitive statement concerning the meaning of insolvency was given by Barwick CJ in *Sandell v Porter*:

> An essential step in making out that a payment is a preference within s 95 [the predecessor of s 122] is to establish by evidence to the satisfaction of the court that the payer was at the time of the payment insolvent. Insolvency is expressed in s 95 as an inability to pay debts as they fall due out of the debtor's own money. But the debtor's own moneys are not limited to his cash resources immediately available. They extend to moneys which he can procure by realisation by sale or by mortgage or pledge of his assets within a relatively short time — relative to the nature and amount of the debts and to the circumstances, including the nature of the business, of the debtor. The conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity. It is the debtor's inability utilising such cash resources as he has or can command through the use of his assets to meet his debts as they fall due which indicates insolvency. Whether that state of his affairs has arrived is a question for the court and not one as to which expert evidence may be given in terms though no doubt experts may speak as to the likelihood of any of the debtor's assets or capacities yielding ready cash in sufficient time to meet the debts as they fall due.[67]

'Insolvency' has now been defined in s 95A of the Corporations Law as meaning, in effect, being unable to pay debts as they become due and payable.[68] The definition is very brief and the principles developed in cases such as *Sandell v Porter* will need to be referred to in order to apply the definition

[63] McPherson, above n 1, 320-5; Lewis, above n 62, 172-9; Keay, above n 62, 111, 116-8.

[64] David Purcell, 'Banks and the Recovery of Voidable Preferences' (1990) 2 *Bond Law Review* 107, 111; See, eg, *M and R Jones Shopfitting Co Pty Ltd (in liq) v National Bank of Australasia Ltd* (1983) 68 FLR 282.

[65] *Calzaturificio Zenith Pty Ltd v NSW Leather and Trading Co Pty Ltd* [1970] VR 605, 609. In *Sheahan v Vogt* (Supreme Court of South Australia, Justice Bowen Pain, 7 May 1993) the Court stated that the proof of insolvency must entail more than the mere mechanical examination of financial statements.

[66] *Re Action Waste Collections Pty Ltd (in liq)* [1981] VR 691.

[67] (1966) 115 CLR 666, 670-1.

[68] This is similar to the definition of s 123(1)(e) of the Insolvency Act 1986 (UK), but unlike the US definition where the balance sheet test is employed: Bankruptcy Reform Act 1978 (US) s 101(32)(A).

effectively.[69] The test in s 95A is, in essence, a cash flow insolvency test. The legislature has recognised the difficulties encountered by the liquidator. The Explanatory Memorandum to the Corporate Law Reform Bill 1992 (Cth) noted that a liquidator:

> being a stranger to the past business operations of a company, is often confronted with considerable difficulty in affirmatively establishing that a company was insolvent at a time prior to the winding up, even though there may be every indication that this was the case.[70]

The Corporations Law, as a result of the Corporate Law Reform Act 1992 (Cth), now includes presumptions of insolvency, that is the company being liquidated will be presumed to have been insolvent at a particular time before liquidation if certain circumstances existed. There are a number of presumptions. They are contained in s 588E(3), (4), (7) and (8). The presumptions apply to 'recovery proceedings'[71] which is a term defined in s 588E(1) and includes an application made by the liquidator to the court pursuant to s 588FF in which an order is sought in relation to a voidable transaction.

The presumptions on which a liquidator in an unfair preference action can rely, are:

- if a company is proved to be insolvent, or it is presumed to be insolvent because it either breached s 289(1) by failing to keep adequate accounting records or it was proved to be insolvent in another recovery proceeding at a point of time within the 12 months immediately preceding the relation-back day (normally this would be the day on which the application to wind up was filed[72]), then the company is presumed to be insolvent from that point of time until the relation-back day;[73]
- if a company has breached s 289(1) by failing to keep adequate accounting records or it has breached s 289(2) by failing to retain such records for a period of seven years, it is presumed to be insolvent for the period to which the inadequacy or absence of the records relates;[74]
- if a company has been proved to be insolvent in other recovery proceedings it is presumed to be insolvent.[75]

Importantly, the second of these presumptions can only be employed in an unfair preference action if the creditor who received the alleged preference is a

[69] See Andrew Keay, *Insolvency: Personal and Corporate Law and Practice* (1993) 2-5 for the general principles applicable.

[70] Explanatory Memorandum, above n 54, para 1020.

[71] Section 588E(2).

[72] The relation-back day is defined in s 9. In relation to a winding up of a company it means:

> (a) if, because of Division 1A of Part 5.6, the winding up is taken to have begun on the day when an order that the company or body be wound up was made — the day on which the application for the order was filed; or
>
> (b) otherwise — the day on which the winding up is taken because of Division 1A of Part 5.6 to have begun.

[73] Section 588E(3).

[74] Section 588E(4).

[75] Section 588E(8).

related entity of the company.[76] Any of the presumptions can be rebutted if the contrary is proved.[77]

It is submitted that the presumptions do not advance the position of the liquidator very far. For the most part liquidators will still be required to prove insolvency. The legislature's expression of understanding the plight of the liquidator appears to be hollow. There is no real assistance to help the liquidator overcome the great disadvantage he or she experiences in coming fresh to a company, whose affairs have usually been poorly administered, where books and records may well be totally inadequate or non-existent.[78]

It is respectfully contended that the recommendation of the Harmer Report, which advocated the introduction of a rebuttable presumption that the company was insolvent during the 90 day period immediately preceding what is now referred to as the relation-back day,[79] has much to commend it. Interestingly, according to the Report there was no criticism of this approach in submissions made to the Commission.[80] If the legislature had incorporated the Harmer recommendation creditors would have had both the right to rebut the presumption by proving solvency and the right to rely on the protective provisions in s 588FG.

The legislature did not implement this recommendation, on the basis that the potential benefit which it offered did not 'justify the element of retrospective liability which it involves.'[81]

Admittedly, the establishment of a 90 day set period is arbitrary but it is difficult to envisage any other method of relieving the substantial burden which is imposed on liquidators; the presumptions in s 588E do not appear capable of assisting liquidators in all but a few cases. The United States of America has wrestled with this issue and determined that it is necessary to establish a set period before liquidation during which the insolvent is presumed to be insolvent.[82]

B *Running Accounts*

To establish an undue preference (and, in fact, an unfair preference) a liquidator had to prove that the transaction had the effect of giving to the creditor an advantage, that is the creditor received more than he or she would receive in a winding up. The concern was that the creditor was the subject of favourable discrimination, *vis-a-vis* the other creditors.

It is difficult to determine whether there has been an advantage bestowed on a

[76] Section 588E(7).

[77] Section 588E(9).

[78] See Wilson Wilde, 'Preference Actions — The Practical Problems of Trying to Prove', unpublished paper delivered at an Insolvency Seminar conducted by the Queensland Law Society and the Institute of Chartered Accountants of Australia in Brisbane, 27 October 1989.

[79] Harmer Report, above n 8, para 635.

[80] Ibid para 640.

[81] Explanatory Memorandum, above n 54, para 1019.

[82] Bankruptcy Reform Act 1978 (US) s 547(f) and see *In re Bennet* 35 BR 357 (1984); *In re World Financial Services Center Inc* 78 BR 239 (1987).

creditor where there are running accounts between the company and the creditor,[83] for example, a supplier of goods on credit to a company where the price of the goods and payments received are recorded on a running account statement. In such a situation moneys are paid on account by the debtor company without differentiating between past and future goods supplied. If preference provisions were strictly applied, all such payments would be preferences. This is generally recognised as being too harsh a result. Accordingly, the courts have developed a running account principle to alleviate the impact on creditors involved in such transactions.[84] The result was that:

> where a payment forms an integral and inseparable part of an entire transaction then the whole of the transaction must be looked at to determine whether the creditor has gained an advantage or has been preferred.[85]

The legislature has taken the opportunity of incorporating this principle in s 588FA.[86]

C *The Protective Provisions*

If a liquidator succeeded in establishing the elements of an undue preference pursuant to s 122(1) of the Bankruptcy Act 1966 (Cth) a creditor was always entitled to avail himself or herself of the protective provisions in s 122(2). In effect, if a creditor could prove that he or she received the alleged preference in good faith and for valuable consideration and in the ordinary course of business, he or she would be permitted to retain the benefit of the transaction.

While it was felt that these protective provisions were warranted in order to prevent what could be harsh and unjustified consequences for some creditors who were unaware of the debtor company's insolvency,[87] the interpretation and application of the criteria which had to be proved by the creditor caused multifarious problems, especially in relation to the 'in the ordinary course of business' element.

