In Search of Equality: New Zealand's Voidable Preference Regime

Gabrielle Smith

A dissertation submitted in partial fulfilment of the degree of the Bachelor of Laws (Honours) at the University of Otago

October 2011

Acknowledgements

Thanks firstly to my supervisor, Struan Scott, for his invaluable guidance, patience and encouragement throughout the year.

Thanks also my friends and flatmates for providing lots of laughs and for making my last year at Otago a fantastic one.

Finally, thank you to mum and dad, for their love and support.

Table of Contents

Introduction **1**

Chapter I – The Primacy of Equality **4**

A. The *Pari Passu* Principle of Distribution **4**

1. Overview 4
2. The practical significance of the pari passu principle 6

B. Exceptions to the *Pari Passu* Principle **7**

1. Secured creditors 7
2. Other proprietary claims 8
3. Preferential creditors 8
4. Set-off 9

C. Reinforcing the *Pari Passu* Principle **10**

1. The rule of invalidity 10
2. The anti deprivation rule 11
3. The statutory avoidance regime 12
   (a) The relation-back period 12
   (b) The avoidance test 14
   (c) Defences to a voidable transaction 17

Chapter II - Competing Policy Objectives **19**

A. The Creditor Equality Rationale **19**

B. The Debtor Deterrence Rationale **20**

C. The Creditor Deterrence Rationale **22**

Chapter III - The New Zealand Avoidance Regimes **27**

A. The 1993 Companies Act: Towards Equality **27**

1. An effects-based test 27
2. The ordinary course of business exception 28
   (a) Possible policy justifications 29
   (b) The emergence of the creditor deterrence rationale 31

B. The Company Amendment Act 2006: Equality Achieved? **34**

1. The running account principle 34
   (a) Rationale and significance 34
   (b) The statutory running account test 36
   (c) The "continuing business relationship" or "running account" 37
   (d) The United States "subsequent new value" exception 39

(e) The peak indebtedness rule ... 40
2. The alteration of position defence ... 41
(a) Justifications for the defence ... 42

Chapter IV - Recommendations for Reform ... 46
A. Repeal Section 296(3) for Voidable Preferences ... 46
B. Shorten the Vulnerability Period ... 47
C. Amend the Running Account Principle ... 49

Conclusion ... 51

Bibliography ... 53

Appendix One: Companies Act 1993 ss 292, 294 – 296 ... 58

Appendix Two: Schedule 7 Companies Act 1993 ... 63

Introduction

This dissertation seeks to answer the question "what is the objective of voidable preference law?" and analyses whether the current legislative regime achieves that objective. While there is general consensus that voidable preference law is an essential part of a broader insolvency regime, the best formulation of the law has eluded legislators for well over a century.[1] The difficulties in creating a workable preference regime may be attributed to the fact that the preference law lacks a clear policy foundation. This failure to understand and clearly articulate the goals of the legislation has lead to oscillation between competing models and significant reform to the preference provisions with each overhaul of New Zealand's insolvency legislation.

The scope of this dissertation is limited to voidable preference law as it relates to corporate as opposed to personal insolvency. The general nature and policy of preference law is the same for both forms of insolvency under the Companies Act 1993 and the Insolvency Act 2006.[2] However, the liquidation of companies presents a more complex range of issues and a more diverse range of creditor claimants. Further, the voidable preference provisions are one category of provisions within a larger avoidance regime. The other categories of fraudulent preference provisions and voidable charges are not considered in this dissertation.[3]

What then, is a preference? Simply put, it is a pre-liquidation transfer that favours one creditor over the general body of creditors. When a preference is given by a debtor company, whether motivated by kindness, a sense of duty, or entirely incidentally, the company is, in effect, "robbing Peter to pay Paul".[4] The recipient of the preference obtains an advantage because it receives payment of its debt before

[1] R Weisberg "Commercial Morality, the Merchant Character, and the History of the Voidable Preference" (1986) 39 Stan L Rev 3 at 10.

[2] The 2006 reforms to the insolvency legislation harmonised the law of preferences for corporate and personal insolvency and only few minor differences now exist between the regimes. For the personal insolvency avoidance regime, see ss 192 – 216 Insolvency Act 2006.

[3] The fraudulent preference provisions govern transactions at undervalue and transactions for excessive or inadequate consideration with insiders, see Companies Act 1993, ss 297 – 299. Voidable charges are governed by s 293. However, the creation of a security interest may also be considered a voidable transaction, see s 292.

[4] John Farrar "The Bankruptcy of the Law of Fraudulent Preference" (1983) JBL 390 at 390.

other creditors who may go on to receive little or nothing at all in the company's liquidation. In essence, voidable preference law intervenes to ensure that the basic insolvency objective of equal treatment among creditors is not undermined by preferential transactions.

However, the mere fact of a preference is not treated as sufficient grounds to justify avoidance. Instead, the conventional wisdom is that there are 'good' preferences and 'bad' preferences, and only those of the bad variety are subject to avoidance and recapture.[5] Parliament's search for the "plus" factor that will distinguish between 'good' and 'bad' preferences is ill founded and has caused unnecessary confusion in this area of law. A re-focusing on the fundamental objective of voidable preference law is required so that the destruction of equality is treated as sufficient to justify the avoidance of a preferential transaction.

Chapter One examines voidable preference law in its wider context of insolvency. The primacy of the principle of *pari passu* is established and the voidable preference provisions are introduced as the primary mechanism to uphold that principle. Against this background, Chapter Two demonstrates that preference law has lost sight of its fundamental objective to protect the equality of distribution. Two competing rationales are examined: debtor deterrence and creditor deterrence. It is established that both rationales are based on flawed policy justifications and have served merely to distract from the creditor equality rationale that forms the true basis of voidable preference law.

Chapter Three analyses New Zealand's voidable preference regimes since 1993 in light of the overriding objective of creditor equality. The legislative history demonstrates consistent shifts towards a more certain regime that treats creditor equality as paramount. However, various aspects of the present voidable preference regime are either inconsistent with the policy of equality or still incorporate the creditor deterrence rationale.

[5] Charles Jordan Tabb "Rethinking Preferences" (1991-92) 43 SCL Rev 981 at 987.

After concluding that the current exceptions to the creditor equality rationale cannot be justified, Chapter Four proposes recommendations for reform to create a regime that affords the best protection to the principle of *pari passu.* The implementation of such recommendations would create a regime that is closer to strict liability which is the true nature of voidable preference law.

Chapter I – The Primacy of Equality

This chapter examines the voidable preference provisions in the wider insolvency law context. The *pari passu* principle is the fundamental principle of insolvency law. However, this chapter establishes that various statutory exceptions to the notion of absolute equality between creditors means that there is often little or nothing left to be distributed amongst the general body of creditors in accordance with *pari passu*. The voidable preference provisions are the most powerful tool at a liquidator's disposal to set aside those payments or transfers that have illegitimately subverted the equality of distribution and swell the pool of assets available to unsecured creditors.

A. The *Pari Passu* Principle of Distribution

1. Overview

One of primary aims of insolvency law is to ensure that the assets of the debtor are distributed amongst creditors in a fair and equitable manner that avoids conflict between creditors.[6] The collective regime and the principle of *pari passu* lie at the heart of this objective.[7]

A *pari passu* distribution means all creditors share equally and rateably in the assets of the debtor.[8] The principle is well established and has been adopted in every substantive insolvency statute in England since the sixteenth century.[9] The *pari passu* principle operates within a compulsory collective proceeding, such as liquidation, which requires each creditor to forfeit his right to take individual action to enforce the debt owed to him and participate equally in the debtor's downfall.

---

[6] Law Reform Division, Department of Justice *Insolvency Law Reform: A Discussion Paper* (Wellington, 1988) at 94.

[7] Roy Goode *Principles of Corporate Insolvency Law* (3rd ed, Sweet & Maxwell, London, 2005) at 79. Ministry of Economic Development *Insolvency Law Review: Tier One Discussion Documents* (Wellington, 2001) at 58.

[8] 'Rateable' here means in common proportions according to the extent of the pre-insolvency claims.

[9] Goode, above n 7, at 78. s 313 Companies Act enshrines the principle by stating that after paying preferential creditors, the liquidator must apply the assets of the company in satisfaction of all other claims, which rank equally among themselves.

Outside of insolvency and the collective proceeding, a creditor is free to use whatever means are available to it to recover its debt. The principle of 'first come first served' prevails, creating a 'race of diligence' where the most vigilant and aggressive creditors are rewarded.[10] This race is accepted when the company is solvent because each creditor can still expect full payment eventually. However, when the company becomes insolvent, payment of one creditor necessarily prejudices others because there are insufficient assets to satisfy all.[11] Allowing the race to continue would result in the swiftest creditors dismembering the company's assets and little or nothing would remain to be distributed amongst unsecured creditors generally. Such a result is viewed as inequitable. Liquidation appears in the law in response to this potential prejudice. The *pari passu* principle replaces the race premise as the defining principle and this shift is justified on the basis "equality is equity".[12]

A *pari passu* distribution is not only equitable but also efficient. The *pari passu* principle provides an effective and orderly means of differentiating between the claims of creditors.[13] This system keeps costs and delays to a minimum and prevents the need for courts to make difficult decisions based on the individual merits of each claim.[14] A *pari passu* distribution can also be explained on the basis of a wider objective of business survival. A debtor's liquidation can have a ripple effect where the non-payment of a particular creditor may contribute to that creditor's financial collapse, creating broader social and economic costs. This effect is particularly true for weaker creditors who are often unable to exert significant pressure to secure preference payments.[15] A rateable distribution spreads the effects of liquidation amongst all creditors, giving each an equal opportunity of surviving the debtor's downfall.

[10] Tabb, above n 5, at 988.
[11] John C. McCoid ''Bankruptcy, Preferences and Efficiency: An Expression of Doubt'' (1981) 67 Va L Rev 249 at 260.
[12] Tabb, above n 5, at 989 citing John N. Pomeroy *A Treatise on Equity Jurisprudence* (5th ed, Bancroft-Whitney and Lawyers Cooperative, San Francisco, 1941) at 144-59.
[13] Alternative distribution rules could be based on the time at which the claim was established or the ability of the creditor to sustain loss, see Vanessa Finch *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, Cambridge, 2002) at 423.
[14] Ibid, at 423.
[15] Andrew Keay "In Pursuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions" (1996) 18 Syd LR 55 at 68.

2. The practical significance of the **pari passu** *principle*

Despite the theoretical significance of the principle, a rateable distribution between creditors is rarely achieved in practice.[16] There are two major reasons for this. Firstly, the law allows creditors to legitimately avoid the principle's operation through the creation of security interests and other real rights. Secondly, statutory priority is conferred upon certain creditors. When the claims of these creditors have been satisfied, there is often very little remaining in the debtor's estate for the *pari passu* principle to attach to.

The erosions to the notion of equality have lead to the argument that the principle of *pari passu* in distribution is a myth.[17] It is argued that what the law disallows is not evasion of the *pari passu* principle but evasion of the collective proceeding generally. The law would operate to avoid any arrangement that illegitimately evades the collective regime irrespective of the distribution rule on liquidation and therefore the real concern is to prevent creditors from using individual remedies to enforce their debts. This argument has force if the *pari passu* principle is taken literally to mean absolute equality between creditors. However, the principle is really invoked as a term of shorthand to describe what is in fact the general statutory rule of distribution.[18] The principle of *pari passu* has been modified by statutory intervention, resulting in a stratified system of distribution whereby defined groups of creditors are given preferential status or enjoy some kind of priority.[19] Thus the achievement of a *pari passu* distribution refers to the pro rata treatment of creditors who share the same priority claim to the debtor's assets, not absolute equality.[20] If equality in this qualified sense is achieved, then the *pari passu* principle is a reality upon liquidation, not a myth.

The major exceptions to the *pari passu* principle are briefly described in the next section. The statutory distribution scheme is such that secured creditors receive first priority, followed by preferential creditors, and then the claims of unsecured creditors

---

[16] Goode, above n 7, at 177.
[17] Rizwaan Jameel Mokal "Priority as Pathology: The *Pari Passu* Myth" (2001) 60 CLJ 3 at 581.
[18] Goode, above n 7, at 79.
[19] I F Fletcher, *The Law of Insolvency* (2nd ed, Sweet & Maxwell, London, 1990) at 2.
[20] Tabb, above n 5, at 987.

are satisfied in accordance with *pari passu*.[21] A creditor can also surmount the *pari passu* principle to its own advantage by bringing itself within other recognised exceptions to the rule such as set-off, an agreed subordination of debt and other equitable claims. Although these exceptions represent an erosion of the *pari passu* principle, each is based on sound policy justification.

B. Exceptions to the *Pari Passu* Principle

1. Secured creditors

The Companies Act defines secured creditors as those persons entitled to a charge on or over property owned by the company and the Act excludes property that is subject to a charge from the ambit of the liquidation.[22] The Act therefore expressly contemplates that secured creditors will operate independently of the liquidation,[23] unless they decide to surrender their security.[24]

Despite the criticism of some commentators,[25] it is accepted that there are sound policy justifications for allowing the creation of charges.[26] However, it should be noted that the creation of some security interests or charges might be open to

[21] Leslie Theron "The Liquidation Process" in Paul Heath (ed) & Michael Whale (ed) *Heath & Whale on Insolvency* (online looseleaf, LexisNexis NZ) at [20.33]: if any surplus remains, it is used to pay deferred creditors and interest to creditors. If any surplus remains after satisfying all creditors, it is returned to the debtor or used to pay shareholders and other entitled persons according to their rights and interests in the company.

[22] Section 2: "charge" is defined as a right or interest in relation to property owned by a company, by virtue of which a creditor of the company is entitled to claim payment in priority to preferential and unsecured creditors but does not include a charge under a charging order issued by a court in favour of a judgment creditor.

[23] See Part 16 of the Act generally. S 240(1) makes it clear that secured creditors are excluded except for very limited purposes, s 248(2) states that liquidation does not limit the secured creditors' rights of enforcement, s 253 provides that the liquidator's principal duty is to take possession of the assets and distribute them or their proceeds to "creditors", which, for this purpose, excludes secured creditors.

