Towards a Coherent Voidable Preference Regime for New Zealand

by

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Abstract

The presence of voidable preference provisions in bankruptcy and insolvency regimes is usually justified on the basis of one of several competing policy rationales: debtor deterrence, creditor deterrence, or pari passu equality. Yet policymakers often overlook the importance of wider policy objectives, such as promoting commercial certainty and enabling a distressed debtor to continue trading. Specifically, policymakers often fail to consider how these wider objectives should be traded off against the underlying policy rationales. In this paper, I argue that many of the current problems of the New Zealand preference regime stem from a lack of a clear, coherent underlying policy basis, and an inappropriate balance of the competing policies at stake. I offer insights into how policymakers should best address the difficult issue of creating a workable voidable preference regime, and suggest several much-needed reforms for improving the coherence of the policy underlying New Zealand’s voidable preference regime.
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CHAPTER 1: INTRODUCTION

Voidable preference provisions, also known as “clawback” provisions, “insolvent transactions” or simply “preferences,” are common to virtually all insolvency statutory regimes based on English common law,\(^1\) having first originated in English jurisprudence as early as 1584.\(^2\) Generally accepted to be an “essential” and “central” part of any successful insolvency regime,\(^3\) these provisions come into play when a debtor at or near insolvency transfers money or some interest in property to a creditor in order to settle a pre-existing debt, so that the creditor receives more from that debtor in satisfaction of the debt than it would have received in the debtor’s liquidation.\(^4\) As Tabb observes, “[t]he essential attribute of such a transfer is that one creditor gets paid and others do not. Creditors are treated unequally, at a time when the debtor was insolvent.”\(^5\) If all statutory elements are satisfied, the liquidator may set aside the debtor’s payment to that creditor – essentially “clawing back” the payment so that it may be returned to the general pool of assets available to be equally distributed to all of the debtor’s creditors (rather than enriching the original creditor at the expense of the group).

Despite the ubiquitous and longstanding nature of these provisions, voidable preferences are – in Weisberg’s words – a “crucial but elusive concept,”\(^6\) and “one of the most unstable categories of

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\(^1\) For example, Canada, the United States, Australia and New Zealand all have voidable preference statutory regimes: see the Canadian Bankruptcy and Insolvency Act RSC, 1985, c B-3, ss 95 to 97 \([BIA (CA)]\); the United States Bankruptcy Code \(\S\) 547; the Australian Corporations Act 2001 (Cth), s 588FE; and the New Zealand Companies Act 1993, s 292.


\(^4\) Broadly, a debtor becomes insolvent when she is unable to pay her debts as they fall due. Insolvency of a debtor should not be confused with the initiation of a formal insolvency regime such as liquidation. The liquidation process does not automatically occur upon the insolvency of the debtor: it must be initiated by some action or proceeding taken by the creditors or the debtor: Roderick J Wood, Bankruptcy and Insolvency Law (Toronto: Irwin Law, 2009) at 16.


\(^6\) Weisberg, supra note 2 at 3.
bankruptcy jurisprudence.” These provisions have spurred centuries of judicial, legislative, academic and industry debate. At a surface level, the debate can be seen as centering on definition. How should statutory language describe voidable preferences? Is a “rule-based” legislative regime made up of detailed, precise legal rules more desirable than a “standard-based” regime made up of broader guiding principles? The heart of the debate, however, runs even deeper. It centres on the competing underlying policy rationales and objectives of the voidable preference regime, and the competing policy aims of insolvency law generally. Consequently, voidable preference regimes tend to schizophrenically change focus from time to time according to which policies are favoured by regulators and judges. As McCoid points out, “[o]rdinarily… setting aside a transaction implies that it never should have occurred.” A core problem in the voidable preference debate is identifying why that transaction should be set aside: should it be for reasons of creditor deterrence, debtor deterrence, or promoting equality among creditors? Another equally fundamental problem is determining how to reconcile these goals with the broader insolvency law objectives of promoting commercial certainty, maximising the value of the debtor’s assets, and enabling a financially distressed debtor to continue trading. Only then can the problem of how to define a voidable preference and formulate an appropriate preference regime that strikes the right balance between rules and standards be addressed.

In this paper, I explore the extent to which the New Zealand voidable preference regime suffers from this malaise of lacking a clear, coherent policy basis. I argue that New Zealand’s voidable preference regime as it currently stands is problematic – as evidenced by relatively high rates of litigation, judicial uncertainty and confusion in interpreting the statutory provisions, the regime’s choppy legislative history, and the terms of the provisions themselves. I argue that these

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7 Ibid at 4. This paper examines the problems with New Zealand’s voidable preference regime in the corporate insolvency context (contained in the Companies Act 1993). The debtor in this context will usually be a “company” within the meaning of s 2(1) of the Companies Act. Considering the equivalent voidable preference provisions in the personal insolvency context (contained in the Insolvency Act 2006) is beyond the scope of this paper. I therefore use the terms “insolvency law,” “insolvency policy” and “insolvency regime” to refer to the law, policies and regimes applicable to insolvent corporations and other statutory entities. I refrain from using the terms “bankruptcy law,” “bankruptcy policy” and “bankruptcy regime,” as unlike other jurisdictions (for example, Canada), in New Zealand these terms specifically refer to the law, policies and regimes applicable to insolvent natural persons. Any quotations cited which use the terminology of “bankruptcy” (such as this quote from Weisberg) should be interpreted accordingly.


problems stem directly from a lack of a coherent unifying rationale underlying New Zealand’s regime, and a failure by policymakers to consciously and carefully consider the competing policy objectives at stake. I argue this has led to the statutory language and jurisprudence around voidable preferences in New Zealand becoming rather muddled and “hodgepodge.” Accordingly, I argue that any reform or judicial consideration of New Zealand’s voidable preference regime should be founded upon a clear and systematic consideration of the competing rationales and objectives at stake – and carefully rationalized within the context of the overall policy aims of New Zealand’s insolvency regime.

The paper is structured as follows. Chapter 2 describes and critically analyses the central underlying policy rationales, competing policy objectives and existing scholarship at the centre of the voidable preference debate, setting the stage for more in-depth discussion of the competing rationales and objectives underlying New Zealand’s regime in following chapters. I evaluate which policies are most appropriate, and suggest a systematic approach by which policymakers can best formulate a voidable preference regime with a principled and coherent policy basis. Chapter 3 briefly surveys the legislative history of New Zealand’s regime, and describes the current New Zealand legislation and jurisprudence, as a platform for discussion of the New Zealand regime in later chapters. Next, Chapter 4 describes and analyses the incoherent nature of the policy underlying the New Zealand regime. I argue that much of the uncertainty and many of the shortcomings in the regime can be directly linked to the lack of a clear underlying policy rationale, and a failure to accommodate wider policy goals such as achieving commercial certainty and assisting distressed debtors to continue trading. Finally, Chapter 5 draws on my conclusions from the previous chapters to put forward suggestions for legislative reform and future judicial approaches. It explores whether a voidable preference regime should exist at all, and whether any reforms should be rule- or standard- based. Chapter 6 concludes.

The approach in this paper is both unique and relevant. There do not appear to be any recent scholarly publications comprehensively evaluating the underlying policy of the New Zealand voidable preference regime.\footnote{A comprehensive (albeit now slightly outdated) largely descriptive analysis of the current law can be found in Chapter 31.6 of John Farrar and Susan Watson, eds, \textit{Company and Securities Law in New Zealand}, 1\textsuperscript{st} ed} While constant legislative reform and litigation has resulted in
various elements of the regime being considered in detail (such as the old “ordinary course of business” test\textsuperscript{11}) – much of the scholarly analysis and judicial consideration is outdated and rather piecemeal, focused on the specific legislative provision in issue, rather than on any underlying, cohesive policy for the regime.\textsuperscript{12} This is quite a contrast to the extensive United States and Canadian scholarship on their equivalent voidable preference provisions. The critique in this paper comes at a unique point in time in development of New Zealand’s voidable preference regime – seven years on from the last set of substantial legislative amendments to the regime, and at a time when the regime is being regularly litigated and subject to intense industry criticism. Finally, I hope that the insights and analysis of the New Zealand voidable preference regime and policy put forward in this paper should serve as a useful platform for future analysis of the policy underlying the equivalent regimes in Canada, the United States, England and Australia.