As a consequence the legislature has amended the criteria for obtaining protection. Section 588FG sets out what must be proved by the person seeking to resist a liquidator's attack. The section distinguishes between the case on the one hand, where a person other than the creditor who received the benefit of the preference is being challenged (s 588FG(1)), and on the other, where a person who was a party to the transaction which is being impugned as a preference is involved (s 588FG(2)). In the former case the person is protected if it is proved that:

[83] This often occurs where there is a banker/customer relationship. See Purcell, above n 64, 110.

[84] See, eg, *Richardson v Commercial Banking Co of Sydney Ltd* (1952) 85 CLR 110; *Queensland Bacon Pty Ltd v Rees* (1967) 115 CLR 266; *Petagna Nominees Pty Ltd v Ledger* (1989) 1 ACSR 547.

[85] Purcell, above n 64, 110.

[86] See section 588FA(2). The Explanatory Memorandum to the Corporate Law Reform Bill 1992, para 1042, makes it plain that the sub-section is aimed at embodying in the legislation the principles enunciated in the cases.

[87] McPherson, above n 1, 320.

(a) the person received no benefit because of the transaction; or
(b) in relation to each benefit that the person received because of the transaction:
  (i) the person received the benefit in good faith; and
  (ii) at the time when the person received the benefit:
    (A) the person had no reasonable grounds for suspecting that the company was insolvent at that time or would become insolvent as mentioned in paragraph 588FC(b); and
    (B) a reasonable person in the person's circumstances would have had no such grounds for so suspecting.[88]

This provision is designed to safeguard innocent parties who received a benefit as a result of the preference.[89]

In the latter case the person is protected if it is proved that:

(a) the person became a party to the transaction in good faith; and
(b) at the time when the person became such a party:
  (i) the person had no reasonable grounds for suspecting that the company was insolvent at that time or would become insolvent as mentioned in paragraph 588FC(b); and
  (ii) a reasonable person in the person's circumstances would have had no such grounds for so suspecting; and
(c) the person has provided valuable consideration under the transaction or has changed his, her or its position in reliance on the transaction.

Focusing on s 588FG(2), which will probably be subject to greater use than s 588FG(1), we can see that there are three elements which must be established on behalf of the creditor: good faith, no suspicion of insolvency and either valuable consideration or change in position.

1 *In the ordinary course of business*

It will be noted that s 588FG contains no reference to 'in the ordinary course of business'. This factor has been deleted because it has been the subject, in the past, of judicial uncertainty as to its interpretation.[90] It has been said by one practitioner that the courts are 'somewhat confused as to what is or is not the ordinary course of business.'[91] In *Taylor v White*,[92] Menzies J in the High Court examined the authorities and came to the conclusion that all the views given were not to the same effect. Bright, before his elevation to the Supreme Court of South Australia bench, indicated as far back as 1961 that it was impossible to come up with a stereotyped definition of the phrase.[93] McPherson has criticised

[88] Unlike the situation which applies to persons who are parties to the transaction, persons who are not parties are not required to prove valuable consideration.

[89] Ronald Harmer, 'Avoidance of Antecedent Transactions in Corporate Insolvency Law: an autopsy of the past and an anatomy of the future', an unpublished paper presented at the Corporate Insolvency Law Conference at the University of Melbourne on 31 October 1992.

[90] Explanatory Memorandum, above n 54, para 1061.

[91] Wilde, above n 78.

[92] (1964) 110 CLR 129, 160. Sweeney J in *Re Hoare* [1972] ALR 1134, 1137 stated that this may have been because of the variation in the facts in each case.

[93] Charles Bright, 'The Ordinary Course of Business' (1961) 1 *Adelaide Law Review* 138, 142. This view, in effect, was expressed more recently by Kennedy J in *Katoa Pty Ltd v Dartnall* (1983) 74 FLR 202, 205.

the test established for determining what is 'in the ordinary course of business' as not affording 'a satisfactory standard by which to judge the majority of transactions.'[94] In the recent case of *Telecom Australia v Russell Kumar and Sons Pty Ltd (receivers and managers appointed)(in liq)*,[95] O'Bryan J was a little more circumspect and merely referred to the law concerning the phrase as constituting a vexed area of the law.[96]

The definitive 'statements' of the meaning of the phrase are usually taken to be those given by Rich J in *Downs Distributing Co Pty Ltd v Associated Blue Star Stores Pty Ltd (in liq)*:

> The provision does not require that the transaction shall be in the course of any particular trade, vocation or business. It speaks of the course of business in general. But it does suppose that according to the ordinary and common flow of transactions in affairs of business there is a course, an ordinary course. It means that the transaction must fall into place as part of the undistinguished common flow of business done, that it should form part of the ordinary course of business as carried on, calling for no remark and arising out of no special or particular situation.[97]

and by Williams J in the same case:

> It seems to me, therefore, that the expression refers to a transaction into which it would be usual for a creditor and debtor to enter as a matter of business in the circumstances of the particular case uninfluenced by any belief on the part of the creditor that the debtor might be insolvent.[98]

It is clear, in principle, that the court was not required to examine what is in the ordinary course of a particular business or trade,[99] but rather it was obliged to consider what was in the ordinary course of business generally.[100] This might be easy to state but it has proven difficult to apply.

It is not intended to embark on an exposition of the law which has developed in relation to the phrase. Suffice it to say that, the phrase has caused difficulties and these were exacerbated by cases in more recent times where some judges held that the intention of the debtor at the time of the giving of the preference had to be taken into account,[101] while other judges required examination of the

[94] McPherson, above n 1, 324.

[95] (1993) 10 ACSR 24.

[96] Ibid 28.

[97] (1948) 76 CLR 463, 477.

[98] Ibid 480.

[99] *Robertson v Grigg* (1932) 47 CLR 257, 267; *Burns v McFarlane* (1940) 64 CLR 108, 125. In the USA what is 'ordinary' is determined by an examination of the parties' prior dealings: see *In re Magic Circle Energy Corp* 64 Bankr 269 (1986), 273. The uncertainty of the phrase's meaning in Australia is manifested by the recent decision in *Casey Interiors Pty Ltd (in liq) v Specialised Roofing Systems Pty Ltd* (Supreme Court of South Australia, Justice Anderson, 15 October 1993) where it was said that the fact that the payments were not unusual in the industry in which the parties were involved meant that they were made 'in the ordinary course of business'. This does not appear to accord with the comments made in other decisions.

[100] *Downs Distributing Co Pty Ltd v Associated Blue Star Stores Ltd* (1948) 76 CLR 463.

[101] See, eg, *Taylor v White* (1964) 110 CLR 129 (Taylor J); *Kyra Nominees Pty Ltd (in liq) v National Australia Bank Ltd* (1986) 4 ACLC 400. See the criticism of the view in James O'Donovan, 'The Kyra Nominees Case: A Chill from the Overdraft' (1987) 5 *Company and Securities Law Journal* 50 and the Harmer Report, above n 8, para 646.

creditor's motive in receiving the preference in addition to the debtor's.[102] It is submitted that the employment of criteria involving motives merely serves to accentuate the uncertainty of a situation and this is borne out by the uncertainty which is evident in some recent decisions. Whether or not the phrase 'in the ordinary course of business' should have been deleted will be discussed later under the heading 'The Unfair Preference : An Evaluation'.

2 *In good faith and no suspicion of insolvency*

The element of good faith which is found in s 122 of the Bankruptcy Act 1966 (Cth) is retained by s 588FG(1)(b)(i) and s 588FG(2)(a). However, the legislature has decided not to include an equivalent of s 122(4)(c).

'Good faith' in the insolvency field connotes honesty and propriety in the sense that there is absent, on the part of the creditor, any knowledge that a preference has been given,[103] that is to act in good faith the creditor must have believed in his or her own mind that there was no need to question the payment or other disposition.[104]

Under s 122 of the Bankruptcy Act 1966 (Cth) there is a need for a subjective appraisal of the state of mind of the creditor at the time that the transaction was effected.[105] However, even if a creditor could establish that he or she acted in subjective good faith, s 122(4)(c) provides that such good faith is negated if the circumstances surrounding the transaction are such as to lead to the inference that the creditor knew, or had reason to suspect, that the debtor was unable to pay its debts as they became due and that the effect of the transaction was to give him a preference or priority over other creditors.