[24] Section 305(1)(c).

[25] For example, see R. Goode "Is the Law Too Favourable to Secured Creditors" (1983-84) 8 Can Bus LJ 53; Finch, above n 13, at 452 – 464.

[26] Keay, above n 15 at 70. See also Australia's Harmer Report, stating that the equality principle should not intrude upon the law as far as it affects security rights: Australian Law Reform Commission, *General Insolvency Inquiry* Report No 45 (Australian Government Publishing Service, Canberra, 1988) at [713].

challenge as either voidable transactions or voidable charges if the security was granted in the two year period prior to commencement of liquidation.[27]

2. *Other proprietary claims*

Claimants with proprietary rights are entitled to enforce their claims ahead of creditors with personal rights who are only entitled to claim a divided in competition with other ordinary creditors. Where a claimant holds proprietary rights in the company's assets, those assets never form part of the pool of free assets available for distribution by the liquidator.[28]

3. *Preferential creditors*

Preferential creditors are unsecured creditors who receive priority status under Schedule 7 of the Companies Act.[29] Such creditors include employees, the Commissioner of the Inland Revenue Department and creditors who are buyers under the Layby Sales Act 1971. The claims of these creditors must be satisfied after the claims of secured creditors and other holders of proprietary rights are met. Although the priority afforded to these creditors represents an exception to the *pari passu* principle, the principle retains some significance in that the claims of creditors within each class of preferential debt rate equally and rateably amongst themselves.[30]

[27] Section 292(3)(a) includes the creation of a charge over the company's property as a type of transaction that may be subject to avoidance. A charge may also be avoided under s 293 if it was given during the specified period and immediately after it was given, the company was unable to pay its due debts. The charge must not have secured any new value provided to the company or have been in substitution for a charge given before the specified period.

[28] Beneficiaries for whom the company holds assets on trust have proprietary rights and are entitled to enforce their claims ahead of ordinary creditors. For example, s 167(1) of the Tax Administration Act 1994 provides that every amount of tax withheld or deducted under the PAYE rules and the Accident Rehabilitation and Compensation Insurance Act 1992 (where applicable) shall be held in trust for the Crown and in the event of liquidation of the employer shall not form part of the estate in liquidation. Where the employer has failed to deal with the tax in the required way, the amounts owing receive preferential status under Schedule 7 to the Companies Act 1993, see Appendix Two.

[29] See Appendix Two.

[30] Schedule 7, rule 2.1, see Appendix Two.

4. Set-off

On liquidation, a creditor is able to set-off a debt owed to it by the insolvent debtor against a debt it owes to the insolvent. Only the balance remaining, if any, is either provable in the liquidation or payable to the liquidator. Section 310 of the Companies Act provides for a mandatory set-off upon liquidation where there have been mutual credits, mutual debts, or other mutual dealings between a company and an unsecured creditor.[31]

Set-off creates an exception to the *pari passu* principle because a creditor is able to resort to self-help by setting off the debts and thereby ensuring payment of his own claim ahead of other creditors. It is clearly preferable for that creditor to treat the debt as having been discharged by reason of set-off than to be required to meet the insolvent's claim in full and then separately seek to recover as an unsecured creditor.[32] The exception is justified on the grounds that insolvency law must assess obligations between a creditor and an insolvent on a net basis. The Supreme Court in *Trans Otway Ltd v Shephard* stated "it is regarded as unfair that someone who owes an amount to an insolvent person should have to pay it in full whilst exposed to the peril of receiving only a dividend, or nothing at all, from the estate in respect of an amount owed by the insolvent."[33] A further justification is based on the need to uphold the legitimate expectations of the parties. Each party to the mutual dealings has extended credit on the basis that he can take what is due to him out of what he owes and this expectation must be upheld.[34]

Similar policy reasoning underpins the running account principle, which is effectively another form of set-off within the avoidance regime. The running account principle

[31] Section 310(1) Where there have been mutual credits, mutual debts, or other mutual dealings between a company and a person who seeks or, but for the operation of this section, would seek to have a claim admitted in the liquidation of the company, —

> (a) An account must be taken of what is due from the one party to the other in respect of those credits, debts, or dealings; and
> (b) An amount due from one party must be set off against an amount due from the other party; and
> (c) Only the balance of the account may be claimed in the liquidation, or is payable to the company, as the case may be.

[32] David Perry and Scot Abel "Set Off" in *Heath and Whale on Insolvency*, above n 30, at [30.1]

[33] *Trans Otway Ltd v Shephard* [2005] NZSC 76 [2006] 2 NZLR 289 at [15].

[34] Goode, above n 7, at 190.

provides that where there is an ongoing relationship between the debtor and creditor so that the balance owed by the debtor is increased and decreased from time to time, the transactions are to be off-set against each other to determine if an overall preference has been created.[35] Insolvency law's acceptance of set-off and the running account test demonstrates that what the law is aimed at preventing is an overall diminution in the debtor's assets and transactions or dealings that form part of wider series will be considered collectively rather than in isolation.

Set-off under section 310 is not open to challenge as a voidable preference.[36] However, the situation may be different where the parties carry out a set-off under their own agreement in the period prior to insolvency. In that case, a set-off may constitute an insolvent transaction as either a payment of money or a transfer of property.[37]

C. Reinforcing the *Pari Passu* Principle

Three mechanisms operate to swell the pool of assets available for distribution to unsecured creditors. The rule of invalidity and the anti-deprivation rule are sub-rules of the general common law principle that parties cannot contract out the insolvency legislation. These two rules continue to be applicable at common law. However, the voidable preference provisions are the liquidator's real arsenal for making recoveries that will benefit unsecured creditors.

1. The rule of invalidity

It is a long standing principle that parties cannot contract out of a *pari passu* distribution on liquidation. The English High Court recently stated that the principle of *pari passu*:[38]

[35] Section 292(4B).
[36] See *Finnigan v He* [2010] 2 NZLR 668 at [19] where Duffy J concluded that s 310 automatically extinguishes any debts that are subject to it and thus any amount set-off no longer exists and is unavailable for use as a payment for the purposes of a voidable transaction under s 292.
[37] See *Trans Otway v Shephard,* above n 33, at [15] – [20].
[38] *HM Revenue and Customs v The Football League Ltd* [2012] EWHC 1372 (Ch) at [64]. See also *Stotter v Equiticorp Australia Ltd* (in liq) [2002] 2 NZLR 686.

> "applies not only to the basis on which the relevant office holder carries out the distribution, but importantly it also applies to any contractual or other provision which has the effect of distributing assets belonging to the insolvent estate on a basis which is not *pari passu"*.

The court has the power to strike down any contract or provision that has as its object or result a distribution of assets that it is inconsistent with *pari passu*.[39] The intention of the parties is irrelevant and thus the principle applies to any agreement that undermines *pari passu* regardless of whether or not it is expressly triggered by the relevant insolvency procedure.[40] Contracts that will be struck down are those that confer a benefit on a particular creditor and operate to divest the estate of an asset belonging to it at the time of liquidation.[41]

However, some agreements that adjust distribution upon liquidation are not considered to offend the *pari passu* rule. A creditor can validly agree to subordinate its own debt to those of the general body of creditors.[42] The legitimacy of debt subrogation agreements demonstrates that the law only seeks to prevent those adjustments to *pari passu* that prejudice the general body of creditors. A distinction is recognised between an arrangement that confers a preference on the general body of creditors by a single creditor agreeing to subrogate its debt and an arrangement where the general body of creditors, without assenting, is disadvantaged by the creation of a preference for a particular creditor or group of creditors.[43]

2. The anti deprivation rule

The anti-deprivation rule is aimed at a different mischief to the rule of invalidity in that it focuses on deliberate "attempts to withdraw an asset on bankruptcy or

---

[39] *British Eagle International Airways Ltd v Cie National Air France* [1975] 1 WLR 758 (HL)

[40] Ibid, at [14].

[41] For example, contracts that provide for the transformation of unsecured debt to secured debt upon liquidation or an increase in security upon liquidation; contracts that confer a higher priority on a particular creditor; contracts that contain vesting clauses, such as a building contract that that provides for the vesting of the builder's materials in the building owner in the event of the builder's liquidation, see *Re Cosslett Contractors Ltd* [1998] Ch. 495.

[42] s 313(3) Companies Act provides that where before the commencement of a liquidation a creditor agrees to accept a lower priority in respect of a debt than that which it would otherwise have had under the Act, nothing prevents the agreement from having effect according to its terms.

[43] *Stotter v Ararimu Holdings Ltd (in statutory management)* [1994] 2 NZLR 655 at 8.

liquidation or administration, thereby reducing the value of the insolvency estate to the detriment of creditors".[44] The debtor must have a deliberate intention, assessed on objective grounds, to evade the insolvency laws[45] and thus the rule will only apply if the deprivation is triggered by the insolvency proceeding.[46]

The rule is not necessarily concerned with an unfair advantage being conferred upon a particular creditor, but rather attempts to diminish the asset pool available for creditors generally. Thus the policy behind the anti-deprivation rule is broadly evident in the fraudulent preference provisions such as transactions at undervalue and transactions with insiders, while the policy behind the rule of invalidity is evident in the voidable preference provisions. However, the enactment of these provisions has not displaced the application of either the anti-deprivation rule or the invalidity rule at common law, which are broader in scope and application than the avoidance provisions.

3. The statutory avoidance regime

The statutory avoidance regime is the primary mechanism for upholding the *pari passu* principle. The operation of the avoidance regime can be best explained by focusing on its three key components: the relation-back period, the avoidance test, and exceptions and defences available to creditors.

(a) The relation-back period

As established, the race of diligence prevails during solvency and it is not until liquidation that the *pari passu* principle takes hold. No problems would arise, and the avoidance provisions would be unnecessary, if insolvency and liquidation were contemporaneous. The race model would continue until the point of insolvency at which time equality would take over in the context of the collective proceeding. However, this convenient ordering of things does not exist in real life.[47] A company is generally insolvent for some time before formal liquidation commences and any

[44] *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2012] 1 AC 383 at [1].
[45] *The Football League Ltd,* above n 38, at [69].
[46] *Belmont Park Investments,* above n 44, at [14) and [80].
[47] Tabb, above n 5, at 989.

transaction entered into during this period violates the *pari passu* principle.

The existence of this transition period, known as the relation-back, creates the need for voidable preference law in order "to impose equality on [preliquidation] behavior so that that behavior will not make the principle of equality in [liquidation] distribution meaningless".[48] The avoidance provisions shift the point at which the *pari passu* principle "bites back" from the date of formal insolvency to the date of technical insolvency,[49] thereby retrospectively halting the race of diligence and helping to ensure that more than "mere tag ends and remnants" remain to be distributed on liquidation.[50]

The issue is how far back in time voidable preference law should reach to set aside preferences. A regime that upholds equality absolutely would set aside all payments from the moment of technical insolvency. However, it is difficult to retrospectively establish the precise moment that a company became insolvent. Thus the law uses a set cut-off point to estimate the length of the transition period and to provide greater commercial certainty in terms of the finality of transactions.

The Companies Act provides for two relation-back or "vulnerability periods": the specified period and the restricted period. The specified period is the period of two years prior to the date of commencement of the liquidation proceedings[51] while the restricted period is the period of six months prior to the date of commencement of the liquidation proceedings.[52] Thus any transactions entered into beyond two years from the date of commencement of liquidation are immune from challenge.

[48] McCoid, above n 11, at 260.
[49] Ministry of Economic Development), above n 7, at 54.
[50] C Seligson "Preferences Under the Bankruptcy Act" (1961) 15 Vanderbilt LR at 115.
[51] Section 192(5).
[52] Section 192(6).

(b) The avoidance test

Section 292(1) provides that a transaction is voidable by a liquidator if it was entered into in the specified period and is an insolvent transaction.[53] An insolvent transaction is defined in s 292(2) as a transaction by a company that:

> (a) is entered into at a time when the company is unable to pay its due debts; and
> (b) enables another person to receive more towards satisfaction of a debt owed by the company than the person would receive, or would be likely to receive, in the company's liquidation.

Unable to pay due debts

The liquidator may only void a transaction if it was made when the company was unable to pay its due debts.[54] As a concept this requirement is easy to express but the determination of the solvency of the company at a given point in time is a difficult task.[55] Parliament recognised this challenge and created a rebuttable presumption of insolvency during the restricted period in order to assist the liquidator. However, if the transaction falls within the specified period, the onus falls on the liquidator to establish insolvency.

---

[53] Section 292(3) provides an exhaustive definition of a transaction but given its width there does not appear to be any noteworthy limitations to its application. s 292(3): a transaction means any of the of the following steps by the company:

> (a) conveying or transferring the company's property;
> (b) creating a charge over the company's property;
> (c) incurring an obligation;
> (d) undergoing an execution process;
> (e) paying money (including paying money in accordance with a judgment or order of a Court);
> (f) anything done or omitted to be done for the purpose of entering into the transaction or giving effect to it; and
> (g) a transaction by a receiver, except a transaction that discharges, whether in part or in full, a liability for which the receiver is personally liable under s 32(1) of the Receiverships Act 1993 or otherwise personally liable under a contract entered into by the receiver.

[54] It should be noted that s 292 does not cover a situation where the company becomes insolvent immediately after entering into the transaction. This is in contrast with s 297 transactions at undervalue and s 293 voidable charges where the insolvency test is whether *immediately after* the charge is given or the transaction is made, the company is unable to pay its debts. Such a distinction can be justified on the basis that these provisions are aimed at depletions of the company's assets rather than creditor equality.

[55] Heath & Whale, above n 30, at [24.48]

In assessing the company's solvency, regard must be had to the company's financial position in its entirety, including the nature of the company's debts, its business, and the question of whether its assets are in a readily realisable form.[56] For the purposes of this dissertation, insolvency is presumed and the methods of establishing inability to pay due debts are not examined.