CHAPTER 2: THE POLICIES BEHIND THE PREFERENCE LAWS

At the core of the voidable preference debate lie fundamental questions as to what the underlying rationales and objectives of voidable preference regimes are or should be. Understanding the wider policy aims of insolvency law, and how preference law fits within the broader context of insolvency law is a highly relevant (and sometimes overlooked) part of the preference policy puzzle. As Jackson observes, “avoiding powers can be understood and systematically examined only by focusing on the goals of the bankruptcy process.” Accordingly, this Chapter offers a critical overview of the main policy objectives of both insolvency law and voidable preference provisions, with a view to providing a platform for critical analysis of the New Zealand voidable preference regime.

2.1 INSOLVENCY LAW POLICY

2.1.1 Insolvency law and voidable preference provisions

The starting point in examining the competing policies behind voidable preference provisions is exploring the relationship between preferences and insolvency law - and why preference provisions only come into play once the debtor becomes insolvent. Outside of insolvency law, debtors are generally permitted to grant preferential payments to certain of their creditors ahead of others. Creditors typically race against each other to seek priority payment from the debtor, through, for example, “grab-law” remedies such as the attachment of liens or other security interests. This “racing” behaviour minimizes the creditor’s risk that the debtor’s assets will be inadequate to satisfy the creditor’s claim: the operating paradigm is “first in time, first in right.”

Provided the debtor is solvent and there are enough assets to satisfy all creditors’ claims, the law does not concern itself with regulating this race between creditors. As

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15 McCoid, supra note 8 at 271.
Countryman observes, a creditor receiving payment from a solvent debtor “has been “preferred” only in the sense that [s]he is not put to the inconvenience of litigation to enforce his claim.”

If a debtor becomes unable to satisfy its obligations to creditors, insolvency law intervenes, providing a set of legal responses to the debtor’s insolvency. The ultimate purpose and nature of these legal responses may differ. For example, liquidation seeks to distribute the proceeds of the debtor’s assets among creditors, whereas restructuring regimes seek to preserve the business as an operating entity. Yet as Wood notes, insolvency law’s responses all have one feature in common: they are all collective in nature and replace the normal “grab law” race amongst creditors. Generally, there are two differing approaches as to what the core purpose of the collective remedies under insolvency law are or should be. Proponents of the economic approach, including Baird, Jackson and Schwartz, argue that the sole purpose is to maximise the collective wealth of creditors, “ensuring the [debtor’s] asset ‘pie’ is as large as possible, given a set of relative entitlements.” They argue that insolvency laws should aim to increase efficiency and reduce costs, and that any additional goals are either ineffectual or counterproductive. For example, a debtor should only be put into liquidation where doing so is less costly to the debtor’s total capital than if the debtor continued to conduct its business. On the other hand, proponents of the traditional view of insolvency (such as Warren) argue that insolvency law plays an important distributive role, and should seek to “temper the harsh effects of a debtor's insolvency and redistribute losses so as to protect those least able to protect themselves in the marketplace.” For example, a debtor should not be put into liquidation where doing so would

17 Countryman, supra note 2 at 715.
18 Wood, supra note 4 at 2.
19 Ibid at 4.
20 Ibid at 3.
23 Alan Schwartz, “A Contract Theory Approach to Business Bankruptcy” (1998) 107 The Yale L J 6, at 185. As will be discussed in Chapter 5, these proponents tend to argue that the costs and inefficiencies associated with voidable preference provisions indicate the provisions should be repealed altogether.
be costly in terms of jobs lost and on the economic and social wellbeing of the debtor’s local community.\footnote{Ibid. Warren argues that “[t]he older employee, the regular customer, the dependent supplier, and the local community are important; and bankruptcy attends to many of their concerns, regardless of whether they have rights recognized at state law.”
}

In the context of this paper’s focus on voidable preferences, the relevant collective legal response to insolvency is liquidation. The benefits of replacing the creditor race with a formal, collective liquidation process are well recognised. First, the liquidation process avoids duplicating enforcement costs incurred by individual creditors each trying to separately enforce their claims.\footnote{Wood, \textit{supra} note 4 at 3.} Secondly, without the liquidation process, the most diligent and quickest acting creditor would “win” in terms of value received from the debtor. This can lead to heavy monitoring costs for all creditors, as creditors must stay constantly aware of both the debtor’s financial status and of other creditors’ actions.\footnote{Jackson, “Logic and Limits,” \textit{supra} note 14 at 16. As Jackson notes, such costs might take the form of creditors constantly checking the courthouse records.} Once the liquidation process is initiated, it obviates the need for individual monitoring by creditors, as the liquidator steps in to take control of distributing the debtor’s assets according to the creditors’ lawful priorities. Thirdly, without the imposition of a collective proceeding, the creditor “race to the bottom” would result in the debtor’s estate being divided in a piecemeal fashion. However, often a greater total value for creditors could be realised if the debtor’s estate were sold intact.\footnote{Ibid.} Notably, all of these problems stem from the inherent conflict and competition between creditors in collecting debts during the creditor “race.” As Jackson puts it, these conflicting rights mean “there is a tendency in [creditors’] debt-collection efforts to make a bad situation worse.”\footnote{Ibid. at 10.} The liquidation process therefore maximises the value of the debtor estate more effectively and efficiently than if no such collective remedy were imposed.

\subsection*{2.1.2 Enhancing commercial certainty}

Among the most important objectives of an effective and efficient insolvency law is promoting commercial certainty in the market and ensuring that insolvency law is both transparent and
A predictable, well-defined insolvency law helps increase the availability of credit and reduce the cost of credit to borrowers, as it better enables creditors to identify and assess probable risks and rates of return associated with lending to a particular borrower. For example, establishing clear rules for ranking of priority claims is important in order to define the scope and value of secured creditors’ rights. In turn, a commercial environment where the risks, rules and procedures around insolvency are predictable and transparent is likely to promote economic stability and growth and encourage investment.

Achieving commercial certainty is particularly important – and problematic – in the context of voidable preferences. As the New Zealand Court of Appeal pointed out in Levin v Market Square, although all material matters arise in the transaction whereby the creditor receives the payment or property from the debtor, “the end result, the ‘preference’ does not (in fact and in law) occur until the liquidation itself.” However, liquidation may occur at a point in time much later than the point of the debtor’s initial insolvency. Preference law therefore interferes in the creditor race retrospectively. This retrospective effect gives rise to a fundamental tension between the goals of preference laws and the need for commercial certainty and finality of transactions. The reversed transfers or payments are often made months (and under the New Zealand regime, up to two years) before the debtor is officially put into liquidation. Yet a creditor may well have legitimately received those payments and subsequently operated on the basis that they were final, unaware that the debtor would later become liquidated. In addition, it is often unclear to creditors whether a debtor is in fact insolvent. Even insolvent debtors themselves may not appreciate that preference law is relevant: as Duggan and Telfer note, 