The creditor had the burden of establishing his or her good faith subjectively, and if he or she could do so, the liquidator had the onus of establishing that the circumstances dictated that the inference in s 122(4)(c) should apply.[106] This was well explained by Latham CJ in *Downs Distributing Co Pty Ltd v Associated Blue Star Stores Ltd*:

> [A] transaction falls within sub-s (4)[(c)], so that a creditor is excluded from the category of a creditor dealing in good faith under sub-s (2)[(a)], if, whatever the creditor may think or believe with respect to the circumstances of the transaction, those circumstances are such as to lead to an inference by the court that there was reason to suspect according to the standards of an ordinary reasonable man [sic] that the debtor was unable to pay his debts as they became due, and that the effect of the transaction would be to give the creditor a preference over

[102] See, eg, *Taylor v White* (1964) 110 CLR 129, 159-60 (Menzies J), 161 (Windeyer J); *Taylor v ANZ Banking Group Ltd* (1988) 6 ACLC 808.

[103] *Re Macadam* (1913) 13 SR (NSW) 206, 207-8.

[104] Ibid.

[105] *Re Chisum Services Pty Ltd* (1982) 1 ACLC 292; *Spedley Securities Ltd (in liq) v Western United Ltd (in liq)* (1992) 27 NSWLR 111.

[106] *Queensland Bacon v Rees* (1967) 115 CLR 266, 287-8; *Taylor v ANZ Banking Corporation Ltd* (1988) 6 ACLC 808; *Spedley Securities Ltd (in liq) v Western United Ltd (in liq)* (1992) 27 NSWLR 111; *Harkness v Commonwealth Bank of Australia Ltd* (1993) 12 ACSR 165, 167; Cf *Re Bird; Ex parte M and G Casabene and Sons* (1979) 39 FLR 281.

other creditors.[107]

Section 588FG does not include a provision identical to s 122(4)(c), although it does add a criterion which qualifies the subjectivity of 'good faith'. According to s 588FG(2)(b) a creditor is required to prove, in addition to good faith, that at the time he or she became a party to the transaction being impugned, he or she had no reasonable grounds for suspecting that the debtor company was insolvent or would become insolvent as a result of the transaction, and a reasonable person in the creditor's circumstances would have had no such grounds for so suspecting.

Importantly, this provision means that the subjective intention of the creditor is not all important, just as it is not under s 122 of the Bankruptcy Act 1966 (Cth). In addition, unlike the situation which prevailed pursuant to s 122(4)(c) where the liquidator was required to establish the existence of circumstances which may have led to the inference that the creditor knew or had reason to suspect that the debtor was insolvent and the effect of the transaction was to give him or her a preference, the liquidator is not, under s 588FG, subject to such an onus.

The onus is patently on the creditor to establish, on the basis of an objective test, that there was no reason to suspect insolvency. This onus is added to the onus, which the creditor previously had under s 122, to prove that he or she subjectively acted in good faith.

The upshot of the introduction of s 588FG appears to be that, as with s 122, both subjective and objective tests apply. However, the major difference is that with s 588FG a greater burden is placed on the creditor. While there was authority, in the shape of *Re Bird; Ex parte Casabene and Sons*,[108] that a creditor not only had the burden of proving his or her subjective good faith but also disproving the existence of any circumstances which might cause s 122(4)(c) to apply in order to safeguard the transaction, the preponderance of authority[109] supported the view that the liquidator had the burden of establishing the circumstances which would be the catalyst for the operation of the inference in s 122(4)(c).

D *The Time Zone*

Unlike s 122 of the Bankruptcy Act 1966 (Cth), s 588FA does not include any reference to the period in which a transaction must fall to be regarded as an unfair preference. This is left to s 588FE which contains the time zones which are applicable to all voidable transactions.

Section 588FE(2) provides that the time zone in which transactions can be deemed to be preferences is that which is applied by s 122, *viz*, during the six

107 (1948) 76 CLR 463, 475.

108 (1979) 39 FLR 281.

109 See, eg, *Queensland Bacon Pty Ltd v Rees* (1967) 115 CLR 266, 287-8; *Taylor v ANZ Banking Corporation Ltd* (1988) 6 ACLC 808; *Spedley Securities Ltd (in liq) v Western United Ltd (in liq)* (1992) 27 NSWLR 111.

months preceding the relation-back day (equivalent to the date of the filing of the petition in bankruptcy) or between the relation-back day and the date of the commencement of the winding up (normally the date of the winding up order and equivalent to the date of bankruptcy).

Importantly, s 588FE(2) helps to resolve a problem which has existed for some time in relation to the interaction of preferences and s 468 of the Corporations Law. This latter section provides, *inter alia*, that dispositions of property of the company after the commencement of winding up[110] are void, unless the court otherwise orders. There has been uncertainty for some time in relation to compulsory liquidations[111] as to whether a liquidator could claim, under s 565 of the Corporations Law (incorporating s 122 of the Bankruptcy Act 1966 (Cth)), that transactions effected during the period from the time of the filing of the application to wind up until the date of the winding up order constituted undue preferences, or whether such transactions could only be avoided under s 468.

There have been two views expressed. The first, and the one which is the older of the two, states that s 565 can apply to dispositions made during the interim period, that is the period between the filing of the application to wind up and the winding up order.[112] The opposing view is that s 565 did not apply to transactions effected in the interim period; it only applied to the six month period prior to the date on which the application to wind up was filed.[113]

It is unnecessary to discuss the two views; this has been done elsewhere.[114] It is only necessary to note that the issue needed to be resolved and that this has now been done by the legislation. Sub-section 588FE(2) provides that a transaction entered into between the filing of a winding up application and the winding up order can constitute a preference. Furthermore, the new definition of 'commencement of winding up' introduced by the Corporate Law Reform Act 1992 (Cth)[115] provides that in a compulsory liquidation this is now (in most cases) taken to be the date of the winding up, and effectively means that s 468 has been emasculated because it now only applies to the period after the winding up order.

E *Related Entities*

The law as it applied to undue preferences made no distinction as to the

110 Prior to the enactment of the Corporate Law Reform Act 1992 (Cth) this was, in compulsory liquidations, the date of the filing of the winding up application.

111 The following discussion has no relevance to voluntary liquidations.

112 See *Re Omnico Ltd* (1976) 1 ACLR 381; *Re Gray's Inn Construction Co Ltd* [1980] 1 All ER 814; *Putnin v Energy Trucking Pty Ltd* (1990) 8 ACLC 485.

113 See *Tellsa Furniture Pty Ltd (in liq) v Glendave Nominees Pty Ltd* (1987) 9 NSWLR 254; *National Acceptance Corporation Ltd v Benson* (1988) 12 NSWLR 213; *Re Rampton Holdings Pty Ltd (in liq)* (1991) 9 ACLC 220; *Sheahan v Workers' Rehabilitation and Compensation Corporation* (1991) 58 SASR 119; *Hamilton v National Australia Bank Ltd* (1991) 9 ACLC 1065.

114 Anthony Derrick, 'Preference Payments and the Interim Period' (1992) 10 *Company and Securities Law Journal* 208.

115 Section 513A.

identity of the creditor — all creditors, save for those able to avail themselves of the protective provisions, were treated alike.

However, s 588FE(4) provides, *inter alia*, that a liquidator can avoid an unfair preference given to a related entity of the company in liquidation if it was given pursuant to a transaction which was entered into during the four years preceding the relation-back day.[116]

This provision appears to fulfil the legislature's expressed purpose in enacting Division 2 which is to ensure that unsecured creditors are not adversely affected by the disposition of assets or the incurring of liabilities by a company which would have the effect of favouring certain creditors and especially related entities.[117]

'Related entity' is defined in s 9 very broadly and means, in relation to a body corporate, any of the following:

> (a) a promoter of the body;
> (b) a relative, or *de facto* spouse, of such a promoter;
> (c) a relative of a spouse, or of a *de facto* spouse, of such a promoter;
> (d) a director or member of the body or of a related body corporate;
> (e) a relative, or *de facto* spouse, of such a director or member;
> (f) a relative or a spouse, or of a *de facto* spouse of such a director or member;
> (g) a body corporate that is related to the first-mentioned body [the body in liquidation];
> (h) a beneficiary under a trust of which the first-mentioned body is or has at any time been a trustee;
> (i) a relative, or *de facto* spouse, of such a beneficiary;
> (j) a relative or a spouse, or of a *de facto* spouse, of such a beneficiary;
> (k) a body corporate one of whose directors is also a director of the first-mentioned body;
> (l) a trustee of a trust under which a person is a beneficiary, where the person is a related entity of the first-mentioned body because of any other application or applications of this definition.