Enables another person to receive more towards satisfaction of a debt

This requirement is known as the "preferential effect" test and requires the liquidator to make a comparison between what the creditor actually received and what the creditor would have likely received in the liquidation had the payment not been made.[57] The liquidation in this context is the actual liquidation as opposed to a hypothetical liquidation occurring at the time of the transaction.[58] Further, the court need only satisfy itself that the transaction has given the creditor the means to

---

[56] *Rees v Bank of New South Wales* (1964) 111 CLR 210 at 218-219. Although not directly referred to in the avoidance provisions, the court may also have regard to the test of solvency provided in s4:
(1) For the purposes of this Act, a company satisfies the solvency test if—
    (a) The company is able to pay its debts as they become due in the normal course of business; and
    (b)The value of the company's assets is greater than the value of its liabilities, including contingent liabilities.
(2) Without limiting sections 52 and 55(3) of this Act, in determining for the purposes of this Act (other than sections 221 and 222 which relate to amalgamations) whether the value of a company's assets is greater than the value of its liabilities, including contingent liabilities, the directors—
    (a)Must have regard to—
        (i)The most recent financial statements of the company that comply with section 10 of the Financial Reporting Act 1993; and
        (ii)All other circumstances that the directors know or ought to know affect, or may affect, the value of the company's assets and the value of the company's liabilities, including its contingent liabilities:
    (b)May rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

[57] *Levin v Market Square Trust* [2007] NZCA 135. The Court of Appeal rejected previous judicial authority that the general body of creditors had to be worse off as a result of the transaction, see e.g., *National Bank of NZ v Coyle* (1999) 8 NZCLC 262,100 at 262. Such a proposition was based on the incorrect assumption that the avoidance regime operates to maximise the pool of assets available for distribution in liquidation. However, an inquiry of this nature is more appropriately directed at a transaction at under value, which is aimed at preventing a depletion of the company's asset base.

[58] A hypothetical liquidation would involve establishing the financial position of the company and the claims of its creditors at the time of the impugned transaction and thus subsequent events such as the accrual of preferential debts or new creditors are ignored. A hypothetical liquidation has been rejected, see *Porter Hire Ltd v Blanchett* HC Auckland CIV-2005-404-3056 1 June 2006 upheld in *Levin v Market Trust*, above n 58.

improve its position over that of other creditors, not that it will necessarily succeed in doing so.[59]

Procedure for setting aside an insolvent transaction

A liquidator who wishes to set aside a transaction that is voidable under s 292 must file a notice with the court and serve the notice as soon as practicable on the creditor.[60] The creditor then has twenty days in which to submit a counter-notice of objection, or the transaction is automatically set aside. The creditor's notice must contain full particulars of the reasons for objecting to the liquidator's notice and those reasons must be supported with evidence. If the creditor does object, the onus lies on the liquidator to commence proceedings to set the transaction aside.

Effect of an insolvent transaction

An insolvent transaction under s 292 is voidable by the liquidator, not void *ab initio*. The relief that the liquidator can obtain as a result of a breach of s 292 may vary, but the most appropriate order will generally be for the preferred creditor to pay or transfer money or assets to the company.[61]

---

[59] E.g. the assignment of a cause of action by the company has the effect of 'enabling' a creditor to improve its position and the liquidator is not required to prove what the outcome of the cause of action will actually be, see *Managh v Morrison* HC Napier CIV-009-441-522, 5 September 2011.

[60] See section 294 Appendix One. Both notices must satisfy the formalities set out in the section.

[61] s 295 If a transaction or charge is set aside under section 294, the Court may make one or more of the following orders:

> (a) an order that a person pay to the company an amount equal to some or all of the money that the company has paid under the transaction:
>
> (b) an order that a person transfer to the company property that the company has transferred under the transaction:
>
> (c) an order that a person pay to the company an amount that, in the Court's opinion, fairly represents some or all of the benefits that the person has received because of the transaction:
>
> (d) an order that a person transfer to the company property that, in the Court's opinion, fairly represents the application of either or both of the following:
>
> > (i) money that the company has paid under the transaction:
> >
> > (ii) proceeds of property that the company has transferred under the transaction:
>
> (e) an order releasing, in whole or in part, a charge given by the company:
>
> (f) an order requiring security to be given for the discharge of an order made under this section:
>
> (g) an order specifying the extent to which a person affected by the setting aside of a transaction or by an order made under this section is entitled to claim as a creditor in the liquidation.

The Act does not expressly state which parties should receive the benefit of any preference recoveries. The general position is that recoveries made by a liquidator are for the general body of creditors and not for the benefit of secured creditors.[62] However, where property is recovered by a liquidator that is subject to a specific charge in favour of the secured creditor, the property will again become subject to the prior charge and will not be available for distribution to the company's unsecured creditors. If however, the charge is non-specific, the property recovered by a liquidator is not subject to the charge.[63] This means that it is unlikely that a recovery by the liquidator will be available to a secured creditor with a General Security Agreement over all present and after acquired property of the company. Thus it is evident that the voidable preference provisions can have a significant impact on the dividend ultimately received by unsecured creditors.

(c) Defences to a voidable transaction

A transaction is prima facie voidable when it is established that it is an insolvent transaction that occurred within the specified period. However, recovery by the liquidator is prevented if a creditor can satisfy the elements of an alteration of position defence.[64]

The running account principle also operates as a kind of exception to the *pari passu* principle. Essentially, where there has been a series of transactions between the company and the creditor, the liquidator must only allege a preference if the overall effect of the series of transactions is to confer an advantage on a creditor.[65] The running account test is an element of a voidable transaction and thus a liquidator should only allege a preference in a running account context when there is a net

[62] Heath & Whale, above n 30, at [24.120]

[63] There has been some suggestion that this rule has changed following the 2006 amendments. The unamended s 295 provided that property recovered was payable or transferable to the *liquidator*, s 295 now states that the recovery is payable to the *company*. However, the Australian provision is worded the same as the current s 295 and the rule that a holder of a non-specific charge is prevented from benefitting from recovery applies, see *Tolcher v National Australia Bank Ltd* (2003) 174 FLR 251. Thus it is unlikely that Parliament intended to change the general rule.

[64] s 296(3). The defendant must establish it acted in good faith, did not have reasonable grounds for suspecting, and a reasonable person in the defendant's position would not have suspected, that the company was insolvent, and the defendant gave value for the property or altered their position in the reasonably held belief that the transfer was valid and would not be set aside.

[65] s 292(4B). See Appendix One.

advantage to the creditor. However, it is often the creditor who will seek to establish a running account in response to a notice by the liquidator seeking to set the transaction aside. The operation of the running account principle and the creditor defence are discussed in detail in the context of the 2006 reforms to the Companies Act.[66]

[66] See Chapter III B

Chapter II - Competing Policy Objectives

The previous chapter established that the voidable preference provisions exist to bolster the *pari passu* principle. Thus one would expect the rationale of creditor equality to underpin the voidable preference provisions. However, the legislative history demonstrates that the policy of equality has never been accepted as the sole objective at work. Two competing rationales can be identified, that of debtor deterrence and creditor deterrence, which have detracted from the primacy of creditor equality.

The debtor deterrence rationale was employed in the 1955 Companies Act and it is now widely accepted that this rationale was fundamentally flawed and in sharp conflict with the *pari passu* principle. However, the creditor deterrence rationale emerged in the 1993 Act through the ordinary course of business exception and it continues to compete with the creditor equality rationale in the current regime through the operation of the alteration of position defence. This chapter establishes that the creditor equality rationale, although not absolute, is paramount, and demonstrates that the policy reasoning behind the debtor and creditor deterrence rationales is both conceptually and practically unsound.

A. The Creditor Equality Rationale

Under the creditor equality rationale, the principle of *pari passu* in the refined sense described earlier is seen as underpinning an avoidance regime. The Privy Council in *Countrywide Banking Corp Ltd v Dean* recognised that:[67]

> "[T]he policy of voidable preference law is to secure the equal participation of creditors in such of the company's property as is available in the liquidation."

Like the *pari passu* principle, the creditor equality rationale can be upheld absolutely or in a qualified manner, through the creation of exceptions and defences. An absolute equality model creates a 'super rule' where all preferential transfers from the point of

---

[67] *Countrywide Banking Corp Ltd v Dean* [1998] 1 NZLR 385 (PC).

technical insolvency are set aside. Such a regime creates strict liability as the vulnerability of a transaction depends only on the factual assessment of whether a particular creditor received preferential treatment.[68] A super rule achieves maximum equality between unsecured creditors but is not necessarily desirable.[69] Firstly, a super rule does not allow for a running account principle, which is an extension of an effects-based test that is consistent with the creditor equality rationale.[70] Secondly, there is force in the argument that setting aside all preferential payments from the moment of technical insolvency would disturb the finality of transactions to an unjustifiable extent. Setting aside transactions that fall within a set period, rather than from the moment of insolvency, helps to uphold the policy of finality of transactions.

Although an absolute equality regime is not recommended, the *raison d'être* of preference law is protection of the legislatively entrenched policy of equal sharing and it should be formulated in the manner that best achieves that policy. However, the debtor deterrence rationale was the initial foundation for voidable preference law. The focus on the state of mind of the debtor represented a failure to shrug off the last of preference law's historical ties to fraudulent conveyances.[71]

B. The Debtor Deterrence Rationale

Under the debtor deterrence rationale, the objective of preference law is deterring debtors from setting themselves up as the lawmaker and judging the relative worthiness of creditors.[72] The intention of the debtor to confer a preference is the crucial element in defining a preference. The following statement from *Re Norris* explains the reasoning behind the rationale:[73]

---

[68] David Brown & Thomas G W Telfer "The New "Australasian" Voidable Preference Law: Plus Ça Change?" (2007) 13 NZBLQ 160 at 5.

[69] Parliament briefly considered enacting a super rule when it reformed the personal bankruptcy regime in 1967. The rule would have given the Official Assignee the power to void any preferential payments to creditors made within six months prior to adjudication. However, the Parliamentary Committee examining the proposal stated that such a reform was undesirable because such ''a power to upset payments made months ago could cause serious disruption to the business world.'' See New Zealand Parliamentary Debates 20 July 1967 at 2071.

[70] See Chapter III B for a discussion on the running account principle.

[71] Lawrence Ponoroff and Julie C Ashby "Desperate times and Desperate Measures: The troubled state of the ordinary course of business defence – and what to do about it" 72 WALR 5 at 6.

[72] Weisberg, above n 1, at 41.

[73] *Re Norris* [1997] 2 S.C.R 168 (Can) at [21].

…[the fraud lies in] the accompanying intent of the insolvent debtor who in the face of imminent bankruptcy is moved to prefer or favour, before losing control over his assets, a particular creditor over others who will have to wait for and accept as full payment their rateable share on distribution…

The debtor deterrence rationale is at odds with the *pari passu* principle as regardless of the state of mind of the debtor, a transaction that has the *effect* of preferring one creditor undermines the goal of creditor equality. However, the early avoidance regimes of most common wealth jurisdictions were based on a debtor intention test and the test has persisted in the English[74] and Canadian systems.[75]

The emphasis on the debtor's intention can be traced back to the beginnings of preference law in England where preference law developed as a branch of fraudulent conveyance law and a preference was thus viewed almost as a species of debtor fraud.[76] In the 1758 case of *Worseley v Demattos,* Lord Mansfield first explained the policy behind avoiding preferential payments:[77]

If a bankrupt may, just before he orders himself to be denied, convey all, to pay the debts of favourites; the worst and most dangerous priority would prevail, depending merely upon the unjust or corrupt partiality of the bankrupt.

In that case the debtor retained possession of his stock after giving a deed and thus committed fraud under the famous *Twyne's Case.* However, Lord Mansfield reasoned that even if possession had been given, a preference would still exist because it was an act performed in contemplation of bankruptcy. Thus preference law as a developed as a gloss on fraudulent conveyance law and a fraudulent intent on the part of the debtor was necessary in order to establish a preference.

[74] The English regime requires that the company, in giving the preference, must have been influenced by a desire to improve the position of the person preferred, see s 239(5) Insolvency Act 1986.

[75] E.g. Alberta Fraudulent Preferences Act*,* s. 2, Ontario Assignments and Preferences Act*,* s. 4(2) providing that the debtor must have intended an "unjust" preference".

[76] Charles Tabb "Panglossian Preference Paradigm?" (1997) 5 Am Bankr Inst L Rev 407 at 410.

[77] *(*1758) 97 ER 407 at 412. A decade later Lord Mansfield cemented this policy in *Alderson v Temple* (K.B. 1768) ER 384.

The avoidance regime in the Companies Act 1955 was based on the debtor deterrence rationale. In order to set aside a preferential payment the liquidator had to establish that the debtor made the payment "with the view…to giving a preference." [78] This required proof that the debtor had the "dominant intention to prefer a particular creditor" although "it need not be the only intention".[79] This presented a significant hurdle to the liquidator and the Court of Appeal in *Tyree Power Construction v DS Edmonds Electrical* stated "it has not often been thought worthwhile for the Official Assignee to invoke the section, whether in bankruptcy or in a company winding up".[80]

The fallacy of the debtor intention test was acknowledged in the 1988 Insolvency Law Reform and its repeal was recommended.[81] The Ministry of Economic Development (MED) acknowledged in the *Tier One Discussion Documents* that "any test that uses the debtor's intention to prefer one creditor as the basis for setting aside transactions is at odds with the primary objective of voidable preference law, which is to achieve equality between creditors." [82] The Companies Act 1993 abandoned the debtor deterrence model and the new legislation was a significant shift towards the creditor equality rationale. However, the reformers were unwilling to let go of the idea that there are some "vague, undefined transactions worth preserving". [83] Thus after a debtor intention inquiry had been rejected, it was a natural progression to then consider the creditor's state of mind under the creditor deterrence rationale.