31 United Nations Commission on International Trade Law, Legislative Guide on Insolvency Law, GAOR (New York, 2005) at 10, 12 [UNICTRAL Guide]. The UNICTRAL Guide is intended to be used as a reference by national authorities and legislative bodies when preparing new laws and regulations or reviewing the adequacy of existing laws and regulations. Indeed, it was referred to extensively by the New Zealand Law Commission in a 2001 report considering the implications of overhauling New Zealand’s insolvency regime: see New Zealand Law Commission, Insolvency Law Reform - Promoting Trust and Confidence: An Advisory report to the Ministry of Economic Development (2001), online: <www.lawcom.govt.nz> [NZLC, Promoting Trust and Confidence].
32 UNICTRAL Guide, supra note 31 at 12.
33 Ibid at 13.
34 Levin v Market Square Trust [2007] 3 NZLR 591 (CA) at [49] [Market Square Trust].
36 As will be discussed in Chapter 4, this long clawback period is a deeply problematic aspect of the New Zealand voidable preference regime.
financially distressed debtors have a tendency to over-estimate their chances of recovery.\textsuperscript{37}

Preference law’s retrospective effect therefore adds a fundamental element of uncertainty to commercial transactions between creditors and debtors. It imposes an “uncertainty cost” where a creditor is unsure whether a transaction will be recaptured, affecting the creditor’s ability to commit resources to other transactions.\textsuperscript{38} Furthermore, it decreases creditors’ ability to assess the risk levels associated with their position in the event of the debtor’s insolvency, and cannot be confident that any repayments will be final.\textsuperscript{39} Therefore, in a commercial environment where the preference regime is unpredictable, unstable and of uncertain scope, we would expect higher costs and reduced availability of credit. Creditors may also begin to require more security before advancing credit.\textsuperscript{40} As Conaglen points out, this would result in “the flow of credit within commerce [being] unhappily affected.”\textsuperscript{41}

\textbf{2.1.3 Enabling a financially distressed debtor to continue trading}

Another significant policy objective of insolvency law is facilitating the extension of credit to distressed debtors by creditors. Insolvency law should avoid penalizing creditors who choose to lend to a troubled debtor. It should avoid pushing debtors into early liquidation, and should instead aim to assist the financial rehabilitation of the debtor. As Ponoroff observes, “even the best bankruptcy…is not as desirable as no bankruptcy at all.”\textsuperscript{42} The collective remedies of voluntary administration\textsuperscript{43} and of creditor compromises\textsuperscript{44} are good examples of New Zealand...
insolvency law upholding this objective. Again, enabling a financially distressed debtor to continue trading is an important consideration in the context of preference law. If an overly strict liability preference regime were imposed, where most transfers falling within the specified period were clawed back from creditors, creditors might be reluctant to lend to financially distressed debtors. In turn, this may lead to the early demise of the debtor, as the debtor’s regular sources of credit would likely dry up at a time when the debtor arguably needs credit most. Yet liquidation may be neither economically efficient nor desirable for an insolvent debtor. The debtor’s financial distress may have been only temporary, and if the debtor had continued in business, liquidation (and any clawback of transfers) may never have ultimately occurred.45 Similarly, allowing a financially distressed debtor to continue trading may allow the debtor to cover some or all of its overhead costs. This would mitigate losses to a greater extent than if it stopped trading altogether, leaving more assets available for distribution to creditors if liquidation ultimately occurs.

2.2 COMPETING RATIONALES FOR PREFERENCE LAWS

2.2.1 The “pari passu” rationale

Supporters of the pari passu rationale (also referred to as the equality or “equal sharing” rationale) argue that preference law is necessary to preserve equal sharing of the debtor’s assets among creditors during the collective liquidation process.46 Once a debtor falls into financial distress and its creditors become aware that a debtor lacks sufficient assets to satisfy all claims, the creditors are likely to start racing more aggressively against each other in order to “grab” their share before all the debtor’s assets are depleted. However, this can lead to unequal and unfair distribution of the debtor’s scarce assets. Some creditors may be paid more than they would have if the debtor’s assets were distributed upon liquidation, with “[l]ittle…left for those

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44 A creditor compromise allows a debtor company and its creditors to (among other things) form a compromise which cancels all or part of that company’s debt, or varies the rights of the creditors or the terms of the debt. Again, this aims to help the distressed debtor company continue trading and avoid liquidation. See Companies Act 1993, s 227 and part 14 generally; and Farrar and Watson, supra note 10, ch 29.
45 Conaglen, supra note 12 at 200.
46 See, e.g. Tabb, “Rethinking Preferences” supra note 5 at 986.
creditors who were not fortunate or diligent enough to obtain a preference.” \(^{47}\) Under the *pari passu* rationale, the intention and motives of both the debtor and the creditor are irrelevant. \(^{48}\) Instead, proponents of the *pari passu* rationale argue that reversing payments made on the eve of insolvency is necessary to ensure that creditors of the same priority ranking receive equal payments. \(^{49}\)

An important caveat to this rationale is that “*pari passu* equality” among creditors cannot be taken literally. \(^{50}\) As Mokal eloquently argues, true *pari passu* equality is largely a myth in modern insolvency regimes. \(^{51}\) A myriad of creditors are excluded from the ambit of the *pari passu* rule, including secured creditors and creditors preferred by statute (such as employees or the tax revenue department). \(^{52}\) In reality, only unsecured creditors are subject to the *pari passu* rule. Yet in the majority of cases, there will be nothing left of the debtor’s assets to distribute amongst these unsecured creditors once prior claims have been paid. \(^{53}\) It is therefore generally accepted that, in this context, “*pari passu*” means preserving the differing priorities of creditors in accordance with the overall distribution scheme under the liquidation regime, so that creditors are paid in the same order and amount under the liquidation process as they would have been had the preference not occurred. \(^{54}\)

**Analysis**

In many ways, the *pari passu* rationale is attractive. It helps ensure that the formal process of insolvency administration remains orderly, and preserves the pre-insolvency positions and entitlements of competing creditors. Without preference law retrospectively preserving equality amongst similarly situated creditors, the insolvency administration process would likely be

\(^{47}\) Tabb, “Panglossian Preference Paradigm?” *supra* note 16 at 409.

\(^{48}\) Countryman supports the *pari passu* rationale, stating “I do not believe that it should be the purpose of preference law to punish "bad" and absolve "good" creditors, but to preserve the bankruptcy distribution policy”: Countryman, *supra* note 2 at 824.


\(^{50}\) Duggan and Telfer, “Canadian Preference Law Reform,” *supra* note 3 at 666.


\(^{52}\) An eve of bankruptcy payment to a secured creditor does not ordinarily constitute a preference. As Schwartz observes, “the creditor has a property right in the firm’s assets, and it is entitled to realize that right in whatever way the security agreement permits.” Schwartz, “Normative Theory,” *supra* note 22 at 24.

\(^{53}\) Mokal, *supra* note 51 at 588.

\(^{54}\) See, e.g. Countryman, *supra* note 2 at 748; Duggan and Telfer, “Canadian Preference Law Reform,” *supra* note 3 at 666; and Mokal, *supra* note 51 at 589.
rendered ineffective, with nothing left for the liquidator to distribute. This would thwart the aims of the liquidation process (outlined above). Yet if achieving absolute equality between creditors were the policy basis of voidable preference provisions, formulating a preference law would be “relatively simple.” Preference law would impose a strict liability “super rule” whereby the liquidator would automatically claw back all transfers from debtors to creditors made within a certain time period. However, as discussed above, this would compromise commercial certainty and raise severe obstacles to a financially distressed debtor being able to continue trading. Basing a voidable preference regime on a pure, strict liability rationale of achieving pari passu equality amongst creditors is thus undesirable. Accordingly, preference regimes do not in reality adhere to such a strong principle of equality – they often contain defences and exceptions to the pari passu policy, such as for transactions conducted in the ordinary course of business. Other competing rationales underlying voidable preference regimes are explicable through moral considerations, such as the “debtor deterrence” and “creditor deterrence” rationales, which (as described below) focus on the intent and state of mind of the respective debtor and creditor.