It is likely that the extension of the time zone is a recognition that those related entities, such as directors and persons associated with directors, may have had the foresight to see liquidation of the company as a distinct probability well in advance and before anyone else. Where such foresight exists it may be tempting for directors to take action or exert influence on the company in order to safeguard their own interests or the interests of associated entities; they may seek to recover loans and other debts owed to them before the company's final demise. Because of inside knowledge and influence, related entities may obtain satisfaction of the debts outside of the six month zone which generally applies to unfair preferences.[118] The affairs of the company may be so orchestrated that the company survives for six months after a preference is given to a related party so

[116] The Harmer Report, above n 8, para 643, in fact recommended two years.

[117] Explanatory Memorandum, above n 54, para 1035.

[118] The Harmer Report, above n 8, para 636, observed that experience has demonstrated that creditors who are related entities are more likely to be favoured by the insolvent company when it suffers financial difficulties.

that the benefit bestowed by the company on the related party is safe from attack.[119]

The Harmer Report recommended a shift of the onus which usually applies in preference claims. It recommended that a related person should be required to prove that the impugned transaction was made by the company, without knowledge on the part of the company that the transaction would be likely to produce the effect that the related person would be the recipient of more than other unsecured creditors.[120] This recommendation was in line with the Commission's view that a related person creditor should not be automatically regarded as a *bona fide* recipient of the benefit of a transaction which can be classified as a preference.[121]

This approach was not implemented by the legislature; apart from the difference in the time zone, related entities are treated in the same manner as other creditors. Perhaps the legislature was wary of introducing what would virtually be an 'intent to prefer' concept. Such a concept is somewhat reminiscent of the English fraudulent preference which was subject to extensive criticism over the years[122] and was amended in 1986 by the Insolvency Act 1986 (Eng).

It is respectfully submitted that it was prudent of the legislature not to introduce an 'intent to prefer' requirement because the inclusion of such a concept could have complicated, rather than simplified, the law of preferences. It is questionable whether it was necessary to provide for a four year time zone. The two year time zone recommended by the Harmer Report would seem to be adequate to prevent most abuses[123] and it is the time which is specified in England.[124]

VI THE UNFAIR PREFERENCE

The unfair preference, as defined in s 588FA, is, in essence, the same as the undue preference and most of the existing concepts of a preference are retained.[125] Section 588FA(1) and (1A) state:

> (1) A transaction is an unfair preference given by a company to a creditor of the company if, and only if:
> (a) the company and the creditor are parties to the transaction (even if someone else is also a party); and
> (b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the com-

[119] Ibid para 642. Where directors effect transactions on behalf of their company knowing that they are preferences and the transactions are subsequently held to be void, they are guilty of misfeasance: see *Re Yorke (Stationers) Pty Ltd* [1965] NSWR 446; *West Mercia Safetywear Ltd (in liq) v Dodd* [1988] BCLC 250.

[120] Harmer Report, above n 8, para 652.

[121] Ibid para 651.

[122] See, eg, Farrar, 'The Bankruptcy of the Law of Fraudulent Preference' above n 34.

[123] Harmer Report, above n 8, para 643.

[124] Insolvency Act 1986 (Eng) s 240(1)(a). The United States has a maximum time period of one year: Bankruptcy Reform Act 1978 (US) s 547(b)(4)(B).

[125] Harmer, above n 89.

pany in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company even if the transaction is entered into, is given effect to, or is required to be given effect to because of an order of an Australian court or a direction by an agency.

(1A) For the purposes of subsection (1), a secured debt is taken to be unsecured to the extent of so much of it (if any) as is not reflected in the value of the security.

Sub-section (2) merely provides, as we have seen earlier, that payments made in respect of running accounts are not to be regarded as unfair preferences.[126]

Section 588FA discloses that the unfair preference, like the undue preference, is dependent on a creditor receiving more from the company as a result of the pre-liquidation transaction than if the creditor proved in the winding up. The section is relatively brief and appears to provide a simpler test than s 122 of the Bankruptcy Act 1966 (Cth). However, when one considers s 588FA closely and in the context of Division 2 of Part 5.7B a liquidator, it is submitted, must establish the same conditions which he or she had to establish in relation to an undue preference.

First, the alleged preference must come within the definition of 'transaction'. This term is defined broadly in s 9.[127] The definition sets out a number of examples and does not purport to be exhaustive; notably it covers more types of transactions than those mentioned in s 122. The definition is based on a recommendation of the Harmer Report.[128]

Secondly, s 588FE provides that the transaction alleged to be a preference can only be set aside if it is capable of being characterised as an insolvent transaction pursuant to s 588FC. Thirdly, it must be established that the transaction

126 Section 588FA(2) states that where:

(a) a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor of the company (including such a relationship to which other persons are parties); and
(b) in the course of the relationship, the level of the company's net indebtedness to the creditor is increased and reduced from time to time as the result of a series of transactions forming part of the relationship;

then

(c) subsection (1) applies in relation to all the transactions forming part of the relationship as if they together constituted a single transaction; and
(d) the transaction referred to in paragraph (a) may only be taken to be an unfair preference given by the company to the creditor if, because of subsection (1) as applying because of paragraph (c) of this subsection, the single transaction referred to in the last-mentioned paragraph is taken to be such an unfair preference.

127 'Transaction' in Part 5.7B in relation to a body corporate or Part 5.7 body, means a transaction to which the body is a party, for example (but without limitation):

(a) a conveyance, transfer or other disposition by the body of property of the body; and
(b) a charge created by the body on property of the body; and
(ba) a guarantee given by the body; and
(c) a payment made by the body; and
(d) an obligation incurred by the body; and
(e) a release or waiver by the body; and
(f) a loan to the body;

and includes such a transaction that has been completed or given effect to, or that has terminated.

128 Explanatory Memorandum, above n 54, para 371; Harmer Report, above n 8, para 637 and also see s AT2(3)(c) in the Harmer Report.

occurred within a specific time zone. In effect, as with an undue preference, it will be incumbent on the liquidator to establish that the company was insolvent at the time of the giving of the alleged preference and that (usually) this occurred within the six months preceding the relation-back day.[129]

Fourthly, as mentioned above, it must be proved that the creditor received more than he or she would have in a winding up, that is an advantage or preference was received.

Section 588FA(1) overcomes any argument that a transaction is not able to be classified as a preference because it was entered into or was given effect to because of a court order.[130]

VII THE UNFAIR PREFERENCE — AN EVALUATION

A *In General*

In this section we will examine both the strengths and the shortcomings of the new legislation, primarily in light of the legal position as it existed with respect to undue preferences and also in light of some of the major problems which existed as a consequence of that position.

At the outset it must be said that it is incumbent on any fresh preference legislation, given the policy which applies to preferences, to achieve a workable compromise between commercial practice and a desire to do justice to all creditors where the debtor company's financial state is precarious.[131] Jackson and Kronman concur with this view.[132] They make the point that preference law involves a reconciliation of two basic and competing aims. They are, 'to protect the contractual arrangements fashioned by the bankrupt and his various creditors during the pre-bankruptcy period',[133] and, 'to minimize the inevitable social costs associated with bankruptcy by spreading its impact among all classes of creditors'.[134] The legislature has recognised the need to achieve this reconciliation.[135]

The legislature has maintained that Division 2 of Part 5.7B contains revised and simpler provisions regulating antecedent transactions.[136] With respect, that is arguable. While s 588FA is a provision which is simpler (and briefer) than s 122 of the Bankruptcy Act 1966 (Cth), one is not able to refer merely to s 588FA to understand unfair preferences. One is obliged to journey to a

[129] The time zone will be four years where the creditor is within the definition of 'related entity' (s 588FE(4)(c)).

[130] This was recommended by the Harmer Report, above n 8, para 653.

[131] Ontario, Ontario Law Reform Commission, *Report on the Enforcement of Judgment Debts and Related Matters*, Part IV, 226 and also see, M Springman, 'The BC Law Reform Commission's Report on Fraudulent Conveyances and Preferences' (1989) 15 *Canadian Business Law Journal* 180, 188.

[132] Thomas Jackson and Anthony Kronman, 'Voidable Preferences and Protection of the Expectation Interest' (1976) 60 *Minnesota Law Review* 971, 986.

[133] Ibid 987.