C. The Creditor Deterrence Rationale

The creditor deterrence rationale emerges when the focus is on the race of diligence described earlier. [84] The argument is that, in the absence of preference law, those creditors who are aware of the debtor's insolvency, and thus the looming equal sharing regime, will seek to 'opt out' of the collective proceeding and race for the

---

[78] Section 309 Companies Act 1955.
[79] *Re Northridge Properties Ltd,* Supreme Court Auckland, M 46 - 49/75, 77/75 13 December 1977 at 36.
[80] *Tyree Power Construction Ltd v DS Edmonds Electrical Ltd* [1994] 2 NZLR 268 (CA) at 273.
[81] Law Reform Division, above n 6 at 94.
[82] Ministry of Economic Development, above n 7, at 58.
[83] Thomas G.W. Telfer "Voidable Preference Reform: A New Zealand Perspective on Shifting Standards and Goalposts" (2003) 12 Int Insolv. Rev 55 at 61.
[84] See Chapter I A.

debtor's assets in order to ensure payment in full.[85] However, if preference law reaches back to recapture preferential payments then creditors will be deterred from taking advantage of their superior knowledge and engaging in the race to dismember the debtor's assets. The avoidance provisions, in effect, remove the incentive of "first come, first served".[86]

Under the creditor deterrence rationale, the avoidance of preferences is further justified on the basis that a race of diligence upon insolvency is ultimately to the detriment of all creditors. Fisher J explained in *Re Modern Terrazzo* that if the race is left unchecked then the law "would encourage each creditor to try and steal a march on the others.... time and energy would be spent upon a communally unprofitable race to see which creditors would carry off the carrion first."[87] The race is communally unprofitable because it imposes high monitoring costs upon creditors who must ensure that they have adequate information to not only know when the race has begun but also to secure a head start.[88]

The creditor deterrence rationale focuses on the creditor's state of mind when receiving a preference.[89] Only those creditors who have knowledge of the debtor's insolvency are motivated to grab at the debtor's assets and must be deterred while unsuspecting creditors would have no reason to engage in the race to dismember.[90] Preference regimes based on the creditor deterrence rationale incorporate creditor knowledge as either an element of the cause of action or as a consideration in an exception or defence. Under the first approach, the liquidator must prove that the recipient creditor intended to receive a preference or knew that the debtor was insolvent.[91] Under the second approach, the preferential effect of the transaction may be established but the transaction is protected if the creditor can prove a lack of

---

[85] Anthony Duggan and Thomas G.W. Telfer, "Canadian Preference Law Reform" (2006-2007) 42 Tex Int'l LJ (forthcoming) at 664; Thomas H. Jackson *The Logic and Limits of Bankruptcy Law* (Harvard University Press, Cambridge, 1986) 126 at 124-125
[86] Keay, above n 15, at 75.
[87] [1998] 1 NZLR 160, at p 174
[88] Thomas H. Jackson "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain" (1982) 91 Yale U 857 at 857.
[89] Duggan and Telfer, above n 86, at 665.
[90] Tabb, above n 76, at 411.
[91] The United States adopted this approach and employed a test that asked, in part, whether the creditor had reasonable cause to believe the debtor was insolvent at the time of the transaction. This test survived until 1978 when it was abandoned in favour of an effects based test.

intention to receive a preference or, more typically, lack of knowledge of the debtor's financial circumstances.[92] New Zealand has followed the latter approach and the creditor deterrence rationale is evident in both the ordinary course of business exception under the 1992 Act and in the alteration of position defence after the 2006 reforms.

The Fallacy of Deterrence

If the creditor deterrence rationale is accepted as the correct foundation for voidable preference law, then the avoidance regime is an unqualified failure. There are overwhelming reasons why the provisions are not capable of achieving a deterrent effect. Firstly, there must be knowledge of the avoidance provisions in order for them to deter creditors. There is evidence to suggest that many creditors do not know the provisions exist, especially small creditors and non-lending institutions who are likely to be the unsecured creditors affected by the operation of the provisions.[93] Secondly, the deterrence effect presupposes knowledge of insolvency. Only those creditors who are aware of the debtor's financial position can know that the race of diligence has been superseded by the equal sharing regime and thus be deterred by the operation of the preference provisions. It is incorrect to assume that all creditors monitor the financial health of a debtor closely enough to know if insolvency has struck.

Assuming a creditor is aware of the provisions and the debtor's financial health, the deterrence rationale further supposes that a creditor will choose not to take the preference because they will be ultimately forced to disgorge it. In reality, there are numerous reasons why a creditor might be able to retain a preference. Firstly, there are often insufficient funds available to the liquidator to commence proceedings to recover all payments believed to be preferential. Alternatively, a creditor may believe that they have an alteration of position defence or they may determine that liquidation is unlikely to eventuate at all. If liquidation does commence, the payment could fall outside the restricted period and be less susceptible to challenge or it may escape the

[92] Tamara M. Buckwold, Uniform Law Conference of Canada *Reform of Fraudulent Conveyances and Fraudulent Preferences Law (Transactions and Undervalue and Preferential Transfers) Part II: Preferential Transfers* (2008) at 17.
[93] Keay, above n 15, citing Rin Nimmer "Security Interests in Bankruptcy: An Overview of Section 547 of the Code" (1980) 17 Houston LR 289 at 291.

specified period altogether. A calculating creditor aware of the details of the provisions might accept the payment and then assist the debtor to stay afloat just long enough to escape either relation-back period.[94]

Given these various intervening factors, a rational creditor will often judge that it is worth accepting the payment and running the risk that it might have to be returned. Even if the payment is found to be preferential, the worst that can happen is the creditor must return the payment. There is no penalty imposed and the creditor is no worse off for having accepted it. The biggest loss the creditor stands to face is potential legal costs.[95] The deterrent effect would undoubtedly be much greater if creditors were penalised for accepting preferences but preference payments are *prima facie* legitimate transactions. Generally neither the debtor nor the creditor has engaged in any dishonorable behaviour and thus penalties have no place in preference law.

The knowledge or belief that a debtor is sliding into insolvency is important only if the purpose of preference law is to deter the race. If the law is incapable of having such a deterrent effect, then the consideration of creditor knowledge in a voidable preference regime cannot be justified. Furthermore, the essential notion of the creditor deterrence rationale is that culpability somehow matters.[96] Those creditors with knowledge of the debtor's insolvency are treated as culpable while those without knowledge are protected. It is apparent that whether or not a preferred creditor was at fault in a moral sense bears no direct relationship to the overriding aim to uphold the principle of *pari passu* upon liquidation. Even if it is accepted that a creditor who has knowingly accepted a preference is guilty of some kind of morally culpable conduct, it is difficult to argue that an "innocent" creditor should be allowed to keep property received at the expense of others while a "guilty" creditor should not if the distinction does not produce any positive outcome in terms of deterrence.[97]

[94] Keay, above n 15, at 78.
[95] Ibid.
[96] Tabb, above n 5, at 990.
[97] Buckwold, above n 92, at 17.

Thus the fallacy of the deterrence is two-sided in that it simultaneously expects too much and too little from creditors.[98] It asks too much in the sense that it expects creditors to behave in ways that are economically irrational. The collective regime is mandatory precisely because creditors cannot be expected to voluntarily forego their individual enforcement rights. At the same time, the deterrence rationale asks too little to the extent that it excuses "innocent" parties who accept property of the debtor oblivious to the debtor's impending financial downfall.

Despite the overwhelming flaws of the creditor deterrence rationale, it has found its way into the Companies Act 1993 and the Companies Amendment Act 2006. The next chapter examines New Zealand's attempts to create an avoidance regime that upholds both the creditor equality rationale and the creditor deterrence rationale.

[98] L Ponoroff ''Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time'' [1993] Wisc L Rev 1439 at 1449.

Chapter III - The New Zealand Avoidance Regimes

New Zealand has made concerted efforts since 1993 towards the creation of an avoidance regime that is upholds the policy of creditor equality. However, these attempts have been consistently undermined by the inclusion of the creditor deterrence rationale, which assesses creditor culpability on the basis of knowledge or suspicion of insolvency.

The 1993 Companies Act represented a radical change in preference law as it abandoned the debtor intention test and demonstrated a new commitment to creditor equality. However, Parliament also introduced an exception for payments made in the "ordinary course of business." The explosion of litigation that ensued over the meaning of the phrase revealed that the 'good' and 'bad' preferences were being distinguished on the basis of the creditor deterrence rationale.

The Companies Amendment Act 2006 repealed the exception with the aim of creating a more certain regime. The amendments strengthened the policy of equality through the recognition of a running account test and it appeared that the creditor equality rationale would finally prevail. However, the alteration of position defence was also amended. The new defence explicitly recognises the creditor deterrence rationale by focusing on the creditor's knowledge of insolvency. Although the reforms aimed to enhance certainty, the new defence has resulted in the litigation of the same factors that were prominent under the ordinary course exception. Thus although the 2006 reform represented another shift towards creditor equality, it also revealed parliament's reluctance to abandon the notion of moral culpability.

A. The 1993 Companies Act: Towards Equality

1. An effects-based test

The 1993 Companies Act moved New Zealand to an effects-based avoidance regime, consistent with that of Australia.[99] The objective was to "remove the evidential

[99] s 588FE Corporations Act

difficulties associated with proving the state of mind of any party to the transaction and, more importantly, ensure that transactions are set aside on a basis that is consistent with the pari passu principle".[100] A transaction was now voidable if it had the effect of conferring a preference, regardless of whether the debtor intended such a result. The effects-based test was retained in the 2006 amendments and the elements and operation of the test has been detailed earlier.[101]

The effects-based test was referred to as a radical change that fundamentally altered the law of preferences.[102] In terms of the creditor equality rationale, this sea change in New Zealand's preference law provided a far superior regime to that which existed under the Companies Act 1955.[103] However, the preferential effect of a transaction alone was not accepted as sufficient grounds for avoidance. In the words of the Court of Appeal, Parliament must have thought it "unduly harsh to make a transaction voidable simply as a result of its preferential effect"[104] and therefore introduced an exception for transactions that take place in the "ordinary course of business".

2. The ordinary course of business exception

The unamended section 292(2) provided that an insolvent transaction was voidable "unless the transaction took place in the ordinary course of business". Transactions that occurred in the restricted period were assumed to have been entered into while the company was insolvent and otherwise than in the ordinary course. However, if the transaction occurred within the specified period the liquidator was required to establish it was outside the ordinary course of business.

The Law Commission did not provide any discussion on the inclusion of the exception in its *Company Law Reform and Restatement* report that formed the basis of the reforms. The incorporation of the exception was perhaps ill considered given that it was in 1993 that Australia abandoned the ordinary course of business as the key

[100] Ministry of Economic Development, above n 7, at 58.
[101] See Chapter I C 3
[102] M Ross ''Payments Made in the Ordinary Course of Business''(2000) 8 Insol LJ 157.
[103] M Conaglen ''Voidable Preferences under the Companies Act 1993'' [1996] NZ Law Rev 197 at 206.
[104] *Re Excel Freight Ltd (in liq)* [2001] 2 NZLR 541 (CA) at 546. This was so even though the 1993 Act retained the alteration of position defence from the 1955 Act in section 296(3).

exception to its voidable preference regime. As Fisher J commented, "one of us must have gotten it wrong" and with the benefit of hindsight, one may safely say that it was New Zealand.[105]

(a) Possible policy justifications

In absence of any further guidelines from Parliament, the courts were left to guess at the policy objectives of the exception in order to determine its meaning and scope. The major policy objectives suggested by the courts are encouraging the provision of credit and the continuation of trade, and preserving the finality of transactions. Although the importance of these objectives is not doubted, the ordinary course of business exception failed in its promotion of them.

(i) Encouraging the provision of credit to debtors

The argument was that if ordinary course payments were not protected, credit would be withheld and debtors would be forced into liquidation at a faster rate. A company's survival often depends on the ongoing supply of goods on credit and thus it is in the interests of all to have ordinary business routines continue up to the last minute. Creditors are incentivised to continue dealing with distressed debtors if ordinary transactions are protected and it is in the interests of the general body of creditors to assist a company to trade out of financial difficulty.[106] The ordinary course of business exception can therefore be seen as aimed at the wider objective of business survival.[107]

However, the same argument can be made in relation to preference law generally. If the law allowed debtors to prefer certain creditors on insolvency then creditors would as a general proposition begin to require more security before advancing credit. Where a debtor could not provide the requisite security, credit might not be given and so ordinary trade processes would be undermined.[108] Fisher J recognised this role of

[105] Fisher J in *Re Modern Terrazzo Ltd* [1998] 1 NZLR 160.
[106] Tabb, above n 5, at 1022.
[107] *Re Excel Freight Ltd (in liq)*, above n 103, at 546.
[108] Conaglen, above n 102, at 203.

preference law generally in *Re Modern Terrazzo Ltd (in liq)*:[109]

> "Exposing creditors to the risk that one of their number might be preferred would normally be contrary to the public interest since it would be a disincentive to the giving of credit and the free flow of trade…It would promote immediate enforcement by each creditor in circumstances where time to pay might otherwise secure the company's future, and hence full payment of all."

It is difficult to see how the ability to set aside preferences and the ability to protect them can be seen as encouraging the provision of credit. In either case, the incentive argument is flawed. There is serious doubt as to whether an exception within a voidable preference regime will have any effect on the behaviour of creditors given that most small businesses and even some large ones have no knowledge of this area of law.[110] A creditor's decision to extend credit will generally be based on their assessment of the likelihood of repayment, not on the possibility of insolvency and subsequent avoidance.[111] Further, even if the ordinary course of business exception could have an incentive effect, some commentators argue that the incentive may be of a perverse nature. The creditor who gets paid in the ordinary course need not co-operate further with the debtor because if the debtor goes into liquidation, the creditor can simply keep the payment and not extend any more creditor to the debtor.[112]

(ii) Finality of transactions

A second justification for the ordinary course exception is the need to uphold the finality of transactions.[113] The assumption is that rights acquired prior to liquidation should be left undisturbed. Tipping J in *Re Excel Freight Ltd (in liq)* stated that by enacting the ordinary course exception "parliament thereby intended a commercially unremarkable payment to stand, even if having preferential effect…otherwise the ordinary processes of commerce would be unduly undermined."[114]

---

[109] *Re Modern Terrazzo Ltd (in liq)*, above n 5, at 174.
[110] Ministry of Economic Development, above n 7, at 57.
[111] Tabb, above n 5, at 1022.
[112] Charles Tabb *The Law of Bankruptcy* (Foundation Press, New York, 1997) at 384.
[113] Brown & Telfer, above n 69, at 6.
[114] [2001] 2 NZLR 541 (CA) at 546.