2.2.2 The debtor deterrence rationale

Advocates for the debtor deterrence rationale believe voidable preference regimes should deter debtors on the eve of insolvency from singling out and paying favoured creditors in the first place. Originating under 16th century English case law, the debtor deterrence rationale is closely linked to the old English notion of “the bankruptcy debtor as an anti-social, immoral, character who regularly took advantage of others.” Bankrupts were seen as criminals, with punishments for non-payment of debts including debtors’ prison or even the death penalty. Unsurprisingly, the early concept of a voidable preference was closely tied to this idea of a

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56 Brown and Telfer, “Plus Ça Change?” supra note 10 at 166.
57 See, e.g. Bankruptcy Code 11 (US), § 547(c)(2).
58 See, e.g. The Case of Bankrupts (Smith v. Mills) (1584) 76 Eng Rep 441, 473 (KB); Alderson v Temple (1768) 96 ER 384 [Alderson v Temple]; Thomason v Freeman 99 Eng Rep 1026, 1028 (KB 1786). For an excellent in-depth discussion and analysis of the old English cases, see Countryman, supra note 2 and Weisberg, supra note 2.
60 Ibid.
debtor as “villain” and a fraud.\textsuperscript{61} This is apparent in the following statement by Lord Coke in The Case of Bankrupts (1584):

…if, after the debtor becomes a bankrupt, he may prefer one …and defeat and defraud many other poor men of their true debts, it would be unequal and unconscionable, and a great defect in the law.\textsuperscript{62}

The Case of Bankrupts was the first judicial articulation of the voidable preference concept,\textsuperscript{63} and its focus on deterring debtors from “playing favourites” among creditors provided the general principle from which the present-day English law on preferences would develop.\textsuperscript{64} While the above quote indicates that Lord Coke may have also been promoting the rationale of equality among creditors, I agree with Duggan and Telfer that if Lord Coke were solely concerned with preserving equal distribution among creditors, the (dishonourable) moral intent of the debtor would be irrelevant.\textsuperscript{65} Like proponents of debtor deterrence today, Lord Coke viewed the debtor’s conduct with suspicion. He was more concerned with imposing penalties on debtors who intentionally usurped the formal liquidation distribution than preserving equality per se. While the debtor is no longer seen as a criminal under modern day preference law, proponents of this rationale remain suspicious that a debtor will attempt to pay friends, relatives or business connections ahead of other creditors in order to preserve friendships, business goodwill or even to temporarily hide from creditors. Consistent with this moralistic approach, preference law based on this rationale does not tend to apply to debtors on the eve of insolvency who do not intend to grant that preference to a creditor. For example, if the debtor was forced to grant the preference through blackmail or physical duress, that preference may not be voidable.\textsuperscript{66}

\textit{Analysis}

To the extent that preference laws based on the debtor deterrence rationale actually deter debtors from granting preferences to favoured creditors, this rationale is plausible. However, no empirical surveys appear to have been conducted as to the actual effect of debtor-focussed

\textsuperscript{61} McCoid, \textit{supra} note 8 at 250.
\textsuperscript{62} The Case of Bankrupts, \textit{supra} note 58.
\textsuperscript{63} Weisberg, \textit{supra} note 2 at 40. Despite these origins in case law, today preference regimes in legal systems based on English common law have a statutory foundation: see, for example, the regimes cited \textit{supra} note 1.
\textsuperscript{64} McCoid, \textit{supra} note 8 at page 250; Duggan and Telfer, “Canadian Preference Law Reform,” \textit{supra} note 3 at 663;
\textsuperscript{65} \textit{Ibid}.
\textsuperscript{66} See Alderson v. Temple, \textit{supra} note 58 at 166, where Lord Mansfield stated that where a creditor pressures a debtor into payment, or “or sues, or threatens [that debtor], without fraud, the preference is good.”
preference law on the conduct of debtors who are at or near insolvency. It is therefore difficult to ascertain the success (or otherwise) of debtor deterrence based preference law. Deterrence based preference law may have little or no effect on debtors who do not expect to be put into liquidation, as they do not expect the preference laws to ever “bite” or come into play. Instead, a debtor interested in survival will continue making payments to its creditors.\textsuperscript{67} Even if debtors do expect to be liquidated, Schwartz argues that the debtor deterrence rationale has no effect. Debtors will be indifferent as to how their assets are distributed among creditors, as they see liquidation and the associated distribution of their assets as inevitable anyway. They therefore have little incentive not to favour their own family or personal connections in order to ensure goodwill for themselves.\textsuperscript{68}

2.2.3 The creditor deterrence rationale

Under the creditor deterrence rationale, preference law is seen as necessary to dissuade creditors from sabotaging the formal insolvency process through procuring preferences and changing their existing position vis-à-vis other creditors.\textsuperscript{69} Not all creditors have access to equal information as to the state of the debtor’s insolvency or whether sufficient assets exist to satisfy all claims, and not all creditors have equal ability to move quickly to recover debt. There is a need to deter creditors from taking advantage of their superior knowledge and/or recovery ability, so that other creditors ignorant of the debtor’s precarious financial position do not miss out on their fair share of the debtor’s assets.\textsuperscript{70} As Ponoroff observes, deterring those culpable creditors with knowledge of the debtor’s insolvency would “distinguish between true credit transactions and ‘deathbed ransacking.”’\textsuperscript{71} Innocent creditors would be protected, and dismemberment of the debtor’s estate (with the associated loss of value) would presumably be avoided.

Jackson takes this proposition a step further, and argues that creditors have an implicit ex-ante collective agreement with each other not to engage in “last-minute grabs” from a debtor on the

\textsuperscript{67} Jackson, “Avoiding Powers,” \textit{supra} note 13 at 758.
\textsuperscript{68} Schwartz, “Normative Theory,” \textit{supra} note 22 at 26.
\textsuperscript{69} Jackson, “Logic and Limits,” \textit{supra} note 14 at 125.
\textsuperscript{70} \textit{Ibid} at 122. Tabb notes that the historical context of the creditor deterrence provisions comes from “earlier times [where] the practical advantage in collecting that local creditors held over more distant creditors was seen as providing a need for a preference recapture law. Otherwise, the extension of credit by geographically removed creditors would be chilled to the detriment of the economy.” Tabb “Rethinking Preferences” \textit{supra} note 5 at 988.
\textsuperscript{71} Ponoroff, \textit{supra} note 42 at 168.
eve on insolvency. Jackson argues that creditors subscribe to this collective agreement when they initially enter into transactions with their debtor, as the collective agreement helps avoid a “race to the bottom” among creditors seeking to enforce their claims. Upholding the collective method of distribution helps maximise the value of the debtor’s estate from which distribution is to be made through reducing monitoring costs and avoiding piecemeal distribution of the debtor’s estate. Jackson argues that preference law should therefore focus on deterring individual creditors from reneging on this collective agreement, as a means to achieving these purposes of insolvency law.

Analysis

Like the debtor deterrence rationale, the creditor deterrence rationale is only attractive to the extent it actually deters creditors from sidestepping the formal insolvency process. Again, no empirical studies appear to have been conducted as to the actual deterrent effect of creditor-focused preference laws on creditors’ conduct. However, it is clear that there are limits to preference law’s deterrent effect on creditors. First, only creditors aware of the debtor’s insolvent state will take into account the possibility that preference law may later come into play. While preference law may encourage creditors to make further inquiry as to the debtor’s situation, it is likely to have little deterrent effect on creditors unaware of the debtor’s financial state, and may even increase the risk that creditors turn a “blind eye” to the debtor’s situation. Secondly, if there are no sanctions on creditors who obtain preferences other than to require them to return the preference with interest, then there is little reason for creditors not to seek or accept preferences. It is often uncertain whether insolvent debtors will go into liquidation, or even whether recapture of the preference will occur. As Duggan and Telfer observe, if liquidation never eventuates, the preference question will disappear. Even where the preference is clawed back by the liquidator, the creditor will only be worse off to the extent that she expended resources in obtaining the preference (through lawyers fees for example), or in litigation costs if

72 Jackson, “Avoiding Powers,” supra note 13 at 758.
73 Ibid.
74 Ibid at 759. See also Jackson, “Logic and Limits,” supra note 14 at 124-128.
75 McCoid, supra note 8 at 263.
76 Ibid at 263; Brown and Telfer, “Plus Ça Change?” supra note 10 at 183.
77 McCoid, supra note 8 at 263.
78 Ibid at 670.
the creditor decides to contest the preference action brought by the liquidator. An economically rational creditor therefore has “much to gain and little to lose” in seeking a preference, as “[t]here is a good chance that one who receives a preference will be able to keep it. Bankruptcy may never be filed.”