[134] Ibid 989.

[135] Explanatory Memorandum, above n 54, para 1034.

[136] Ibid para 27.

number of other sections of the Corporations Law[137] and some of those, such as s 588FE, do not give up their secrets readily. Once the intricate cross-referencing has been performed and one has digested the scheme of the legislation it may be possible to concur with the legislature and say that there is a simpler provision. However, even once this work has been done it is questionable whether the end product is simpler (and much better) than its predecessor.

As discussed earlier it would appear that a liquidator is required to establish the same elements which he or she was required to do when claiming an undue preference. Therefore, can it be said that the provision is easier to apply than its predecessor?

It is likely that the application of the unfair preference will not be much more extensive or much easier to establish than the undue preference. After asserting that, it must be admitted that there may be more simplicity and efficiency in three ways. Firstly, as the term 'transaction' is broad there may be fewer arguments as to whether the dealing between the company and the creditor can constitute the type of dealing which is subject to challenge;[138] a limited number of extra transactions which may not have been subject to s 122 of the Bankruptcy Act 1966 (Cth) may come within the scope of s 588FA. Secondly, in some cases a liquidator will find it easier to establish insolvency on the part of the company being wound up. However, the liquidator would not be granted 'the flying start'[139] which would be the effect of a provision which provided for an automatic presumption of insolvency in respect of the 90 days preceding the relation-back day. It is submitted that when compared with other preference elements, proof of insolvency has generally consumed a disproportionate amount of the liquidator's time and effort.[140] This is unsatisfactory.

Finally, where a creditor can be classified as a 'related entity' the liquidator will have a four year time zone with which to work, and it will open up claims in a few cases where no claim could previously have been mounted.

It is submitted that the onus on the liquidator has not been eased in any appreciable way. The legislature obviously felt that this was not appropriate even though the Harmer Report, particularly in respect of proving insolvency, had recommended an easing of the onus.[141]

B *Court Orders*

Undeniably, s 588FF, which lays down the orders which a court may make where a voidable transaction has occurred, is a positive move. Hitherto, a liquidator has sought a declaration from a court that a particular transaction is a

137 Notably ss 588FC, 588FE, 588FF, 588FG, 588E, 9, 95A.

138 It must be noted that the words used in s 122(1) of the Bankruptcy Act 1966 (Cth) are broad. For instance, 'conveyance' and 'transfer' are regarded as words of the widest significance: see *Re Hardman* 4 ABC 207, 210 (1932).

139 Wilde, above n 78.

140 Richard Aaron, 'The Bankruptcy Reform Act of 1978: The Full-Employment-for-Lawyers Bill' [1980] *Utah Law Review* 19, 43.

141 See, eg, the Harmer Report, above n 8, para 639.

preference and hence void, and that a sum (the amount of the alleged preference) be paid to him or her by the defendant creditor. Section 588FF permits a court more flexibility to do justice between the parties, particularly when one or more may not have committed any wrongdoing.[142] A creditor who has acted in good faith, had no reasonable grounds for suspecting that the company was insolvent and provided valuable consideration or changed his or her position in reliance on the transaction is protected totally from a preference claim by s 588FG(2). If a creditor does not fall within s 588FG(2) and a preference is successfully claimed, the court may still refrain from ordering the repayment of all of the money paid to the creditor.[143]

One critic of the previous state of affairs, O'Donovan, advocated the enactment of a provision in terms of s 311A(7) of the New Zealand Companies Act 1955 (NZ).[144] While sections 588FF and 588FG do not do this, effectively they could, depending on interpretation, produce effects similar to the New Zealand provision.

Despite the fact that, in general, s 588FF is a meritorious innovation it appears that it may have an effect which the legislature did not intend. Subsection (1) provides, in effect, that if the court finds that a preference was given to a creditor, the court may order that the creditor pay an amount equal to what was paid as a preference or return the property which constituted the preference, to the company.[145] Where a court found, under the previous law, that an undue preference had been given it would order that the amount of the preference be paid by the creditor to the liquidator.[146] This did not confer any interest in the amount upon the liquidator[147] as it has been stated clearly that he or she held the amount in trust for the unsecured creditors of the company.[148] Historically, the reason for ordering the payment or return of property to the liquidator was to ensure that the unsecured creditors exclusively received the benefit of the recovery. If the order was made in favour of the company and the company's property was subject to a debenture holder's charge, the debenture holder could, arguably, claim the property recovered.[149]

The question which must be asked is,[150] whether the fact that the court must order the creditor to pay or return property to the company means that if a debenture holder has a valid charge over company property it can claim the property delivered or money paid to the company pursuant to the court's order. Of course, if the answer is in the positive, then it would mean that in many

[142] Explanatory Memorandum, above n 54, para 1056.

[143] Section 588FF(1)(a).

[144] O'Donovan, 'Undue Preferences: Some Innocents "Scape Not The Thunderbolt"' above n 5, 335ff.

[145] Section 588FF(1)(a).

[146] See, eg, the order made in *Spedley Securities Ltd (in liq) v Sparad (No 100) Ltd* (1993) 12 ACSR 32, 46.

[147] *N A Kratzmann Pty Ltd (in liq) v Tucker (No 1)* (1970) 123 CLR 257, 285.

[148] *Re Yagerphone Ltd* [1935] 1 Ch 392; *Re Quality Camera Co Pty Ltd* [1965] NSWR 1330.

[149] *Re Yagerphone Ltd* [1935] 1 Ch 392, 396.

[150] This issue was brought to my attention by Michael Gedeye of the University of Auckland. The discussion in the article remains my responsibility.

cases the unsecured creditors would receive little or nothing as the debenture holder would be entitled to be paid first.

It would appear from *Re Yagerphone Ltd*[151] that the debenture holder would have a good case to claim the fruit of the order if its charge was fixed before the preference was given. In *Re Yagerphone Ltd* Bennett J held that the debenture holder could not claim any interest in the recovered preference because at the time of the giving of the preference its charge had not crystallised.[152]

The answer to all of this may be for a liquidator to argue that the property received pursuant to the court's order is impressed with a trust in favour of the unsecured creditors of the company as soon as it is recovered by the company.[153] Courts might find such an argument attractive for two reasons. Firstly, the judgment in *Re Yagerphone Ltd,* though brief and *ex tempore,* has been followed consistently for many years and the concern of the judge in that case was to protect the unsecured creditors. Secondly, if debenture holders will be able to claim the property recovered from a preference action, it is very likely that in the vast majority of cases liquidators will not be inclined to initiate proceedings to recover preferences. This would often mean that preferences would go unrecovered and as a consequence the principle of fairness discussed earlier in relation to the distribution of the company's property would be rendered otiose. If anything, creditors would become more aggressive in seeking payment from companies which appear to be floundering seriously. Secured creditors have no right to commence preference proceedings. Section 588FF(1) states that the liquidator is to bring any application for the avoidance of a transaction under Division 2 of Part 5.7B.

As indicated above there appears to be no basis for thinking that the legislature intended secured creditors to be especially favoured by Division 2 of Part 5.7B. However, it seems that unless liquidators are able to argue successfully that the property returned to the company is impressed with a trust for the unsecured creditors of the company as soon as it is recovered, then either proceedings to recover preferences will not be initiated, or if proceedings are commenced, in many liquidations they will benefit debenture holders which have charges over company property.

C *Commencement of Proceedings*

While on the topic of s 588FF it is notable that s 588FF(1) clearly states that the actual proceedings initiated to claim a preference must be commenced by the liquidator. This codifies what has been accepted in recent cases,[154] that is the liquidator is the proper plaintiff in preference proceedings. The positive side

151 [1935] 1 Ch 392.

152 Ibid.

153 This was suggested by Professor O'Donovan when arguing that the company should be the proper plaintiff in a preference action. See James O'Donovan, 'Procedural Aspects of Recovering Voidable Preferences' (1993) 1 *Insolvency Law Journal* 65, 67.

154 See, eg, *Petromart Pty Ltd (in liq) v McLean* (1986) 11 ACLR 248; *Horn v York Paper Co Ltd* (1991) 23 NSWLR 622.

of this is that now there can be no argument as to who should initiate the action. However, it may be argued that the legislation should have provided that the company was the proper plaintiff, thereby protecting the liquidator from personal liability for the costs of an unsuccessful action.[155]

D *Rights of Creditors Surrendering Benefits of Unfair Preferences*

Section 588FI of Division 2 of Part 5.7B provides that where a transaction is an unfair preference and the creditor disgorges so as to put the company in the same position as if the transaction had not been entered into, because of a liquidator's request or court order, the creditor is entitled to prove in the winding up as if the transaction had not been entered into. Section 588FI(2) specifically states that a court in making an order under s 588FF is not permitted to prejudice a right or interest of the creditor.