Allowing ordinary commercial transactions to stand is arguably more economically efficient than avoidance because the litigation and administration costs associated with setting aside payments are minimised. Further, the ordinary course exception arguably minimises the uncertainty cost associated with preference law. Without such an exception, creditor recipients in the vulnerability period cannot be sure of the finality of a payment and thus their ability to use the payment or property is hindered. By excluding ordinary course transfers, this uncertainty cost is avoided by creditors who are viewed as having done nothing wrong.[115] However, given the huge interpretational issues surrounding the meaning of the exception, the exception could not have possibly formed the basis for business or credit planning decisions nor given any assurance of the certainty of a payment.[116] Thus the ordinary course safe harbour itself did not reduce any uncertainty cost nor promote the finality of transactions.

In saying that, the need to protect the finality of transactions is an important consideration that must be balanced against the desire for equality. If the policy of repose were to be given full weight, this would mean allowing all payments to stand and the abolition of preference law entirely. An intermediate position is to use a set vulnerability period as the law currently does. Prior to the vulnerability period, all payments are secure and thus the finality of transactions is preserved. Within the vulnerability period, there is no reason for the policy of creditor equality not to receive primacy.[117]

(b) The emergence of the creditor deterrence rationale

Section 292(4) provided that in determining whether a transaction took place in the ordinary course of business, no account was to be taken of any intent or purpose on the part of a company *except* if the creditor or other recipient knew of the company's intention. Thus if it could be established that the creditor knew that in accepting a payment it was receiving preferential treatment, the payment was outside the ordinary course. Establishing actual knowledge of preferential effect under section 292(4) was

[115] Tabb, above n 5, at 1027.
[116] D Brown ''Voidable Preferences on Liquidation - Steering the ''Ordinary Course of Business'' Test Back on Track'' (2001) 7 NZBLQ 97 at 100.
[117] Tabb, above n 5, at 1028.

a difficult task but the factors considered in the general litigation of the ordinary course exception demonstrated that suspicions of insolvency would distinguish between ordinary and extraordinary transactions.

Authority from the High Court either implicitly or explicitly supported such an inquiry.[118] Baragwanath J in *Re Anntastic Marketing Ltd* explicitly recognised the relevance of creditor knowledge and stated that the correct test was:[119]

> "whether the trader subjectively was, or objectively ought in the particular circumstance to have been, alerted to a real risk that the transaction was abnormal for reasons of financial weakness. Other forms of want of ordinariness do not bear on the mischief at which the provision is directed".

Baragawanath J explicitly recognised that the ordinary course exception aimed to treat those creditors who must have had knowledge of insolvency but nonetheless accepted a preference as culpable and undeserving of protection. However, a knowledge inquiry was rejected by the Court of Appeal in *Waikato Freight and Storage (1988) Ltd v Meltzer* on the basis that the creditor culpability line of reasoning "tends to draw attention away from the true inquiry which is whether, in its actual setting, the transaction was objectively 'abnormal'.'' [120]

Despite the Court of Appeal's ruling, the key considerations in an ordinary course inquiry were inextricably tied to a creditor's knowledge of insolvency. Factors that often signaled that a transaction was outside of the ordinary course were the use of post-dated cheques and late payments,[121] while payments in rounded sums have been referred to as a "hallmark" of a debtor in financial difficulty.[122] The existence of

---

[118] See *Re Excel Freight Ltd*, above n 103, at 827; *Re Daytone Industries Ltd (in liq)* HC Auckland, M13434/98, 27 November 1998.

[119] [1999] 1 NZLR 615, HC Auckland, judgment 9 September 1998. Baragawanath J affirmed the test in *Re Excel Freight*, above n 103, at 827. The test set down by Baragawanath J was taken from the Australian alteration of position defence that would later form the basis of New Zealand's defence after the 2006 Companies Act reform.

[120] *Waikato Freight and Storage (1988) Ltd v Meltzer* [2001] 2 NZLR 541 (CA) at 550.

[121] See Telfer above n 84, at 70 citing *Re Island Bay Masonry Ltd (in liq); Firth Industries Ltd v Gray &Anor* (1998) 8 NZCLC 261 at 751; *Meltzer v Attorney General* (1999) 8 NZCLC 261 at 958 (CA); *Re Daytone Industries Ltd (in liq)* HC Christchurch, CP 505/98, 17 May 1999.

[122] *Firth Industries Ltd v Gray &Traveller* (1998) 8 NZCLC 261 at 751, *Re Eastern Bay Forestry Contractors Ltd (in liq)* [2005] BCL 164.

pressure was also a factor that negated a finding of an ordinary course transfer.[123] Thus routine inquiries or requests for payments were often acceptable while threats of seizure or legal proceedings typically suggested that payment was outside of the ordinary course of business.[124] These factors all suggest that the creditor must have had knowledge or suspicions of insolvency and therefore the ordinary course exception sought to deter only those creditors who knowingly engaged in the dismemberment the debtor. The fallacy of the creditor deterrence rationale has already been established and thus any focus on the creditor's state of mind is unjustifiable.[125]

Further, even if the creditor deterrence rationale is accepted, creditor knowledge is a poor standard for setting apart good and bad preferences. In practice, the distinction between a liquidator's successful recovery of a payment and a creditor's successful defence of a preference claim is often marginal. For example, in *Meltzer v Origo (The Source) Ltd* the court considered that six payments amounting to $61,791.42 were made outside of the ordinary course of business.[126] The payments were a result of the pressure exerted on the company to make payments or face discontinuance of supply. Prior to the payments being made, there was a history of trading where credit was extended to the company over a considerable period of time, resulting in significant arrears. New credit terms and a personal guarantee were executed in order to secure continuing supply from Origo and reduce the debt. Despite the continuance of supply, one of the proposed policy objectives of the ordinary course exception, Origo was treated as culpable because of its extra vigilance in ensuring payment for that supply.

Conversely, in *Re Wienk Industries Ltd (in liquidation),* continuance of supply was found to negate knowledge or suspicion of insolvency despite strong evidence to the contrary.[127] A preferential payment for $55,747.82 was held to have been made in the ordinary course of business despite the fact that the creditor had actually been negotiating with the debtor for the sale of its business, which it was able to acquire for just $1.00. Further evidence in the form of a letter from the creditor's solicitors

[123] *Chatfield v Mercury Energy Ltd; Contaminated Enterprises Ltd (in Liq) v Mercury Energy Ltd* (1998) 8 NZCLC 261 at 645.
[124] Telfer, above n 84, at 69.
[125] See Chapter 2 C.
[126] High Court Auckland M1015/97, 7/12/1998,
[127] High Court Auckland CIV-2003-404-816 17 September 2004.

acknowledged their client's awareness of the debtor's financial difficulty. However, the payments were found to be in the ordinary course because the creditor continued to supply the debtor with product valued at more than $23,000 which the court held must have meant the creditor was unaware of insolvency.

The arbitrariness of the exception lead to the conclusion that "liquidators rightly take the view that the outcome in a particular case will depend entirely upon who is the sitting Judge."[128] The Law Commission in its 1989 report stated that the previous debtor intention test had lead "to the unsatisfactory situation where creditors may be treated differently according to the quirks of their circumstances. The purpose of a voidable transaction regime is to avoid this, yet the present law permits it".[129] The creditor knowledge inquiry under the ordinary course of business exception undoubtedly yielded the same result.

Despite the heavy litigation of the ordinary course exception, its meaning remained unclear. The Ministry of Economic Development in its 2001 report, recognised that the knowledge of the other party to the transaction was still a factor in establishing the voidability of a transaction and that the exception created an unacceptable amount of uncertainty. The ordinary course of business exception was repealed in the 2006 reforms but only to be replaced by another preference safe harbour that was similarly premised on the creditor deterrence rationale.

B. The Company Amendment Act 2006: Equality Achieved?

1. The running account principle

(a) Rationale and significance

The ordinary course of business exception was repealed and replaced with a running account test which provided a "principled and consistent basis for determining which

[128] M Ross, above n 103, at 173.
[129] New Zealand Law Commission, *Company Law Reform and Restatement,* NZLC Report 9 (1989) at [649].

transactions should be set aside".[130] Prior to the 2006 amendment, a liquidator had to establish that individual transactions had the effect of giving the creditor more (and thereby other unsecured creditors less) than they would receive on liquidation. No account was taken of other recent transactions between the creditor and the company.[131]

Given that the Companies Act 1993 had moved to an effects-based test, then arguably where there is a series of transactions between the debtor and creditor, one should look to the *net effect* of those dealings over the period of vulnerability. If the net effect is that the creditor continued to supply goods and services whose total value exceeds or is equal to the value of payments the creditor has received in that period, then the creditor cannot be said to have received an advantage over other creditors. It is only when one of the payments is viewed in isolation that it can be said to be a preference. Parliament accepted that the running account principle was consistent with the effects-based test and that it would promote the continuation of supply on a credit basis to financially distressed debtors without having to rely on a broad standard such as the ordinary course of business exception.

The running account principle, like the statutory set-off regime, fits well with the notion that what matters in preference analysis is the aggregate impact of the transfer on the estate. A simple example may illustrate the significance of the principle in practice. Suppose that when a company became insolvent it owes its supplier $30,000. The supplier is aware that the company has liquidity problems but agrees to continue to supply goods to a value of $10,000 per month so long as $10,000 payment is received the start of the following month. Assume that this pattern continues for the next six months and at the end of that period, a liquidator is appointed. In the absence of a running account principle, each of the six $10,000 payments would be vulnerable to attack as voidable preferences. This is so despite the fact that the total amount of debt outstanding at $30,000 remains unchanged at the time of liquidation. The commercial reality is that while the company's assets have been depleted by $60,000 in payments, the assets have also been enlarged by $60,000 worth of supply. Therefore there is no net reduction in the debt owed to the supplier or a net reduction

[130] Ministry of Economic Development, above n 7, at 59.
[131] Brown & Telfer, above n 69, at 13.

in the debtor's estate. In such circumstances, it would appear wrong to avoid the payments made to the supplier simply because they can be viewed as extinguishing an antecedent debt.

(b) The statutory running account test

The New Zealand running account test in section 292(4B) is taken from section 588FA(3) of the Australian Corporations Act 2001.[132] The essential elements of the section are:[133]

a) There is has to be a "continuing business relationship" between the creditor and the insolvent company, a running account being the primary example; and
b) There has to be a "series of transactions" that results in increases and reductions of the company debtor's indebtedness to the creditor from time to time; and
c) If the factors in (a) and (b) are both present, the series of transactions will be notionally regarded as a single transaction, and will only be voidable (subject to the other elements and defences) by the liquidator, if that single transaction has preferential effect.

---

[132] Section 292(4B) provides 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 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 insolvent transaction voidable by the liquidator if the effect of applying subsection (1) in accordance with paragraph (c) is that the single transaction referred to in paragraph (c) is taken to be an insolvent transaction voidable by the liquidator.

[133] Brown & Telfer, above n 69, at 14.

(c) The "continuing business relationship" or "running account"

The term 'continuing business relationship' is not defined other than to give a 'running account' as an example, which is also undefined. The Australian High Court in *Air Australian Services v Ferrier* acknowledged the "almost talismanic significance" that had attached to the phrase 'running account' but stated that it really required no more than an "active account running from day to day" as opposed to an account where no further debits are contemplated.[134]

In *Sutherland v Eurolinx* Santow J identified the essential characteristics of a running account or continued business relationship.[135] He held that must be a mutual and ongoing assumption between the company and the creditor of payment and reciprocal supply throughout the relevant period. The assumption need not be explicit in the sense that the parties do not need to have expressly agreed that their credit arrangement was to operate as a "running account". Further, the payments must continue to have as at least one operative, mutual purpose, namely the purpose of inducing further supply. Such purpose must not become subordinated to a predominant purpose of recovering past indebtedness.

Santow J went on to explain that actual suspicion of insolvency, though coupled with a purpose of getting a previous account paid, does not of itself preclude the running account or continuing business relationship defence provided there still remains at least a substantive mutual purpose of continued supply.[136] However, where the debtor is known to be in financial difficulty, the creditor, by demanding payment, may signal that that this has now become its predominant purpose.[137]

---

[134] (1996) 185 CLR 483; 14 ACLC 1403, at p 504; p 1416.
[135] *Sutherland v Eurolinx* (2001) 37 ACSR 477 at [148].
[136] Ibid, at [167]
[137] Ibid.

This means that a finding of suspicion of insolvency under an alteration of position defence may also bring a continuing business relationship to an end. This was the outcome in the recent case of *Blanchett v McEntee Hire Holdings Ltd*.[138] The crucial factor was that the creditor had issued a Stop Credit Notice to the company stating that credit would no longer be extended if debts were not recovered. The court did not accept the creditor's argument that this was part of the creditor's usual credit control processes and a way of preserving the trade relationship. Instead, it established that the creditor, or a reasonable person in the creditor's position, would have had suspicions of insolvency. This meant that the creditor was denied the protection of the defence and also that the continuing business relationship came to an end at the time the notice was issued. Payments made after that point were excluded from the running account test despite the continuation of supply.

The result in *McEntee* is inconsistent with the "ultimate effect" objective of the running account test. Suspicion of insolvency is irrelevant to the net economic impact on the debtor's estate. Despite the fact McEntee may have had suspicions of insolvency, it continued to supply the debtor. The net effect of the series of transactions was that the creditor received a much smaller preference than it otherwise would have had the transactions been considered in isolation.

These difficulties with establishing a running account or continuing business relationship were recognised by the MED in the *Tier One Discussion Documents.* The MED stated that a test based on the Australian approach would require an examination of the parties' state of mind with all the evidential difficulties associated with proving motive or knowledge.[139] Such an approach was to be avoided after the previous difficulties with the ordinary course exception. The MED recommended that a running account principle based on the United States approach, rather than the Australian provision, be adopted. However, the United States approach also presents difficulties that were not addressed in the MED's recommendations.

[138] [2011] NZCCLR 4 (HC).
[139] Ministry of Economic Development, above n 7, at 63.