Another weakness with the creditor deterrence rationale is the fact that creditors have only limited power to force debtors to pay preferences. Schwartz points out that although a secured creditor can threaten attachment if the debtor does not grant the preference, the debtor can credibly respond by filing for liquidation (or threatening to do so) so that all attachments will be stayed. In other words, it is really the choice of the distressed debtor to give a preference. This argument is less convincing however. As Duggan and Telfer point out, Schwartz “too readily assumes a debtor's willingness to play the bankruptcy card.” The commercial reality is that doing so would destroy good relations and the business reputation of the agents controlling the debtor.

### 2.3 CONCLUSION

In conclusion, neither the debtor deterrence nor the creditor deterrence rationales provide an entirely convincing underlying account of voidable preference regimes. They each make some attempt to preserve commercial certainty and to reduce the incidence of preferential transfers through deterring creditors and debtors from receiving and granting transfers (as applicable). However, as discussed above, the effectiveness of this deterrence is questionable. In addition, importing a sort of quasi-criminal *mens rea* to the non-criminal act of giving a preference seems undesirable. “Innocent” creditors who are deemed unaware of the debtor’s insolvent (or near insolvent) state will generally not have their payments clawed back under the creditor deterrence rationale. Yet as Tabb argues, “[w]hether preferred creditors knowingly opted out or were just

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79 *Ibid* at 265. For an outline of the process by which voidable preference actions are brought in New Zealand, see Chapter 3 part 3.2.3.
80 *Ibid* at 263. See also Countryman, *supra* note 2 at 748, arguing that the absence of sanctions beyond returning the preference with interest means it is it is “ridiculous” to expect creditor deterrence to be the purpose of preference provisions.
82 Tabb, “Panglossian Preference Paradigm?” *supra* note 16 at 410.
lucky should not be relevant to whether they get to keep the preferential payment.”

In my view, a similar argument applies in the debtor deterrence context. Whether a debtor gives a preference intentionally or is “innocent” in the sense that her hand is forced by a blackmailing creditor has no effect on the detrimental effect of that preference on other creditors, who will now receive less. The creditor and debtor deterrence rationales are also flawed as their focus on intention ignores the strong policy of equal distribution among creditors.

That leaves the \textit{pari passu} rationale. In my view, the \textit{pari passu} rationale offers the most convincing policy basis for a voidable preference regime. First, if (as many proponents of \textit{pari passu} argue) the principle of equality is “fundamental and all-pervasive” to insolvency law and necessary for an orderly and cost effective liquidation, it seems consistent that the underlying rationale of voidable preference provisions is to promote equal sharing. Secondly, the \textit{pari passu} policy appropriately emphasises the importance of achieving relative equality of distribution amongst creditors and preserving the formal insolvency process, and is best equipped to capture the largest range of undesirable preferential transactions. Thirdly, Tabb comments that “there are good preferences and bad preferences, with only the latter subject to avoidance and recapture.” This suggests that a preference regime should identify “bad” types of transaction and prevent them from occurring. The most effective rationale in capturing these “bad” transactions is \textit{pari passu}. Rather than assessing the innocence (or otherwise) of the parties involved or whether undue pressure was exerted, the \textit{pari passu} rationale bypasses these difficult, moralistic, issues and assesses the effect on the creditor receiving the preference. A preference law based on \textit{pari passu} equality is thus able to claw back a variety of “bad” transactions, including (a) where the debtor intends to grant a preference, (b) where a creditor intentionally seeks a preference, and (c) where a creditor exerts undue pressure on a debtor to grant a preference. While all three situations include a blameworthy party, only a \textit{pari passu} based law would capture all situations. The debtor deterrence rationale would likely only capture situation (a), while the creditor deterrence rationale would likely only capture situations (b) and (c).

\begin{thebibliography}{9}
\bibitem{Tabb} Tabb, “Rethinking Preferences” \textit{supra} note 5 at 990.
\bibitem{Ibid} \textit{Ibid}, supra note 3 at 665.
\bibitem{Goode} Goode, \textit{Principles of Corporate Insolvency Law} (London, Sweet & Maxwell, 1997) (2\textsuperscript{nd} ed) at 142.
\bibitem{Ibid} \textit{Ibid}, at 982.
\end{thebibliography}
Yet as discussed above, there is general agreement that a regime based wholly on achieving *pari passu* equality amongst creditors is undesirable. There is a need to preserve commercial certainty, and to assist distressed debtors in continuing trading. However, attempting to form a single cohesive “super theory” of *pari passu* which appropriately incorporates all such exceptions on a unified, principled basis is likely to be a fruitless search. Indeed, Weisberg is sceptical that preference law can ever be formulated on a cohesive policy basis, describing preference law as a “vague and overinvested legal idea” which only “pretends to be an important and scientifically sound instrument for regulating commercial behaviour.”

I am more optimistic that it is possible to formulate a workable preference regime on a principled policy basis. Rather than seeking to identify a unifying “super theory,” I believe a more helpful approach is to view preference policymaking as involving a careful and systematic balancing exercise between competing policy objectives.

First, the appropriate rationale underlying the preference laws should be identified – which, as argued above, should be the *pari passu* rationale. However, achieving a strict liability *pari passu* regime would be highly damaging to commercial certainty and would undermine a financially distressed debtor’s ability to continue trading. Secondly, therefore, policymakers should therefore carefully identify appropriate trade-offs between *pari passu* and these wider policy considerations. This will involve a careful balancing of the interests of different parties to the transaction. For example, creditors as a group would likely prefer a *pari passu* strict liability regime provided they were an unpaid, unsecured creditor who would stand to gain if a preference was returned to the wider asset pool. However, as soon as an individual creditor receives payment, she will immediately prefer a preference regime that includes exceptions for receipt of payment. The creditor will also wish for a preference regime that helps sustain a distressed debtor in business, as if the debtor avoids liquidation, the creditor’s payment will not be clawed back.

Balanced against these interests are those of the wider business community, who would prefer whatever trade-offs best uphold sufficient certainty to be able to make a confident assessment of the risks involved in any transaction or dealing. Thirdly, policymakers should address the problem of how best to draft preference provisions that achieve *pari passu* equality.

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89 Tabb, “Panglossian Preference Paradigm?” *supra* note 16 at 420.
In particular, an appropriate equilibrium between a rule and standard based regime should be reached, as this will also enhance certainty in the practical interpretation and application of the regime.\textsuperscript{91} Lastly, appropriate limitations or exceptions should be incorporated into the regime, which reflect the trade-offs between achieving \textit{pari passu} equality between creditors, enhancing commercial certainty, and enabling financially distressed debtors to continue trading.\textsuperscript{92} As Telfer puts it:

\begin{quote}
The question is not whether the preference regime upholds the equality principle. Rather, the more significant question is whether the regime makes appropriate exceptions to the equality principle…The principle of equal distribution has to be balanced against the consequences of upsetting a settled transaction.\textsuperscript{93}
\end{quote}

The remainder of this paper argues that the policy underlying New Zealand’s regime is incoherent, and that many of the regime’s problems can be attributed to the failure of policymakers to carefully identify and engage with the issues raised in this systematic approach.