Section 588FI produces the same effect as s 122(5) of the Bankruptcy Act 1966 (Cth). It is included in the Corporations Law, *inter alia*, in order to encourage creditors to give up the benefit of preferences.[156] It is submitted, respectfully, that this is naïve. The attitude of creditors, often as a result of legal advice, is one of pragmatism. They will obtain payment from a company in difficulty even if it is likely to constitute a preference, because the worst that can happen is the restoration of the *status quo* if he or she is required to disgorge. Liquidation may never occur; even if it did, it may be outside of the six months time zone and even if it did occur within the time zone, the liquidator may not discover it or may decide that he or she has an insufficient 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? Furthest from the creditor's mind is likely to be any thought given to s 122(5) of the Bankruptcy Act 1966 (Cth) or s 588FI that if the creditor disgorges he or she will be entitled to claim in the winding up. The creditor will, except where his or her position is hopeless, be doing all that he or she can to retain the preference.

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

[155] O'Donovan, 'Procedural Aspects of Recovering Voidable Preferences' above n 153; In *Ferrier and Knight v Civil Aviation Authority* (Federal Court of Australia, Lockhart J, 24 March 1994) the liquidators who commenced preference proceedings, which failed, were held personally liable for costs. Lockhart J did not consider whether the liquidators could indemnify themselves from the company's assets. Normally they are entitled to do so, however company assets may not always cover such costs. Ordinarily if there is such a danger the liquidator seeks indemnities from creditors before initiating proceedings.

[156] Explanatory Memorandum, above n 54, para 1067.

a case, the creditor 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.[157]

There is no stigma involved in a creditor not disgorging until proceedings have been issued. Furthermore, there is no penalty imposed on the creditor. Section 588FI is in effect encouraging creditors to refrain from repaying a preference, rather than encouraging payment. Therefore, the section is redundant.

E *The Protective Provisions*

Division 2 of Part 5.7B has introduced substantial changes to the protective provisions available to the recipient of an alleged preference. Perhaps the major change is the abolition of the element of 'in the ordinary course of business' which appeared in s 122(2) of the Bankruptcy Act 1966 (Cth). This abolition has occurred, principally, because of the judicial uncertainty in interpreting what was meant by the phrase.[158] It is undeniable that there has not only been uncertainty, but also confusion.[159]

Liquidators may not be happy about this abolition. They may contend that the element was important because it would stop a creditor from successfully defending a preference claim where the payment was incurred in good faith but not in the ordinary course of business. In this regard the recent decision of *Re McFarlane Constructions Pty Ltd (in liq)*[160] is a case in point. It was accepted by Derrington J that the creditor acted in good faith and had no reason to suspect that the debtor company was insolvent. Yet the liquidator succeeded because the payment involved was not made in the ordinary course of business. Under the new preference regime it is likely that the liquidator would fail in his or her claim.

Such an argument loses its force if s 588FG(2)(b)(ii), that is, that the creditor must have no reasonable grounds for suspecting that the company was insolvent, is interpreted in such a way that a creditor who is involved in a transaction which is not in the ordinary course of business cannot establish that he, she or it had no reasonable grounds for suspecting that the company was insolvent. If that interpretation prevails, the liquidator has lost nothing from the elimination of the 'in the ordinary course of business' element.

Somewhat ironically, the United States only introduced an 'ordinary course of

[157] The point in time from which interest is to be calculated is the subject of divergency of judicial opinion. One of the major views is that the date is the relation-back day: see *Re Mike Electric (Aust) Pty Ltd (in liq)* (1983) 71 FLR 117; *Re Toowong Trading Pty Ltd* [1989] 1 Qd R 207; *Maurice Drycleaners Pty Ltd (in liq) v National Australia Bank Ltd* (1990) 8 ACLC 798; *Hamilton v Commonwealth Bank* (1992) 10 ACLC 1611. In these cases reference was made to the commencement of winding up which is now the date of the relation-back day. The other major view is that the date is the date of the demand made by the liquidator: see *Re RHD Power Services Pty Ltd (in liq)* (1991) 9 ACLC 27; *Spedley Securities Ltd (in liq) v Western United Ltd (in liq)* (1992) 27 NSWLR 111.

[158] Explanatory Memorandum, above n 54, para 1061.

[159] For examples of the uncertainty and confusion, see references above nn 91-6.

[160] (1993) 11 ACSR 748.

business' protection in respect of preferences quite recently in s 547(c)(2) of the 1978 amendment. The purpose of the innovation was to permit normal financing relations between the parties.[161]

Unlike the Australian requirement of ordinary course of business, the American protection is not linked to any other requirement. If a creditor can establish the elements of 'in the ordinary course of business' in s 547(c)(2) he, she or it is able to successfully defend an attack by the trustee who is winding up the affairs of the company. Consequently, proof of the ordinary course of business has far greater effect on the trustee in his or her recovery claim than it would have had on a liquidator in Australia, where the creditor was also obliged to establish good faith and valuable consideration.

In the United States the 'ordinary course of business' exception has precipitated most of the reported litigation concerning the exceptions to preference avoidance.[162] This appears to have been because the provision is 'both complex and, in several key respects, seriously deficient.'[163]

These deficiencies have meant that the courts have considered transactions solely from a factual perspective[164] with the result that there is a lack of judicial uniformity.[165] While the elements of s 547(c)(2) are easy to state, they are difficult to apply and this emanates from the inconsistency evident in the approaches adopted by the United States courts.[166]

This state of affairs appears to lend weight to the position assumed by the legislature in Australia that 'in the ordinary course of business' as a concept is not worth retaining — it is more trouble than it is worth.

Overall the statement by Schaffer that the abolition of the concept of 'in the ordinary course of business' is a welcome change,[167] is to be supported when all of the problems which the concept caused over the years are considered. The new state of affairs will overcome anomalies such as a creditor receiving a payment, which is a preference, in good faith believing that the transaction was in the ordinary course of business, and subsequently having to disgorge, because while the transaction was in the ordinary course of the creditor's business it was not in the ordinary course of business generally as dictated by the case law.[168] Under the new legislation, if that creditor had no reasonable grounds for suspecting the insolvency of the debtor company he or she would be entitled to

161 United States, House of Representatives Report No 595, 95th Congress, 1st Session (1977) 373; United States, Senate Report No 989, 95th Congress, 2nd Session (1978) 88.

162 Michael Herbert, 'The Trustee Versus The Trade Creditor: A Critique of Section 547(c)(1), (2) and (4) of the Bankruptcy Code' (1983) 17 *University of Richmond Law Review* 667, 679.

163 Ibid.

164 The Australian courts seem to have adopted the same approach: see *Telecom Australia v Russell Kumar and Sons Pty Ltd* (1993) 10 ACSR 24, 29.

165 Michael Bloom, 'Exceptions to Bankruptcy Preferences; Countryman Updated' (1992) 47 *Business Lawyer* 529, 541.

166 Ibid 542. See also Charles Reynolds, 'Maginot Line Defenses To A Preference Action' (1987) 21 *University of Richmond Law Review* 317.

167 Ron Schaffer, 'New Insolvency Law Will Make Clawbacks Easier' (1993) *Australian Accountant* (May) 63, 64.

168 O'Donovan, 'Undue Preferences: Some Innocents "Scape Not The Thunderbolt"' above n 5, 323.

invoke the protective provisions.

Often it has been difficult to recognise conduct which departs from the ordinary course of business and 'in many cases it boils down to a matter of degree, that is, the extent to which a transaction is unusual or out of the ordinary.'[169] It is contended that it is not fair that a creditor's defence should be so tenuously balanced. There should be more certain rules as to what will determine whether a transaction is, or is not, in the ordinary course of business so that a creditor's defence does not have to be founded on marginal grounds and a creditor can properly assess whether he, she or it has a fair defence to the preference claim. Furthermore, as it is not easy to know what conduct is, or is not, within the meaning of the phrase, it makes it difficult for a liquidator to decide whether to proceed against a particular creditor. Any advice which he or she had received would, ordinarily, have been rendered with concomitant caveats that there are no definitive rules as to the nature of transactions which are not in the ordinary course of business. As a result many actions initiated by a liquidator are often hazardous.