(d) The United States "subsequent new value" exception

The United States uses a 'subsequent new value' exception which does not depend on establishing a running account or a continuing business relationship.[140] Thus the test avoids any examination of the purpose of payment and the intentions of the parties.

However, the United States approach is not a pure net effect rule. The exception only permits new value to the debtor that postdates the preferential payment to be offset against the preference. This means that if a preferential payment is made after the new value has been provided, that payment cannot be netted against previous supply and is instead vulnerable to avoidance. A pure net effect rule would permit a creditor to offset all advances made during the vulnerability period against the payments received.[141] The availability of the exception rests on the timing of the transfers and the advances, not on the economic impact of the series of transactions. Two sets of transactions with exactly the same economic effect are treated differently, due merely to a fortuity of dates.[142]

Thus although the effectiveness of the New Zealand running account principle is limited by the factual assessment required to establish a continuing business relationship, the United States approach does not present a faultless alternative. Under the New Zealand test, where a continuing business relationship is in place, all transactions can be off-set regardless of timing. However, suspicions of insolvency may affect when the continuing business relationship ceases. The best way to address that concern is to amend the current running account test, rather than adopt the United States approach.

---

[140] Section 547(c)(4) of the Bankruptcy Code provides that the trustee may not avoid under the section a transfer to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—

> (A) not secured by an otherwise unavoidable security interest; and
> (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;

[141] Ponoroff, above n 97, at 1449.

[142] Michael J Herbert " The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) & (4) of the Bankruptcy Cod" 17 U Rich L Rev 667 at 676

(e) The peak indebtedness rule

The advantage afforded to creditors through the running account principle is further undermined by what is known as the 'peak indebtedness' rule. Section 292(4B) states that the liquidator must treat all the transactions as if they form a single notional transaction and only allege a preference if that single transaction confers a net advantage on the creditor. However, the section is silent as to when the running account begins and ends and thus it is unclear which transactions must be considered in a series.

Australian and New Zealand courts have held that the liquidator is able to choose the commencement and termination points for the period in which the transactions will be netted out.[143] Accordingly, a liquidator is entitled to choose the period of peak indebtedness; that is, the starting date and end date, if not the date of liquidation, that will result in the greatest preference being shown to haven been conferred on the creditor. The peak indebtedness rule effectively allows the liquidator to "cherry-pick" which transactions should be subject to the test and make possible largest recovery.[144]

The peak indebtedness rule was accepted in New Zealand in the aforementioned case of *McEntee*.[145] The liquidators challenged five payments made by the liquidated company to McEntee between 31 January 2008 and 12 June 2008. McEntee argued that the liquidators should have taken the running account as beginning on the date of the commencement of the voidable period. On this analysis, the net reduction of the company's indebtedness to McEntee, and thus the net preference, was $6,720.68. However, as previously established, the court found that the continuing business relationship between the company and McEntee had ended on 9 January 2008 when

[143] *Rothmans Exports Pty Ltd v Mistmorn Pty Ltd* (1994) 15 ACSR 139; 12 ACLC 936; *Olifent v Australian Wine Industries Pty Ltd* (1996) 19 ACSR 285; 14 ACLC 510. The rule was accepted in New Zealand in *Blanchett v McEntee Hire Holdings Ltd*, above n 38.
[144] Telfer & Brown, at 15.
[145] At 38.

McEntee issued a 'Stop Credit Notice' against the company. This meant that all the payments made after this date were preferences and approximately $21,384.35 was to be returned to liquidator. The court held, in the alternative, that if its finding was wrong and the relationship had continued up to the date of the liquidation, the liquidators were able to choose 9 January 2008 as the date from which the running account began. This would have resulted in a voidable amount of $18,124.12, being the net effect of the transactions between 9 January 2008 and the date the liquidation application was filed.

McEntee demonstrates the significant impact the peak indebtedness rule has on creditors. The ability of the liquidator to choose any starting date undermines the "ultimate effect" premise as it allows the liquidator to arbitrarily disregard the value of goods or services supplied after the commencement of the specified period but before the chosen start date of the continued business relationship.[146] As part of the recommendations for reform, it is suggested that the running account principle be amended to prevent the operation of the peak indebtedness rule and to overcome the evidential difficulties associated with proving the predominant purpose of payment.

These difficulties aside, the running account principle is a significant improvement on the ordinary course of business exception and its introduction upheld the policy of creditor equality. However, the alteration of position defence represents the last signification erosion to the creditor equality objective. This defence was not only maintained in the 2006 reforms but was also amended to reflect the creditor deterrence rationale.

2. *The alteration of position defence*

The avoidance regime as it currently stands promotes the creditor equality rationale through the effects-based test and the running account principle, but shifts to a culpability and deterrence focus in the alteration of position defence.[147]

---

[146] H Bolitho, Continuing Business Relationships — Eight Questions in Search of an Answer (1998) 16 Company and Securities Law Journal 581 at 599.
[147] Brown & Telfer, above n 69, at 7; Murray Tingey, Dean Elliott and Nick Moffatt in *Heath and Whale*, above n 30, at [24.1]

The amended section 296(3), identical to section 588FG(2) of the Australian Corporations Act, provides that:

> "A court must not order the recovery of property of a company (or its equivalent value) by a liquidator, whether under this Act, any other enactment, or in law or in equity, if the person from whom recovery is sought (A) proves that when A received the property--
>
> > "(a) A acted in good faith; and
> >
> > "(b) A reasonable person in A's position would not have suspected, and A did not have reasonable grounds for suspecting, that the company was, or would become, insolvent; and
> >
> > "(c) A gave value for the property or altered A's position in the reasonably held belief that the transfer of the property to A was valid and would not be set aside."

The alteration of position defence in section 296(3) applies to all claims by a liquidator to recover property under the Act, in equity or common law or otherwise.[148] The focus here is on the availability of the defence in relation to recipients of voidable preferences.

(a) Justifications for the defence

(i) Creditor deterrence

The creditor deterrence rationale is introduced through the new two-limbed test of suspicion in section 296(3)(b) which assesses the suspicions of the creditor on both objective and subjective grounds. Regardless of whether a creditor is able to establish alteration of position and good faith,[149] a creditor who had suspicions of insolvency is denied the protection of the defence because that creditor has knowingly engaged in

[148] Note that recovery is also precluded where a person who is not a party to the transaction with the company acquires title or interest in property as a bona fide purchaser for value without notice of the circumstances under which the property was acquired from the company, or the circumstances relating to the giving of the charge. The availability of this defence is not questioned.

[149] Alteration of position requires some detrimental conduct that, but for the payment or transaction, would not have occurred; see *Re Bee Jay Builders Ltd* [1991] 3 NZLR 560. Value requires new value be given at the time of the impugned transaction. This means that previous extension of credit will not be considered valuable consideration.

the dismemberment of the debtor and attempted to opt-out of the collective regime. Presumably, a creditor with suspicions of insolvency should have known not to alter their position in reliance on the payment.

The fallacy of the deterrence rationale has been detailed earlier but the flawed reasoning is particularly evident in relation to the alteration of position defence.[150] A creditor is only protected by the defence if it can establish it had no reasonable grounds for suspecting insolvency, thus the creditor is motivated not to monitor the financial position of the debtor in order to avoid to any accusation it had knowledge of insolvency. If there is no suspicion of insolvency because the debtor chooses not to monitor, there is no awareness on the part of the creditor that they are involved in the dismembering process and hence no deterrence.[151] Thus the defence itself undermines the deterrent effect it aims to achieve.

Furthermore, the unstated premise of alteration of position defence is that culpability matters and that innocence should therefore be rewarded.[152] The creditor's knowledge of the debtor's insolvency, or lack thereof, does little to comfort other creditors similarly situated who will receive that much less from the liquidation as a result of the preferential transfer.[153] As was stated in the United States Cork Report "to argue that…creditors should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality amongst creditors."[154]

One may also question whether even a supposedly innocent creditor is really so innocent, or whether in most cases the liquidator is simply unable to prove that opt-out behaviour is nevertheless taking place.[155] Even then, a suspicious creditor is often no more blameworthy than an unknowing one. If a creditor can be shown to have had actual suspicions of insolvency, it will not be protected by the defence even if it did not engage in a 'scramble' for the debtor's assets but was merely paid fortuitously.[156]

---

[150] See Chapter II C
[151] Andrew Keay *Avoidance Provisions in Insolvency Law* (Law Book Company, Sydney, 1997) at 53.
[152] Tabb, above n 5, at 992.
[153] A Keay ''Liquidators Avoidance of Preferences: Issues of Concern and a Proposal for Radical Reform'' (1996) 18 Adel L Rev 160 at 185.
[154] H.R. Rep. No. 595 at 178 (1977).
[155] Tabb, above n 5, at 992.
[156] Keay, above n 155, at 187.

A creditor in these circumstances appears no more culpable than a creditor who had no suspicions of insolvency and could thus rely on the defence.

Furthermore, the reasonable suspicion test has resulted in litigation around similar facts to those raised under the "ordinary course of business" standard. The question is whether, in the circumstances of the trading relationship and the knowledge of the creditor at the time (rather than with hindsight), the cumulative factors present would have been grounds for suspicion of insolvency.[157] Factors that have been relevant to the test include post-dated and dishonoured cheques, late payments, and demands for payment by the creditor.[158] These indicators were also prominent under the "ordinary course of business" cases.

The main goal of the repeal of the ordinary course of business was to remove uncertainties and inconsistencies. At the time of the reforms, it was stated that "it would be ironic if New Zealand were to jettison nearly eight years of jurisprudence on the ordinary course of business if only to replace it with a new source of litigation". However, the two-limbed test of suspicion involves the examination of the same issues only with different terminology and in the form of a defence, rather than an element of the cause of action.[159]

(ii) Individual justice

The MED in the *Tier One Discussion Documents* justified the alteration of position defence on the basis that the pursuit of collective justice for creditors as a whole must be tempered by individual justice for particular creditors in the circumstances of each case.

The concern is that without a creditor defence, there would be no flexibility to deny recovery in circumstances where forcing a creditor to return a preferential payment may be unjustifiability harsh on that creditor. Such an occasion would be rare as generally creditors have altered their position through the continuation of supply and

[157] Brown & Telfer, above n 69, at 10.
[158] Ibid.
[159] Ibid at 11.

are thus protected by the operation of the running account principle. Furthermore, as established in the previous section, the line between a successful and an unsuccessful defence is often marginal. Those creditors who are protected by the defence are not necessarily any more deserving than those creditors who are denied protection due to the arbitrary operation of the reasonable suspicion test.

Nonetheless a risk remains that without a creditor defence there is no opportunity to promote individual justice where the circumstances require it. However, it is important to remember that the legislation exists to protect creditors collectively. Potential harm to an individual creditor cannot justify the erosion to policy creditor equality by allowing certain creditors to retain preferential payments. This idea was put succinctly by Baragawanath J in *Re Anntastic Marketing Ltd:*[160]

> "It is to be remembered that the unfortunates who did not get paid are faceless, represented only by the liquidator. The inevitable sympathy for honest claimants who, having had the misfortune to deal with an insolvent now face the prospect of having to repay the money received from it long after the event, must not affect the judgment whether those who were never paid at all are entitled to equality of treatment".

The fact is that if the aim of the avoidance provisions is to ensure that there is equality between creditors, then any preference which causes the debtor's assets to be dissipated jeopardises that aim, regardless of whether the creditor can establish alteration of position or lack of knowledge of insolvency.[161] If preference law is to uphold the fundamental principle of creditor equality and allow for a true *pari passu* distribution, and reduce the level of uncertainty and litigation surrounding voidable preference law, the alteration of position defence cannot be justified. The true nature of preference law is akin to strict liability and thus any attempt at distinguishing between 'innocent' and 'guilty' creditors on the basis of knowledge is misplaced.

---

[160] *Re Anntastic Marketing Ltd,* above n 119.
[161] Keay, above n 155, at 177.

Chapter IV - Recommendations for Reform

The 2006 amendments to the voidable preference provisions meant that New Zealand came very close to achieving a regime that upholds the fundamental rationale of creditor equality. However, the current regime could work better than it currently does both in terms of ease of application and faithfulness to the underlying goal of a *pari passu* distribution. Firstly, the alteration of position defence is an unjustifiable erosion of the objective of creditor equality and it should be repealed in relation to voidable preferences.

However, an absolute equality regime is not recommended. There are two valid competing policy objectives that should be given weight within a voidable preference regime; the finality of transactions and the facilitation of credit to financially distressed debtors. The policy of preserving the finality of transactions can be effectively upheld by a shorter, single relation-back period. The current specified period of two years is excessively long and would upset the finality of transactions to an unjustifiable extent within the stricter regime proposed.

The policy of encouraging the provision of credit is encouraged through the existing running account principle. The running account test should be amended so that its operation is consistent with "ultimate effect" premise and to create greater certainty for creditors. These recommendations are consistent with policy of equality and also reduce concerns that the repeal of the alteration of position defence will be unjustifiably harsh to individual creditors. The implementation of these three recommendations would allow preference law to serve its fundamental purpose of bolstering the *pari passu* principle.

A. Repeal Section 296(3) for Voidable Preferences

Section 296(3) applies to any recovery made by a liquidator under the Companies Act 1993. The defence should only be repealed in relation to voidable transactions. This requires section 296(3) to be amended to state that the defence is not available in relation to any order made under section 295.

Repeal of the defence will result in an avoidance regime that is strict liability in nature. Avoidance will depend only on the liquidator establishing that the transaction occurred within the specified period and was of preferential effect. In the case of a running account or continuing business relationship, the liquidator may only allege a preference if ultimate effect of the dealings is to confer a net advantage on the creditor. It will still be open to a creditor to establish a running account or continuing business relationship where the liquidator has not done so or to prove that the company was solvent at the time of the transaction.

B. Shorten the Vulnerability Period

As previously established, the policy of finality of transactions is upheld through the use of a relation-back period as opposed to setting aside all transactions from the moment of technical insolvency. A set vulnerability period allows for greater certainty and prevents a costly factual inquiry in every case.