\textsuperscript{91} The tension between rules and standards in insolvency law is discussed further in Chapter 5, part 5.2.
\textsuperscript{92} Duggan and Telfer pose series of questions raising similar issues in preference law design in Duggan and Telfer, “Canadian Preference Law Reform,” \textit{supra} note 3 at 684 and in Anthony Duggan and Thomas G W Telfer, chapter 6 of Stephanie Ben-Ishai and Anthony Duggan (eds) \textit{Canadian Bankruptcy and Insolvency Law: Bill C-55, Statute C.47 and Beyond} (Markham, ON: LexisNexis, 2007).
\textsuperscript{93} Telfer, \textit{supra} note 11 at 63.
CHAPTER 3: THE NEW ZEALAND POSITION

3.1 LEGISLATIVE HISTORY

The history of the New Zealand voidable preference regime is a turbulent one. The New Zealand regime has been substantially amended on a number of occasions, and has been heavily litigated over the years. It is useful to briefly survey this legislative history, as background both to the descriptive account of the current regime contained in this Chapter, and to the substantive evaluation that follows in Chapter 4.

The New Zealand voidable preference provisions have a relatively long history. New Zealand’s first statute governing company law, the Companies Act 1908, closely echoed the debtor deterrence rationale in English jurisprudence. Acts relating to property by a company were invalid if they “constitute[d] an undue or fraudulent preference of the creditors in a bankruptcy” by the debtor.94 This focus on debtor intent was continued in section 309 of the Companies Act 1955, which provided that a transfer to a creditor within the two-year clawback period was voidable if it was made “with a view to giving that creditor...a preference over the other creditors.”95 As the Court of Appeal in Tyree Power Construction put it, this requirement:

implied both an act of free will on the part of the insolvent, i.e. free from pressure from others; and a dominant intention to prefer the creditor over others.96

The onus of proving this requirement was borne by the liquidator, a “tremendously difficult” burden that made bringing a successful preference claim almost impossible.97 Indeed, the Court of Appeal in Tyree Power Construction noted that “it has not often been thought worthwhile for

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94 Companies Act 1908, s 247.
95 In full, s 309(1) provided that “every conveyance or transfer of property, every security or charge given over any property, every obligation incurred, every execution under any judicial proceeding suffered, and every payment made (including any payment made in pursuance of a judgment or order of a Court), by any company unable to pay its debts as they become due from its own money, shall be voidable as against the liquidator, if—
(a) it is in favour of any creditor or any person in trust for any creditor with a view to giving that creditor or any surety or guarantor for the debt due to that creditor a preference over the other creditors; and
(b) the making, suffering, paying, or incurring of the same occurs within 2 years before the commencement of the winding-up of the company.”
96 Tyree Power Construction v D S Edmonds Electrical Ltd [1994] 2 NZLR 268 (CA) at 272 [Tyree Power Construction].
the Official Assignee to invoke [section 309]…in a company winding up.”

When the Companies Act 1955 was overhauled and replaced with the new Companies Act 1993, the voidable preference provisions were also updated. The low incidence of preference actions and a wish to “remove the evidential difficulties associated with proving the state of mind of any party to the transaction” was one key reason for the overhaul of the debtor-deterrence focussed regime. Accordingly, the principal rationale behind the unamended 1993 regime shifted away from debtor intention to become broadly pari passu. The test of whether a preference had occurred became objective, based on whether the creditor received preferential treatment through payment of an amount in excess of that which would have been received had it participated with other creditors of equal rank in the distribution of the proceeds of sale of assets on liquidation. This more objective regime was initially thought “far superior” to the 1955 debtor deterrence regime.

However, consistent with the need to balance commercial certainty against an absolute rule of equality, a new exception for transactions conducted in the “ordinary course of business” was also introduced as part of the 1993 reforms. This exception introduced elements of the creditor deterrence rationale, as it focused on whether the creditor believed they were receiving payment and supplying goods in “the ordinary course of business.” The exception subsequently proved deeply problematic and a major source of uncertainty for creditors and liquidators alike, and it was repealed just 13 years later, by the Companies Amendment Act 2006. In addition to the removal of the ordinary course of business exception, several other aspects of the regime were significantly amended. The current regime (as amended by the Companies Amendment Act 2006) is described in detail below. The policy rationales and objectives of the current regime, and the extent to which they are coherent, are discussed in Chapter 4.

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98 Tyree Power Construction, supra note 96 at 273.
99 Tier One Discussion Documents, supra note 97 at 57.
100 Companies Act 1993 (pre 2006 amendments), s 292.
101 See, e.g. Conaglen, supra note 12 at 206.
102 Companies Act 1993, s 292(2) (as unamended by the Companies Amendment Act 2006).
103 Tier One Discussion Documents supra note 31 at 90.
104 Companies Amendment Act 2006, s 27(2).
3.2 OVERVIEW OF CURRENT PROVISIONS

3.2.1 “Insolvent transaction”

Section 292(1) of the amended Companies Act 1993 provides that a transaction by a company is voidable by a liquidator if it is an “insolvent transaction” and is entered into within the “specified period” of two years prior to the commencement of the liquidation. Similar to the unamended 1993 Act, the focus is on an objective assessment of preferential effect on a creditor, with “insolvent transaction” relevantly defined by section 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.

“Transaction” is defined broadly by section 292(3), and includes transactions by a receiver, unless the receiver is personally liable for that transaction. The payment must be in satisfaction of a debt. The insolvent transaction must be entered into during the “specified period” (often referred to as the “clawback period” or the “vulnerability period”). The specified period varies slightly depending on the method by which the debtor company is put into liquidation. In general, it is a period at least two years before the debtor company was put into liquidation – a period that is significantly longer than in equivalent jurisdictions.

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105 S 292(3) of the Companies Act 1993 defines “transaction” as 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); or (f) anything done or omitted to be done for the purpose of entering into the transaction or giving effect to it.

106 Companies Act 1993, s 292(4).

107 If, for example, the debtor company were merely gifting money or property, the appropriate provision would be s 297 of the Companies Act 1993, which deals with transactions at undervalue.

108 Companies Act 1993, s 292(5). Where no application for liquidation is made to the court, the specified period is a period of two years before the date of commencement of liquidation together with the period commencing on that date and ending at the time at which the liquidator is appointed: s 292(5)(a). For a company put into liquidation by the court, the specified period is the period of two 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: s 292(5)(b). Where an application was made to the court to put the debtor company into liquidation, but after the making of the application to the court a liquidator was subsequently appointed to the company board, or appointed by special resolution, the specified period is the period of two 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: s 292(5)(c).

109 As will be discussed in Chapter 4, the length of this period is a highly problematic aspect of the New Zealand regime.
Unable to pay due debts: s 292(2)(a)

Determining whether a debtor company made the transaction at a time when it was unable to pay its due debts is often difficult to establish. Parliament recognised this evidentiary difficulty and chose to aid the liquidator by creating a rebuttable presumption of insolvency during the “restricted period” – in general terms, the six months preceding the company’s liquidation. At all other times during the two year specified period, the liquidator bears the onus of establishing the company’s insolvency. For the purposes of this paper, insolvency is assumed, and the methods by which it may be established are not substantively discussed. In brief, the debtor company’s position in its entirety must be considered – a temporary lack of liquidity is not sufficient. The relevant consideration is the company’s present (as opposed to long-term) ability to meet debts from its available resources, taking into account the nature of the company’s debts, its business, and whether the assets are in readily realisable form. Hindsight must be used with caution.

Preferential effect: s 292(2)(b)

The New Zealand Court of Appeal held in Levin v Market Square Trust that the test for preferential effect in section 292(2)(b) requires a comparison “between the amount the creditor actually received from the company and the amount that creditor would have received as part of the general body of creditors in the liquidation had the payment not been made.”

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110 Unlike the transactions at undervalue provision (s 297) and voidable charges (s 293), s 292 does not cover a situation where the company becomes insolvent immediately after entering into the transaction. Under s 292, the focus is on the company’s financial status (and whether the company was able to pay its due debts) at the time the payment or transfer was made.