Consequently, it is repectfully submitted that the decision of the legislature in dispensing with the concept of 'in the ordinary course of business' is a prudent step.

While the concept of 'in the ordinary course of business' has been dispensed with, the legislature has retained the concept of good faith which has itself experienced a fair share of problems of interpretation. However, this has been principally due to s 122(4)(c) of the Bankruptcy Act 1966 (Cth)[170] which was discussed earlier. There has been no reproduction of s 122(4)(c) in Division 2 of Part 5.7B and that might lead one to conclude that there would be a reduction in the number, or even elimination, of the uncertainties connected with the concept of good faith. However, just as s 122(4)(c) acted as a supplement to 'good faith', so does s 588FG(2)(b). This supplements 'good faith' by requiring that on an objective test, the creditor has no reasonable grounds for suspecting that the company was insolvent at the time of the transaction and a reasonable person in the circumstances of the creditor would have no such grounds for suspecting insolvency.

Consequently, although a creditor may have acted in complete subjective good faith this will not be determinative — in addition his or her state of mind will be judged against that of the reasonable person. The inclusion of some form of objective test appears fair given that it is often difficult to impugn a statement of subjective good faith. The concern which might be expressed is that unlike

[169] Purcell, above n 64, 113.

[170] See, eg, *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266; *Spedley Securities Ltd (in liq) v Western United Ltd (in liq)* (1992) 27 NSWLR 111; Section 122(4)(c) states:

> a creditor shall be deemed not to be a purchaser, payee or encumbrancer in good faith if the conveyance, transfer, charge, payment or obligation was executed, made or incurred under such circumstances as to lead to the inference that the creditor knew, or had reason to suspect:
>
> (i) that the debtor was unable to pay his debts as they became due from his own money; and
>
> (ii) that the effect of the conveyance, transfer, charge, payment or obligation would be to give him a preference, priority or advantage over other creditors.

s 122(4)(c), which burdened the liquidator with establishing the existence of circumstances which may have led to the inference that the creditor knew or had reason to suspect that the debtor was insolvent and the effect of the transaction was to give him or her a preference, no such burden is imposed pursuant to s 588FG(2)(b). The onus is clearly on the creditor to prove, on the basis of an objective test, that there was no reason to suspect insolvency.

Liquidators might respond that this is only reasonable when one takes into account the fact that they are obliged to prove a number of substantive elements before a creditor has to consider establishing any facts whatsoever. However, creditors are required, in effect, to prove a negative and establishing a negative can be extremely difficult. In this context a creditor might wonder how far he or she must go in producing proof before it can be said that there are no reasonable grounds in existence. It may be difficult to feel with certainty that one has, at any stage, obtained sufficient evidence to meet the condition. Hearings may become lengthier as creditors seek to ensure that they meet the condition by introducing more and more evidence, some of which may be unnecessary. This is not desirable. Section 588FG(2)(b) is to be contrasted with the new insolvent trading provision, s 588G. In this latter section the initiator of proceedings against a director, usually the liquidator,[171] must establish that at the time of the incurring of the debt in issue there were reasonable grounds for suspecting that the company was insolvent.

United States experience suggests that there may be substantial difficulty for a liquidator seeking to prove reasonable grounds for suspecting insolvency. Before the 1978 amendment to its Bankruptcy Code, the United States Code contained, in s 60b,[172] a provision similar to s 588FG(2)(b). It stated, *inter alia*, that 'a trustee in bankruptcy could avoid a preference if the creditor receiving it had, at the time of reception, reasonable cause to believe that the debtor was insolvent.' It is notable that the provision placed the onus on the trustee to prove 'reasonable cause to believe' and this produced substantial criticism. It was argued that the burden was too heavy[173] and it resulted in creditors being provided with protection when they knew the truth of the situation, because the trustee could not satisfy the burden of proof.[174]

In rebuttal, creditors might argue that s 588FG(2)(b) imposes an unreasonable burden on them as it requires the proof of a negative and matters will have to be decided on a case-by-case basis. This occurred in relation to the 'in the ordinary course of business' element and caused substantial uncertainty.

When s 60b of the United States legislation was eliminated the reason was that the courts had adopted a case-by-case approach which produced inconsistencies and consequently gave creditors no guidance as to what was permissible

[171] See s 588M(2), but note s 588R.

[172] The sub-section is discussed in detail by Charles Neider in 'Voidable Preferences: An Analysis of the Proposed Revisions of Section 60b of the Bankruptcy Act' [1974] *Wisconsin Law Review* 481.

[173] Broome, above n 31, 94.

[174] William Collier, *Collier on Bankruptcy* (Matthew Bender (publisher), 14th ed, 1974) vol 3, para 60.52[2], 1056.

behaviour.[175] Neider identified another problem; he stated that there were substantial practical difficulties involved in determining whether insolvency as defined in the bankruptcy legislation might exist in any particular case.[176]

While the s 60b provision involved different wording it is submitted that the difference does not save s 588FG(2)(b) from potentially the same criticism. There may be, as with s 60b, difficulties in developing consistent, delineated rules which engender a feeling of some certainty.

F *Costs*

One of the major problems which a liquidator has in challenging any alleged preference is that he or she may have insufficient funds to commit to an action of recovery.[177] If a liquidator is advised that it is very arguable whether a preference has been given, he or she may be reluctant to risk any funds which are available lest the action be lost and the funds consequently exhausted by the costs, not only of his or her own legal advisers, but of the creditor.

The liquidator can either seek indemnities from creditors or the establishment of creditors' fighting funds in order that he or she can initiate, or further, proceedings. Creditors are not always keen to be involved in such actions as they may regard it as tantamount to 'throwing good money after bad'. Normally creditors will only get involved if they can be assured that there is a likelihood of success.

The Harmer Report expressed concern that liquidators of companies without funds would be unable to attack antecedent transactions such as preferences.[178] The Commission recommended that a fund, to be known as the Insolvent (Assetless Companies) Fund, be established 'to enable the winding up of and investigation into insolvent assetless companies.'[179]

The Attorney-General's Department decided not to implement the proposal on the basis that it would place another levy upon Australian companies.[180] Unfortunately, neither Division 2 of Part 5.7B nor any other provisions enacted by the Corporate Law Reform Act 1992 (Cth) address the liquidator's difficulty in relation to lack of funds and the costs of litigation. This is to be regretted because, as it has been contended in this article, the initial burden imposed on liquidators in establishing the existence of an unfair preference is very similar to that which was imposed with respect to undue preferences and therefore the costs involved in litigation to obtain a court order would probably be similar.

175 Broome, above n 31, 94; Neider, above n 172, 486.

176 Neider, above n 172, 486. Interestingly, there have been calls for the re-introduction of s 60b at the expense of the concept of 'in the ordinary course of business': see, eg, Chaim Fortgang and Lawrence King, 'The 1978 Bankruptcy Code: Some Wrong Policy Decisions' (1981) 56 *New York University Law Review* 1148, 1167-71.

177 Wilde, above n 78.

178 Harmer Report, above n 8, paras 337-8, 340, 343.

179 Ibid para 346. The fund was to be established by an annual levy on all companies payable at the time of filing of their annual returns, and the amount of the levy was to be prescribed by regulation: see paras 348-50.

180 In addition to, eg, the Training Guarantee Levy and the Superannuation Guarantee Levy.

It is perhaps somewhat surprising that the legislature did not include in the Corporate Law Reform Act 1992 (Cth) a provision of the same ilk as s 139ZQ of the Bankruptcy Act 1966 (Cth). This section was introduced by the Bankruptcy Amendment Act 1991 (Cth) and constituted a legislative response, *inter alia*, to two problems which confront trustees in bankruptcy, namely insufficient funds to mount court actions to recover property disposed of pursuant to voidable transactions, and the complexity of litigation.[181] The section was designed both to make the recovery of funds simpler and more cost effective and to ensure a better return for creditors.[182]

Rather than relying on litigation to recover a preference, a trustee can employ the administrative recovery procedure which is set down by s 139ZQ. The section states in sub-section (1):

> If a person has received any money or property as a result of a transaction that is void against the trustee of a bankruptcy under Division 3, the Official Receiver:
> (a) if the Official Trustee is the trustee — on the initiative of the Official Receiver; or
> (b) if a registered trustee is the trustee — on application by the trustee;
> may require the person, by written notice given to the person to pay to the trustee an amount equal to the money or the value of the property received.