The cut-off point for any vulnerability period will always be arbitrary. However, the policy of repose is served by a defined preference period and the need for commercial certainty dictates that the period be a relatively short one.[162] In 2001 the MED recommended that there should be a single vulnerability period, as opposed to a restricted and a specified period, of six months from the date of commencement of liquidation.[163] I support the MED's prior proposal for a single, shorter vulnerability period. A single period that coincides with the presumption of insolvency is simpler and more certain.

However, I recommend that the vulnerability period for voidable transactions be three months from the date of commencement of liquidation. The MED proposed a six month vulnerability period on the basis that the alteration of position defence would still be available to creditors. Australia uses a six month relation-back period but also has the alteration of position defence.[164] The proposal for a stricter regime calls for a

[162] Ponoroff, above n 97, at 1516
[163] Ministry, above n 7, at 65.
[164] Section 588FE Corporations Act

shorter time period. A three month period would be consistent with the 90 day vulnerability period employed in United States regime which is also more akin to strict liability.[165] The current specified period of two years is excessively long and although there is limited empirical evidence in relation to New Zealand companies, it is unlikely to match the period of technical insolvency before liquidation commences.[166]

Presumption as to Insolvency

The presumption that the company was unable to pay its debts during the specified period should remain. It is very difficult for a liquidator to retrospectively establish insolvency, especially as there are often limited funds to challenge preferences. The presumption of insolvency considerably assists the liquidator in commencing proceedings when a creditor objects to a notice setting aside a preferential transfer.

In saying that, it is even more difficult for a creditor to prove solvency in the specified period given that creditors, unlike the liquidator, do not have easy access to the company's financial records. Thus the presumption of insolvency could theorectically lead to some transfers being avoided when the company is actually solvent but the creditor is unable to establish this.

However, this risk is outweighed by the advantage to creditors generally from the presumption of insolvency. If the liquidator was required to prove insolvency in the specified period, costs would be significantly increased as a court case would generally always be required to establish insolvency. This increase in costs would reduce the pool of funds available to unsecured creditors.[167] Furthermore, the risk that the company was actually solvent in the three months prior to liquidation is relatively

[165] s 547 Bankruptcy Code. Note, however, that the United States uses two relation-back periods, one is a one month period with no defences whatsoever and the other is a three month period where various exceptions are available.
[166] United States research has shown that companies are generally insolvent for the period of 90 days before liquidation has commenced, see the Harmer Report, above n 26, at [639]; Elizabeth A. Orelup, "Avoidance of Preferential Transfers Under the Bankruptcy Reform Act 1978" (1979) 65 *Iowa L Rev* 209 at 217.
[167] David Brown *Voidable Transactions - A Report for the Ministry of Commerce,* (Wellington, 1999) at 79.

low. The shorter vulnerability period is more likely to reflect the length of a de facto 'cash flow' insolvency prior to formal insolveny.[168]

The presumption should remain rebuttable by the creditor. If the company was solvent at the time of the transaction then the creditor is entitled to keep the preference because at that point in time the race of diligence is still permitted and the principle of *pari passu* is yet to take hold. Thus it should remain open to the creditor to establish solvency if it has grounds to do so.

C. Amend the Running Account Principle

The running account principle has been identified as a principled extension of the effects-based test. However, two problems currently undermine the efficacy of test. Firstly, issues arise concerning the relationship between the alteration of position defence and the assertion of a continuing business relationship. Secondly, the operation of peak indebtedness rule is unfairly prejudicial to creditors.

If a creditor is found to have a reasonable suspicion of insolvency and is thus precluded from relying on the alteration of position defence, such a finding may also bring the continuing business relationship to an end. This means that payments and advances made after that point cannot be included in the series of transactions to be netted out.

The policy justification for the running account principle is that insolvency law generally is concerned with the net economic impact of the dealings between a creditor and a debtor. The knowledge or intentions of the parties is irrelevant to that assessment. The counter argument is that if purpose is treated as irrelevant then the running account principle may encourage collusion between a debtor and creditor.[169] As liquidation draws near, the creditor may have an 'unused balance' of value and thus the company and the creditor may arrange for the company to make payment to the creditor in an amount equal to the un-used balance, thus ensuring that no net

[168] Brown, at 79.
[169] W Stacy Jr Johnson "The Running-Account Creditor and Section 547(c)(4) of the New Bankruptcy Code" 16 Wake Forest L Rev. 962 (1980) at 973; Ponoroff, above n 97, at 1475.

preference is created but a payment has been made that did not have the continuation of supply as its predominant purpose. It is submitted that regardless of whether the parties had such an intention, the net economic impact on the company's assets remains unchanged by the purpose of the payment.[170] Thus suspicions of insolvency should not prevent the running account principle from operating. If the alteration of position defence was to be repealed, then this problem may be minimised. However, the common law on the running account principle still requires a predominant purpose of payment to be established and thus suspicion of insolvency would remain relevant.

The second concern is the operation of the peak indebtedness rule. This rule allows a liquidator to choose when the continuing business relationship begins and thus select the period of peak indebtedness. Such a rule permits the liquidator to ignore the true economic impact of a series of transaction and ignore the value of full supply advanced during the specified period.

These two issues could be addressed by amending section 292(4B) to specify which transactions must be considered as a part of a continuing business relationship. The transactions to be netted out would be those that occurred between the date of the commencement of the specified period and the date of commencement of the liquidation. This would allow for a true assessment of the net economic impact of the mutual dealings between a creditor and the company during the vulnerability period. Furthermore, this strengthening of the running account test would offer greater protection to those creditors who continue to deal with a financially distressed debtor. Thus amending the running account would achieve the dual goals of ensuring substantial equality among similarly position creditors while still promoting the continuation of trade with a distressed debtor.

[170] Ponoroff, above n 97, at 1466.

Conclusion

New Zealand's voidable preference law has been gradually shifting towards recognition that creditor equality is its fundamental objective. Preference law shook off its antiquated morality notion when it abandoned the debtor's state of mind as the key element of a preference in the Companies Act 1993. However, Parliament was reluctant to fully embrace the equality principle and thus shifted the focus to the creditor's culpability in receiving a preference through the ordinary course of business exception and the alteration position defence.

There is an inherent desirability in identifying an element of culpability in preference law, as it is always easier to punish certain behaviour rather than set preferences aside on the basis of the principle of equality. Parliament is reluctant to enact a regime that fully embraces the equality rationale for fears that such a regime would appear too inflexible and be rejected by creditors. The notion of equality in the abstract is always very appealing to creditors when they face the possibility of non-payment, however, as soon as a preferential payment is received creditors are only interested in ensuring that the equality principle is not used against them.[171] Thus Parliament sought to create a distinction between 'innocent' and 'guilty' creditors on the basis of their knowledge of insolvency in the Companies Amendment Act 2006.

This attempt to treat one creditor as more culpable than another ignores the fact that preferences are entirely legitimate transactions outside of insolvency and only become illegitimate by the retrospective operation of voidable preference law. If liquidation occurred at the same time as technical insolvency, the voidable preference provisions would be entirely redundant. However, the lag time between insolvency and liquidation creates the need for voidable preference law to impose equality on pre-liquidation behaviour. This is the primary objective of preference law and the culpability or knowledge of a creditor has no relevance to that aim.

[171] Telfer, above n 84, at 57.

The true nature of voidable preference law is akin to strict liability. However, an absolute, automatic avoidance regime is not suggested. The running account principle is based on the sound premise that insolvency law is concerned with the net effect of the dealings between a creditor and debtor and thus some preferential payments should be allowed to stand. Furthermore, a short vulnerability period prevents undue disturbance of settled transactions. However, the erosion to creditor equality through the alteration of position defence cannot be justified. Repeal of the defence would uphold the equality rationale, reduce litigation and allow for greater preference recovery for the benefit of collective body of unsecured creditors. The implementation of these recommendations would create a regime that finally operates to give unsecured creditors a real chance at a *pari passu* distribution.

Bibliography

Primary Sources

Cases

New Zealand

Blanchett v McEntee Hire Holdings Ltd [2011] NZCCLR 4 (HC).

Chatfield v Mercury Energy Ltd; Contaminated Enterprises Ltd (in Liq) v Mercury Energy Ltd (1998) 8 NZCLC 261

Countrywide Banking Corp Ltd v Dean [1998] 1 NZLR 385 (PC).

Finnigan v He [2010] 2 NZLR 668

Firth Industries Ltd v Gray &Traveller (1998) 8 NZCLC 261

Levin v Market Square Trust [2007] NZCA 135

Meltzer v Origo (The Source) Ltd High Court Auckland, M1015/97, 7/12/1998

National Bank of NZ v Coyle (1999) 8 NZCLC 262,100

Porter Hire Ltd v Blanchett HC Auckland, CIV-2005-404-3056, 1 June 2006

Re Anntastic Marketing Ltd (in liq) [1999] 1 NZLR 615s

Re Daytone Industries Ltd (in liq) HC Auckland, M13434/98, 27 November 1998

Re Excel Freight Ltd (in liq) [2001] 2 NZLR 541 (CA)

Re Modern Terrazzo Ltd [1998] 1 NZLR 160

Re Northridge Properties Ltd Supreme Court Auckland, M 46 - 49/75, 77/75 13 December 1977

Re Wienk Industries Ltd (in liquidation) High Court Auckland, CIV-2003-404-816 17 September 2004.

Stotter v Ararimu Holdings Ltd (in statutory management) [1994] 2 NZLR 655

Stotter v Equiticorp Australia Ltd (in liq) [2002] 2 NZLR 686

Trans Otway Ltd v Shephard [2005] NZSC 76, [2006] 2 NZLR 289

Tyree Power Construction Ltd v DS Edmonds Electrical Ltd [1994] 2 NZLR 268 (CA)

Waikato Freight and Storage (1988) Ltd v Meltzer [2001] 2 NZLR 541 (CA)

Australia

Air Australian Services v Ferrier (1996) 185 CLR 483; 14 ACLC 1403
Rees v Bank of New South Wales (1964) 111 CLR 210
Sutherland v Eurolinx (2001) 37 ACSR 477
Tolcher v National Australia Bank Ltd (2003) 174 FLR 251

United Kingdom
Alderson v Temple (K.B. 1768) ER 384
Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd [2012] 1 AC 383
British Eagle International Airways Ltd v Cie National Air France [1975] 1 WLR 758 (HL)
HM Revenue and Customs v The Football League Ltd [2012] EWHC 1372 (Ch)
Worseley v Demattos (1758) 97 ER 407

Legislation

New Zealand
Companies Act 1955
Companies Act 1993
Companies Amendment Act 2006
Insolvency Act 2006
Tax Administration Act 1984

Australia
Corporations Act 2001

The United States
Bankruptcy Act of 1841
Bankruptcy Act of 1867
Bankruptcy Code 1978

The United Kingdom
Insolvency Act 1986

__Secondary sources__

Books

Vanessa Finch *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, Cambridge, 2002)

I F Fletcher, *The Law of Insolvency* (2nd ed, Sweet & Maxwell, London, 1990)

Roy Goode *Principles of Corporate Insolvency Law* (3rd ed, Sweet & Maxwell, London, 2005).

Paul Heath (ed) & Michael Whale (ed) *Heath & Whale on Insolvency* (online looseleaf, LexisNexis NZ)

Thomas H. Jackson *The Logic and Limits of Bankruptcy Law* (Harvard University Press, Cambridge, 1986)

W Stacy Jr Johnson "The Running-Account Creditor and Section 547(c)(4) of the New Bankruptcy Code" 16 Wake Forest L Rev. 962 (1980)

Andrew Keay *Avoidance Provisions in Insolvency Law* (Law Book Company, Sydney, 1997)

Charles Tabb *The Law of Bankruptcy* (Foundation Press, New York, 1997)

Journal articles

Michael A. Bloom, Richard D. Gorelick, Heather A. MacKenzie "Exceptions to Bankruptcy Preferences: Countryman Updated" (1991-1992) 47 Bus. Law. 532

H Bolitho "Continuing Business Relationships — Eight Questions in Search of an Answer" (1998) 16 Company and Securities Law Journal 581

David Brown & Thomas G W Telfer "The New "Australasian" Voidable Preference Law: Plus Ça Change?" (2007) 13 NZBLQ 160

M Conaglen ''Voidable Preferences under the Companies Act 1993'' (1996) NZ Law Rev 197

Vern Countryman "The Concept of a Voidable Preference in Bankruptcy" (1985) 38 VAND. L. Rev. 713.

R C.C. Cuming "Transactions at Undervalue and Preferences Under the Bankruptcy and Insolvency Act: Rethinking Outdated Approaches" (2002) 7 Can Bus J 5

Anthony Duggan and Thomas G.W. Telfer, "Canadian Preference Law Reform" (2006-2007) 42 Tex Intl LJ 661

John Farrar "The Bankruptcy of the Law of Fraudulent Preference" (1983) JBL 390.