111 Companies Act 1993, s 292(4A). Like the specified period, the start and finish dates of the restricted period vary according to the method by which the debtor company was put into liquidation. Where no application to the court is made, the restricted period is six months before the date of commencement of liquidation together with the period commencing on that date and ending at the time at which the liquidator is appointed: s 292(6)(a). Where a company is put into liquidation by the court, the restricted period is the period of six 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 was made: s 292(6)(b). Where an application was made to the court to put the debtor company into liquidation, but after the making of the application to the court a liquidator was subsequently appointed to the company board, or appointed by special resolution, the restricted period is the period of six 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: s 292(6)(c).

112 Sandell v Porter (1966) 115 CLR 666 (HCA) at 670 and 671.

113 Ibid; Rees v Bank of New South Wales (1964) 111 CLR 210 (HCA) at 218 and 219 [Bank of New South Wales].


115 Market Square Trust, supra note 34 at [42].
liquidator must establish on an objective basis and “in a practical, realistic and businesslike way”\textsuperscript{116} that this requirement has been met: the intentions of the parties are irrelevant.\textsuperscript{117} In contrast to the previous position,\textsuperscript{118} and upholding the judgments in \textit{Chatfield v Mercury Energy Ltd}\textsuperscript{119} and \textit{Thompson}\textsuperscript{120} the Court of Appeal in Levin confirmed there is no need for the general body of creditors to have been disadvantaged by the preferential transfer: the focus is whether the transfer has a preferential effect on the creditor who received it.\textsuperscript{121} The Court also confirmed that the test for preferential effect concerns what the creditor(s) would receive in the debtor company’s actual liquidation, rather than what they would have received in a hypothetical liquidation on the date the payment actually occurred.\textsuperscript{122}

3.2.2 Running account as single “insolvent transaction”: s 292(4B)

Under Section 292(4B), a series of transactions occurring as part of a “continuing business relationship” between a creditor and a debtor are treated as a single transaction. Modeled on equivalent Australian legislation,\textsuperscript{123} section 292(4B) was introduced as part of the 2006 amendments to the 1993 regime, partially replacing the old “ordinary course of business” exception.\textsuperscript{124} The typical example of a series of transactions under section 292(4B) is a running account between a creditor who supplies goods or services to the debtor on credit. Rather than focusing on a single transaction in isolation from the wider business relationship, the liquidator

\textsuperscript{116} Ferrier v Civil Aviation Authority (1994) 125 ALR 122 at 142.

\textsuperscript{117} Shephard v Steel Building Products (Central) Ltd [2013] NZHC 189 at [26] [Shephard v Steel].

\textsuperscript{118} See, e.g. National Bank of New Zealand v Coyle (1999) 8 NZCLC 262,100 at 262.

\textsuperscript{119} Chatfield v Mercury Energy Ltd (1998) 8 NZCLC 261,645. Randerson J said at 261 that “the focus of s 292(2)(b) is very different [from the focus of its predecessor section, s 309 of the Companies Act 1955]. It is not concerned with the overall effect of the transaction on the assets of the company. Rather, it is concerned with whether the creditor has received a greater payment than it would otherwise have received in the liquidation.”

\textsuperscript{120} Cobb & Co Restaurants Ltd v Thompson (2004) 9 NZCLC 263,638 (HC) [Thompson].

\textsuperscript{121} Market Square Trust, supra note 34 at [43]. Requiring that the pool of assets available for distribution to creditors in liquidation must be decreased for a preference to occur is more appropriately dealt with provisions prohibiting “transactions at undervalue” in s 297 of the Companies Act 1993. The purpose of preventing transactions at undervalue is to prevent depletion of a company’s asset base: Paul Heath and Mike Whale, \textit{Heath and Whale on Insolvency} (LexisNexis NZ Ltd, 2013), ch 24.

\textsuperscript{122} Market Square Trust, supra note 34 at [44] to [49]. The Court of Appeal observed that a hypothetical liquidation concept would impose considerable practical difficulties on liquidators, as the liquidator would have to assess who the creditors were at the time of the alleged preference, and then assess the effect of the transfer on the creditor in question against those creditors.

\textsuperscript{123} Corporations Act 2001 (Cth), s 588FA(3). Australian Courts have worked with the running account principle for over 50 years: initially, as a common law principle and, more recently, as a statutory provision: Kaleb James Crossland, \textit{Personal Bankruptcy and Insolvency} (LexisNexis New Zealand Ltd, 2013), part VII at 63.

\textsuperscript{124} Companies Amendment Act 2006, s 27(2). As is argued in Chapters 4 and 5, the s 296(3) creditor defence was also likely intended to partially replace the ordinary course of business exception.
must consider whether the net effect of the running account on that creditor is “preferential.”

Again, there is no need for the other creditors to have been disadvantaged by a net reduction of assets available to meet the competing demands of other creditors. Where there is a net increase in the creditor’s indebtedness over the course of the running account, there is no debt for which the creditor has received a payment under section 292(1), and thus no insolvent transaction that the liquidator can cancel. It is only where there is a net reduction in the creditor’s indebtedness that an insolvent transaction may arise.

While it is on balance an improvement on its ordinary course predecessor, section 292(4B) is not without its interpretative difficulties. Indeed, Young J described its almost-identical Australian counterpart as “very verbose” complaining that its “concatenation of words is sometimes difficult to comprehend.”

Problematically, the phrase “continuing business relationship” is not defined, other than the example given of “running account,” which is also undefined. This has given rise to uncertainty around a number of key aspects of section 292(4B), as described briefly below.

Applicability of the “peak indebtedness” rule

Section 292(4B) does not define when the running account period commences and terminates, or whether a liquidator can select the start or end dates of the running account period. Under the equivalent Australian provision (which also does not specify this point), the High Court of Australia held in Rees v Bank of New South Wales that liquidators may “cherry pick” the most favourable date for the start of the running account period, provided that date falls within the

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126 See note 121 above.
127 Shephard v Steel, supra note 117.
128 Sutherland v Liquor Administration Board (1997) 24 ACSR 176 at 181. In full, section 292(4B) provides that where 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
(a) 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—
(b) subsection (1) applies in relation to all the transactions forming part of the relationship as if they together constituted a single transaction; and
(c) 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.
clawback period.\textsuperscript{129} This rule became known as the “peak indebtedness” rule, as liquidators are likely to “cherry pick” the period during which the debtor company is most heavily indebted to the creditor. This maximises the potential returns to the unsecured creditors, as it allows liquidators to exclude other transactions occurring outside that period that may have lessened the preferential effect on the creditor, thus reducing the net value of the payment or assets able to be clawed back. However, the majority of the High Court of Australia in \textit{Airservices Australia v Ferrier} brought the applicability of the peak indebtedness rule into doubt, commenting that:

\begin{quote}
... a payment made during the six month [clawback] period cannot be viewed in isolation from the general course of dealing between the creditor and the debtor before, during and after that period.\textsuperscript{130}
\end{quote}

In New Zealand, the position has not yet been authoritatively decided. In \textit{Blanchett v McEntee}, the High Court supported the peak indebtedness rule in \textit{obiter}, commenting that:

\begin{quote}
[\textit{I}liquidators ought to be able to cherry pick a date that best suits the general body of creditors because s 292(4B) does not limit a liquidator’s ability to do so and if the liquidator’s ability was to have been limited then the Act should have done that.}\textsuperscript{131}
\end{quote}

However, in \textit{Shephard v Steel}, Associate Judge Abbott rejected the peak indebtedness rule, stating that:

\begin{quote}
I find the Court’s reasoning in \textit{Ferrier} persuasive. Allowing the liquidator to pick a point of peak indebtedness is inconsistent with the basic principle of the continuing business relationship test enshrined in s 292(4B), which is to place the transaction in the wider context of ‘all the transactions forming part of the relationship.’\textsuperscript{132}
\end{quote}