Any amount payable to the trustee is recoverable as a debt in court proceedings.[183] A person who is sent a notice under s 139ZQ may apply to the court to have the notice set aside.[184]

The advantage of the procedure in s 139ZQ is that the onus is not placed on the trustee to initiate court proceedings against a creditor to whom he or she believes a preference has been given. Rather the onus is placed on the creditor to take action to have the s 139ZQ notice set aside. A further advantage for the trustee is that while he or she may be hesitant about instituting proceedings in the courts to recover a preference because it is arguable whether, in fact, a preference was given, a trustee would not have the same hesitation in availing himself or herself of s 139ZQ.

It is possible that a procedure akin to that provided for in s 139ZQ could deter creditors from aggressively seeking preferences. Certainly such a procedure would mean that many creditors would not retain alleged preferences.

The provision appears to have been successful and well-employed by the Official Receiver either on behalf of the Official Trustee or private registered trustees.[185] The most controversial aspect of the provision is that if a person who is sent a notice fails to comply with it, he, she or it is guilty of an offence.[186] Although this encountered criticism, it is unlikely to be the reason for the

181 Explanatory Memorandum to the Bankruptcy Amendment Bill 1991, para 25.97.

182 Ibid.

183 Bankruptcy Act 1966 (Cth) s 139ZQ(8).

184 Bankruptcy Act 1966 (Cth) s 139ZS(1).

185 George Caddy, 'Notices Under Section 139ZQ' (1993) *New Directions in Bankruptcy* 7-10.

186 Section 139ZT. See Grant Hutchinson and Andrew Keay, 'The Bankruptcy Amendment Act 1991: Clipping the Wings of the High Flyers?' (1992) 66 *Law Institute Journal* 387, 389.

legislature not embracing the procedure for liquidations, because the Official Receiver is, apparently, utilising s 139ZQ with enthusiasm.[187] Of course, in light of the perceived success of the s 139ZQ process the Attorney-General's Department may form the opinion that the same process should be available in liquidation, thus bringing liquidation into line with bankruptcies.

VIII CONCLUSION

The avoidance of preferences is designed to ensure, as far as possible, that there is a *pari passu* distribution of the assets of a company in liquidation among its general creditors. If allowed to stand, preferences would produce inequity in that some creditors, who were either diligent or just fortunate in collecting their debts before liquidation, would receive more than other creditors on a *pro rata* basis.

Preferences have been subject, under different tests, to challenge for many years, probably having their roots in the English statute of 1570 known as the Statute of Elizabeth.[188] Until the advent of the Corporate Law Reform Act 1992 (Cth), s 122 of the Bankruptcy Act 1966 (Cth), which deals with undue preferences, was incorporated by reference into the Corporations Law and therefore applied to preference claims in liquidations. This scheme was abolished by the Corporate Law Reform Act 1992 (Cth); this legislation replaced the undue preference with the unfair preference.

While the unfair preference is defined in s 588FA of the Corporations Law, its scope and application can only be appreciated by reference to a number of sections in the Corporations Law.[189] The legislation dealing with unfair preferences is contained in Division 2 of Part 5.7B which constitutes a code articulating which pre-liquidation transactions are voidable by order of the courts.

The unfair preference legislation is heavily founded on the legislation in the Bankruptcy Act 1966 (Cth) which provides for undue preferences, however a number of crucial differences are to be discovered when comparing the respective legislation. It is contended that the differences represent an attempt by the legislature to rectify problems which were either inherent in, or emanated from, the provision regulating undue preferences. The major change precipitated by the new provisions is in relation to the conditions on which a creditor who has received a preference may seek protection, and consequently be relieved from compulsion to disgorge any benefit received from the company in liquidation.

The requirement imposed on a creditor by s 122 of the Bankruptcy Act 1966 (Cth) of having to prove that a benefit was received 'in the ordinary course of business' was eliminated and replaced by an obligation on the part of the creditor to establish that he or she had no reasonable grounds to suspect that the company was insolvent. The creditor is still obliged, as he or she was under s 122, to prove that he or she acted in good faith and provided valuable

[187] Caddy, above n 185.
[188] Also known as the Statute of Fraudulent Conveyances, see above n 15.
[189] See Corporations Law and the sections mentioned above n 137.

consideration.[190] It has been submitted that deletion of the 'in the ordinary course of business' ingredient is meritorious because the phrase was subject to such various interpretations by the courts that uncertainty was created.

The result of the changes to the protective provisions is that the onus placed upon the creditor is made more burdensome in that he or she must prove that he or she had no reasonable grounds to suspect insolvency, while under s 122 the onus was on the liquidator to show that there were circumstances in existence which should lead a court to infer that the creditor knew or had reason to suspect insolvency.

The unfair preference, like the undue preference, is dependent on a creditor receiving more from the company as a result of the transaction than if the creditor proved in the liquidation. Furthermore, a liquidator is obliged to establish the same elements as he or she had to establish when claiming an undue preference.

It has been submitted that while s 588FA and its supporting provisions introduce helpful concepts, the legislation is not really much simpler or more efficient, if at all, than s 122. There are aspects of the new legislation which will appeal to liquidators, such as the introduction of the requirement that a creditor attempting to defend a preference must prove that he or she had no reasonable grounds for suspecting the company's insolvency. Overall however, liquidators will not, it is contended, be overly attracted to the new provisions. It appears that creditors will not be impressed by the legislation because, *inter alia*, they have had a heavier burden imposed on them when seeking to invoke the defences against a preference claim.[191] Against that, creditors will be heartened to know that if they receive a preference and then disgorge it at a later date (usually after receiving a demand from the liquidator) they will not be penalised.

It is submitted that the abolition of the undue preference and the introduction of the unfair preference will not change things dramatically. Perhaps, as discussed above, creditors will find it a little harder to establish a defence to a preference claim. The new legislation fails to address some issues which could have been dealt with by a regime introduced specially to handle voidable transactions. It is contended that the provisions dealing with other voidable transactions, such as uncommercial transactions, have addressed problems which existed with the avoidance provisions in the Bankruptcy Act 1966 (Cth) as they applied to companies.

After saying that, one must appreciate that a regime dealing with any antecedent transaction issue cannot operate at all times and for all purposes. The law of preferences always represents a compromise between protecting the contractual arrangements made by a debtor company with its creditors prior to liquidation on the one hand, and minimising the cost to creditors of a winding up of an insolvent company by spreading the load among all general creditors

190 Instead of proving 'valuable consideration' a creditor may establish under s 588FG(2)(c) that he or she changed his or her position in reliance on the transaction.

191 See s 588FG(2)(b).

on the other hand.[192] Regard must be had both for the fact that creditors could not carry on business if they had to continually make investigations into their debtor's financial affairs before accepting payment of debts[193] and the fact that liquidators are appointed to companies usually without any background knowledge of the company's affairs and where, frequently, the affairs and records are unkempt and generally disorganised.

An important point to note is that after the introduction of such a far-reaching Division as Division 2 of Part 5.7B, preferences continue to be able to be challenged by liquidators. There have been, at times, calls for the abolition of the right to set aside preferences.[194] While this approach has its merits,[195] it also has substantial drawbacks,[196] and the legislature obviously has decided not to adopt the rather radical process of eliminating the avoidance of preferences. Instead it has changed the nomenclature attached to preferences which can be set aside and it has changed the face of preferences. However, changes to preferences are not to be regarded as far-reaching, for when one analyses the elements and effect of the unfair preference it appears that it will not be substantially different from the undue preference. Furthermore, the legislature has regrettably failed to take the opportunity presented by the restructuring of the preference provisions to deal with some shortcomings of the previous preference regime, such as the difficulties experienced by liquidators in establishing insolvency, which required attention.

192 Jackson and Kronman, above n 132, 989.

193 See the comments by Lucas J in *Re An Application by JGA Tucker and Reid Murray Developments (Qld) Pty Ltd* [1969] Qd R 193, 212.

194 See, eg, John Morris, 'Bankruptcy, Preferences and Efficiency: An Expression of Doubt' (1981) 67 *Virginia Law Review* 249, 270ff; Pincus J (now of the Queensland Court of Appeal) submitted to the Australian Law Reform Commission that preferences be abolished save where payments to a creditor have been exacted by illegal means or payments have been made in a conspiratorial fashion in order to prejudice creditors: see the Harmer Report, above n 8, para 631.

195 See, eg, Farrar, 'The Bankruptcy of the Law of Fraudulent Preference' above n 24, 406.

196 Ibid 407.