R. Goode "Is the Law Too Favourable to Secured Creditors" (1983-84) 8 Can Bus LJ 53

Michael J Herbert " The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) & (4) of the Bankruptcy Cod" (1982 – 1983) 17 U Rich L Rev 667

Thomas H. Jackson "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain" (1982) 91 Yale U 857

Andrew Keay "An Exposition and Assessment of Unfair Preferences" (1993-1994) 19 Melb U L Rev 545

Andrew Keay "In Pursuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions" (1996) 18 Syd LR 55

Andrew Keay ''Liquidators Avoidance of Preferences: Issues of Concern and a Proposal for Radical Reform'' (1996) 18 Adel L Rev 160

Trisk Keeper "Maxmising returns to creditors" (2011) 1 NZLJ 401

John C. McCoid ''Bankruptcy, Preferences and Efficiency: An Expression of Doubt'' (1981) 67 Va L Rev 249

Rizwaan Jameel Mokal "Priority as Pathology: The *Pari Passu* Myth" (2001) 60 CLJ 3

Elizabeth A. Orelup, "Avoidance of Preferential Transfers Under the Bankruptcy Reform Act 1978" (1979) 65 Iowa L Rev 209

L Ponoroff ''Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time'' (1993) Wisc L Rev 1439

Lawrence Ponoroff and Julie C Ashby "Desperate times and Desperate Measures: The troubled state of the ordinary course of business defence – and what to do about it" 72 WALR 5

Max Radin "The Nature of Bankruptcy" (1940) 89 U P L Rev 1

M Ross ''Payments Made in the Ordinary Course of Business''(2000) 8 Insol LJ 157

Harris P. Quinn “Subsequent New Value Exception under Section 547(c)(4) of the Bankruptcy Code - Judicial Gloss Is Creditors' Loss” (1993-1994) 24 Mem St U L Rev 667

C Seligson "Preferences Under the Bankruptcy Act" (1961) 15 Vanderbilt LR

Charles Jordan Tabb “Panglossian Preference Paradigm?” (1997) 5 Am Bankr Inst L Rev 407

Charles Jordan Tabb “Rethinking Preferences” (1991-92) 43 SCL Rev 981

Thomas G.W. Telfer “Voidable Preference Reform: A New Zealand Perspective on Shifting Standards and Goalposts” (2003) 12 Int Insolv Rev 55

Thomas M. Ward and Jay A. Shulman “In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing” (1983-1984) 61 Wash U L Q 1

R Weisberg “Commercial Morality, the Merchant Character, and the History of the Voidable Preference” (1986) 39 Stan L Rev 3

Reports

Australian Law Reform Commission, *General Insolvency Inquiry* Report No 45 (Australian Government Publishing Service, Canberra, 1988)

David Brown, *Voidable Transactions - A Report for the Ministry of Commerce,* (Wellington, 1999)

Law Reform Division, Department of Justice *Insolvency Law Reform: A Discussion Paper* (Wellington, 1988).

Ministry of Economic Development *Insolvency Law Review: Tier One Discussion Documents* (Wellington, 2001).

New Zealand Law Commission, *Company Law Reform and Restatement,* NZLC Report 9 (1989)

Tamara M. Buckwold, Uniform Law Conference of Canada *Reform of Fraudulent Conveyances and Fraudulent Preferences Law (Transactions and Undervalue and Preferential Transfers) Part II: Preferential Transfers* (2008)

Appendix One: Companies Act 1993 ss 292, 294 – 296

292 Insolvent transaction voidable

(1) A transaction by a company is voidable by the liquidator if it—

(a) is an insolvent transaction; and

(b) is entered into within the specified period.

(2) An insolvent transaction is a transaction by a company that—

(a) is entered into at a time when the company is unable to pay its due debts; and

(b) enables another person to receive more towards satisfaction of a debt owed by the company than the person would receive, or would be likely to receive, in the company's liquidation.

(3) In this section, transaction means any of the following steps by the company:

(a) conveying or transferring the company's property:

(b) creating a charge over the company's property:

(c) incurring an obligation:

(d) undergoing an execution process:

(e) paying money (including paying money in accordance with a judgment or an order of a court):

(f) anything done or omitted to be done for the purpose of entering into the transaction or giving effect to it.

(4) In this section, transaction includes a transaction by a receiver, except a transaction that discharges, whether in part or in full, a liability for which the receiver is personally liable under section 32(1) or (5) of the Receiverships Act 1993 or otherwise personally liable under a contract entered into by the receiver. (4A) A transaction that is entered into within the restricted period is presumed, unless the contrary is proved, to be entered into at a time when the company is unable to pay its due debts.

(4B) 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 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 insolvent transaction voidable by the liquidator if the effect of applying subsection (1) in accordance with paragraph (c) is that the single transaction referred to in paragraph (c) is taken to be an insolvent transaction voidable by the liquidator.

(5) For the purposes of subsections (1) and (4B), specified period means—

(a) the period of 2 years before the date of commencement of the liquidation together with the period commencing on that date and ending at the time at which the liquidator is appointed; and

(b) in the case of a company that was put into liquidation by the court, the period of 2 years before the making of the application to the court together with the period commencing on the date of the making of that application and ending on the date on which, and at the time at which, the order was made; and

(c) if—

(i) an application was made to the court to put a company into liquidation; and

(ii) after the making of the application to the court a liquidator was appointed under paragraph (a) or paragraph (b) of section 241(2),—

the period of 2 years before the making of the application to the court together with the period commencing on the date of the making of that application and ending on the date and at the time of the commencement of the liquidation.

(6) For the purposes of subsection (4A), restricted period means—

(a) the period of 6 months before the date of commencement of the liquidation together with the period commencing on that date and ending at the time at which the liquidator is appointed; and

(b) in the case of a company that was put into liquidation by the court, the period of 6 months before the making of the application to the court together with the period commencing on the date of the making of that application and ending on the date on which, and at the time at which, the order of the court was made; and

(c) if—

(i) an application was made to the court to put a company into liquidation; and

(ii) after the making of the application to the court a liquidator was appointed under paragraph (a) or paragraph (b) of section 241(2),—

the period of 6 months before the making of the application to the court together with the period commencing on the date of the making of that application and ending on the date and at the time of the commencement of the liquidation.

294 Procedure for setting aside transactions and charges

(1) A liquidator who wishes to set aside a transaction or charge that is voidable under section 292 or 293 must—

(a) file a notice with the court that meets the requirements set out in subsection (2); and

(b) serve the notice as soon as practicable on—

(i) the other party to the transaction or the charge holder, as the case may be; and

(ii) any other party from whom the liquidator intends to recover.

(2) The liquidator's notice must—

(a) be in writing; and

(b) state the liquidator's postal, email, and street addresses; and

(c) specify the transaction or charge to be set aside; and

(d) describe the property or state the amount that the liquidator wishes to recover; and

(e) state that the person named in the notice may object to the transaction or charge being set aside by sending to the liquidator a written notice of objection

that is received by the liquidator at his or her postal, email, or street address within 20 working days after the liquidator's notice has been served on that person; and

(f) state that the written notice of objection must contain full particulars of the reasons for objecting and must identify any documents that evidence or substantiate the reasons for objecting; and

(g) state that the transaction or charge will be set aside as against the person named in the notice if that person does not object; and

(h) state that if the person named in the notice does object, the liquidator may apply to the court for the transaction or charge to be set aside.

(3) The transaction or charge is automatically set aside as against the person on whom the liquidator has served the liquidator's notice, if that person has not objected by sending to the liquidator a written notice of objection that is received by the liquidator at his or her postal, email, or street address within 20 working days after the liquidator's notice has been served on that person.

(4) The notice of objection must contain full particulars of the reasons for objecting and must identify documents that evidence or substantiate the reasons for objecting.

(5) A transaction or charge that is not automatically set aside may still be set aside by the court on the liquidator's application.

295 Other orders

If a transaction or charge is set aside under section 294, the court may make 1 or more of the following orders:

(a) an order that a person pay to the company an amount equal to some or all of the money that the company has paid under the transaction:

(b) an order that a person transfer to the company property that the company has transferred under the transaction:

(c) an order that a person pay to the company an amount that, in the court's opinion, fairly represents some or all of the benefits that the person has received because of the transaction:

(d) an order that a person transfer to the company property that, in the court's opinion, fairly represents the application of either or both of the following:

(i) money that the company has paid under the transaction:

(ii) proceeds of property that the company has transferred under the transaction:

(e) an order releasing, in whole or in part, a charge given by the company:

(f) an order requiring security to be given for the discharge of an order made under this section:

(g) an order specifying the extent to which a person affected by the setting aside of a transaction or by an order made under this section is entitled to claim as a creditor in the liquidation.

296 Additional provisions relating to setting aside transactions and charges

(1) The setting aside of a transaction or an order made under section 295 does not affect the title or interest of a person in property which that person has acquired—

(a) from a person other than the company; and

(b) for valuable consideration; and

(c) without knowledge of the circumstances under which the property was acquired from the company.

(2) The setting aside of a charge or an order made under section 295 does not affect the title or interest of a person in property which that person has acquired—

(a) as the result of the exercise of a power of sale by the grantee of the charge; and

(b) for valuable consideration; and

(c) without knowledge of the circumstances relating to the giving of the charge.

(3) A court must not order the recovery of property of a company (or its equivalent value) by a liquidator, whether under this Act, any other enactment, or in law or in equity, if the person from whom recovery is sought (**A**) proves that when A received the property—

(a) A acted in good faith; and

(b) a reasonable person in A's position would not have suspected, and A did not have reasonable grounds for suspecting, that the company was, or would become, insolvent; and

(c) A gave value for the property or altered A's position in the reasonably held belief that the transfer of the property to A was valid and would not be set aside.

(4) Nothing in the Land Transfer Act 1952 restricts the operation of this section or sections 292 to 295.

Appendix Two: Schedule 7 Companies Act 1993

Schedule 7 Preferential Claims (Rules 1 & 2)

1 Priority of payments to preferential creditors

(1) The liquidator must first pay, in the order of priority in which they are listed,—

(a) the fees and expenses properly incurred by the liquidator in carrying out the duties and exercising the powers of the liquidator, and the remuneration of the liquidator; and

(b) the fees and expenses properly incurred by the administrator in carrying out the duties and exercising the powers of the administrator and the remuneration of the administrator; and

(c) the reasonable costs of a person who applied to the court for an order that the company be put into liquidation, including the reasonable costs incurred between lawyer and client in procuring the order; and

(d) the actual out-of-pocket expenses necessarily incurred by a liquidation committee; and

(e) to any creditor who protects, preserves the value of, or recovers assets of the company for the benefit of the company's creditors by the payment of money or the giving of an indemnity,—

(i) the amount received by the liquidator by the realisation of those assets, up to the value of that creditor's unsecured debt; and

(ii) the amount of the costs incurred by that creditor in protecting, preserving the value of, or recovering those assets.

(2) After paying the claims referred to in subclause (1), the liquidator must next pay, to the extent that they remain unpaid, the following claims:

(a) subject to clause 3(1), all wages or salary of any employee, whether or not earned wholly or in part by way of commission, and whether payable for

time or for piece work, in respect of services provided to the company during the 4 months before the commencement of the liquidation:

(aa) subject to clause 3(1), all untransferred amounts of an employee's payroll donations by an employer or PAYE intermediary under section 24Q of the Tax Administration Act 1994 during the 4 months before the commencement of the liquidation:

(b) subject to clause 3(1), any holiday pay payable to an employee on the termination of his or her employment before, or because of, the commencement of the liquidation:

(c) subject to clause 3(1), any compensation for redundancy owed to an employee that accrues before, or because of, the commencement of the liquidation:

(d) subject to clause 3(1), amounts deducted by the company from the wages or salary of an employee in order to satisfy obligations of the employee (including amounts payable to the Commissioner of Inland Revenue in accordance with section 163(1) of the Child Support Act 1991 and section 167(2) of the Tax Administration Act 1994 as applied by section 70 of the Student Loan Scheme Act 2011):

(e) subject to clause 3(1), any reimbursement or payment provided for, or ordered by, the Employment Relations Authority, the Employment Court, or the Court of Appeal under section 123(1)(b) or section 128 of the Employment Relations Act 2000, to the extent that the reimbursement or payment does not relate to any matter set out in section 123(1)(c) of the Employment Relations Act 2000, in respect of wages or other money or remuneration lost during the 4 months before the commencement of the liquidation:

(f) amounts that are preferential claims under section 263(2):

(g) all amounts payable to the Commissioner of Inland Revenue in accordance with section 167(2) of the Tax Administration Act 1994 as applied by section 67 of the KiwiSaver Act 2006:

(h) all sums that, by any other enactment, are required to be paid in accordance with the priority established by this subclause.

(3) After paying the claims referred to in subclause (2), the liquidator must next pay all sums, for which a buyer is a creditor in the liquidation of the company under section 11 of the Layby Sales Act 1971,—

(a) paid by the buyer to a seller on account of the purchase price of goods; or

(b) to which the buyer is or becomes entitled to receive from a seller under section 9 of the Layby Sales Act 1971.

(4) After paying the claims referred to in subclause (3), the liquidator must next pay the amount of any costs referred to in section 234(c). (5) After paying the claims referred to in subclause (4), the liquidator must next pay, to the extent that it remains unpaid to the Commissioner of Inland Revenue or to the Collector of Customs, as the case may require, the amount of—

(a) tax payable by the company in the manner required by Part 3 of the Goods and Services Tax Act 1985; and

(b) tax deductions made by the company under the PAYE rules of the Income Tax Act 2004; and

(c) non-resident withholding tax deducted by the company under the NRWT rules of the Income Tax Act 2004; and

(d) resident withholding tax deducted by the company under the RWT rules of the Income Tax Act 2004; and

(e) duty payable within the meaning of section 2(1) of the Customs and Excise Act 1996.

2 Conditions to priority of payments to preferential creditors

(1) The claims listed in each of subclauses (2), (3), (4), and (5) of clause 1—

(a) rank equally among themselves and, subject to any maximum payment level specified in any Act or regulations, must be paid in full, unless the assets of the company are insufficient to meet them, in which case they abate in equal proportions; and

(b) in so far as the assets of the company available for payment of those claims are insufficient to meet them,—

(i) have priority over the claims of any person under a security interest to the extent that the security interest—

(A) is over all or any part of the company's accounts receivable and inventory or all or any part of either of them; and

(B) is not a purchase money security interest that has been perfected at the time specified in section 74 of the Personal Property Securities Act 1999; and

(C) is not a security interest that has been perfected under the Personal Property Securities Act 1999 at the commencement of the liquidation and that arises from the transfer of an account receivable for which new value is provided by the transferee for the acquisition of that account receivable (whether or not the transfer of the account receivable secures payment or performance of an obligation); and

(ii) must be paid accordingly out of any accounts receivable or inventory subject to that security interest (or their proceeds).

(2) For the purposes of subclause (1)(b), the terms account receivable, inventory, new value, proceeds, purchase money security interest, and security interest have the same meanings as in the Personal Property Securities Act 1999.

(3) To the extent that the claims to which subclause (1) applies are paid out of assets referred to in paragraph (b) of that subclause, the amount so paid is an unsecured debt due by the company to the secured party.

(4) Clause 9 of this schedule, as was in force immediately before the commencement of the Personal Property Securities Act 1999, continues to apply in respect of a company whose property was subject to a floating charge that, before the commencement of that Act, became a fixed or specific charge.