Recently, two subsequent High Court decisions, \textit{Levin v Timberworld Ltd}\textsuperscript{133} and \textit{Levin v Z Energy Ltd},\textsuperscript{134} have followed \textit{Shephard} and \textit{Ferrier} in rejecting the peak indebtedness rule. While highly persuasive, these cases are not binding on future courts as they were decided at High Court level. The applicability of the peak indebtedness rule thus remains open to be authoritatively determined by a higher court, as does the exact starting point of the continuing business relationship.\textsuperscript{135} As is discussed further in Chapter 4, it is also unsettled at New Zealand.

\begin{footnotes}
\textsuperscript{129} \textit{Bank of New South Wales, supra} note 113 at 136.
\textsuperscript{130} \textit{Airservices Australia v Ferrier} [1996] 137 ALR 609 (HCA) at 623 [\textit{Ferrier}].
\textsuperscript{131} \textit{Blanchett v McEntee Hire Holdings Ltd} (2010) NZCLC 264,763 (HC) at [69] [\textit{Blanchett v McEntee}].
\textsuperscript{132} \textit{Shephard v Steel, supra} note 117 at [35].
\textsuperscript{133} \textit{Levin v Timberworld Ltd} [2013] NZHC 3180 [\textit{Timberworld}].
\textsuperscript{134} \textit{Levin v Z Energy Ltd} [2014] NZHC 688 [\textit{Z Energy}].
\textsuperscript{135} In \textit{Shephard v Steel}, the continuing business relationship was deemed to start when the running account balance was zero, at the point when the parties first started doing business with each other: \textit{supra} note 117 at [35]. However,
\end{footnotes}
law whether the intention of a creditor or of a debtor is relevant to determining when a continuing business relationship begins and ends under section 292(4B).

3.2.3 Procedure of setting aside

If a transaction is voidable as an “insolvent transaction” under section 292, the liquidator must file a notice in Court in order to set aside that transaction, and must serve the notice as soon as practicable on the creditor. Under section 294(3), the creditor named in the notice then has 20 working days within which to send a written notice of objection to the liquidator. If the creditor does not object during that period, the transaction will be automatically set aside. In the event the creditor does object, the liquidator may apply to the court for the transaction to be set aside. Where the transaction is set aside under section 294, the court may make a range of orders for relief under section 295. Most frequently, the court will order the preferred creditor to pay or transfer to the company money or assets equal to the value received under the insolvent transaction. There is no scope for an order to be made for punitive purposes or with the aim of deterring future preferences from being accepted or granted.

Timberworld suggested that the continuing business relationship should start from the beginning of the specified period: supra note 133 at [50].

Companies Act 1993, s 294(1)(a). This notice must comply with the procedural requirements set out in s 294(2), which include (but are not limited to) that: the notice must in writing, specify the transaction to be set aside, describe the property or state the amount the liquidator wishes to recover, state the liquidator’s postal, email, and street addresses, and state that the creditor has 20 working days within which to object by written notice to the liquidator to the transaction being set aside.

Companies Act 1993, s 294(1)(b).

S 294(3) provides that the transaction or charge is automatically set aside as against the creditor on whom the liquidator has served the liquidator’s notice, if that creditor 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. S 294(4) also relevantly provides that the creditor’s notice of objection sent to the liquidator must contain full particulars of the reasons for objecting and must identify documents that evidence or substantiate the reasons for objecting.

Companies Act 1993, s 294(5). The process of automatically setting aside preferences under s 294 differs from the position under pre-2006 regime under the Companies Act 1993.

Farrar and Watson, supra note 10 at 954. The full list of orders available to the court under section 295 are as follows:

(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
3.2.4 **Third party bona fide defence: section 296(1)**

Third party bona fide purchasers for value are protected by section 296(1) of the Act. Thus, even if a transaction is found to be an “insolvent transaction” and is automatically set aside under section 296(4), or the Court makes an order under section 295, this does not affect the title or interest of a person in property, provided that the person acquired that property from a person other than the company,\(^{142}\) for valuable consideration\(^{143}\) and without knowledge of the circumstances under which the property was acquired from the company.\(^{144}\)

3.2.5 **Defence available to creditors: section 296(3)**

Even if all elements of section 292 are met and the transaction is voidable, a court may deny recovery by the liquidator if the creditor can establish the requirements of section 296(3).\(^{145}\) Section 296(3) relevantly provides:

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.

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\(^{141}\) In Farrell v Aps the High Court stated that the purpose of a court order to set aside a transaction is to “eliminate any element of preference benefitting a creditor,” rather than for punitive purposes: Farrell v Aps [2012] NZHC 417 at [35].

\(^{142}\) Companies Act 1993, s 296(1)(a).

\(^{143}\) Ibid, s 296(1)(b).

\(^{144}\) Ibid, s 296(1)(c).

\(^{145}\) The person seeking the order bears the onus of proof of establishing each element within section 296(3): see, e.g. Thompson, supra note 120.
The defence differs substantially from its pre-2006 predecessor. Yet as will be discussed in Chapter 4, despite the changes wrought by the Companies Amendment Act 2006, the defence is problematic on a policy level. The elements of the defence are briefly outlined below.

**Good faith: section 296(3)(a)**

In order to satisfy this element, the creditor must show that she honestly believed that the transaction would not involve any element of undue preference either to herself or to any guarantor at the time when the creditor received the alleged preference. A creditor will also fail the test if she is aware that the debtor intended to grant her the preference at the time she received the money or property. The test is wholly subjective. As Blanchard J commented in the leading case of *Market Square Trust*:

> a creditor is likely to fail this test where he or she has actual or implied knowledge of the company’s financial difficulties, due to the company’s cheques being dishonoured, its failure to pay its debts on time, or other circumstances indicating serious cash-flow problems.

However, some awareness of financial difficulty is not necessarily enough to establish a lack of good faith. For example, in *Grant v Shears*, the High Court found that the creditor had acted in good faith despite threatening to serve a statutory demand on the debtor as a result of a late payment. In the recent case of *Giant Engineering v Rapid*, the Court of Appeal held that the creditor (Rapid) satisfied the good faith requirement, despite the fact that Rapid knew that Giant Engineering had suffered a substantial fire damaging its premises and machinery, and that Giant was consequently experiencing liquidity difficulties. The Court of Appeal found that Rapid had assumed Giant’s liquidity problems were temporary, and that its cash flow problems would soon be mitigated by payments from insurers. In addition, it held that Rapid’s entry into a

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146 Prior to the amendments made by s 31 of the Companies Amendment Act 2006, the elements of section 296(3) were satisfied if: (a) the person from whom the recovery is sought received the property in good faith; (b) the person from whom the recovery is sought has altered his or her position in the reasonably held belief that the transfer to her was validly made and would not be set aside (in other words, if the creditor had relied on the payment’s validity to her detriment); and (c) in the opinion of the court, it is inequitable to order recovery or recovery in full.

147 *Fences & Kerbs Ltd* [2013] 3 NZLR 82 (CA) at [86] [*Fences & Kerbs (CA interim)*]. See also *Re Orbit Electronics Auckland Ltd* (1989) 4 NZCLC 65,170 (CA), approved in *Market Square Trust*, supra note 34 at [54].


150 *Grant v Shears* [2012] NZHC 1772.

151 *Giant Engineering v Rapid*, supra note 149 at [18].
reciprocal payment agreement (whereby the two parties swapped cheques for their respective amounts outstanding to each other\textsuperscript{152}) demonstrated that Rapid intended to assist Giant through its liquidity difficulties, and that Rapid did not intend to obtain a preference.\textsuperscript{153}

**Suspicion of insolvency: section 296(3)(b)**

Section 296(3) is closely based on the equivalent Australian provision.\textsuperscript{154} The first limb of the test in section 296(3)(b) – i.e. that a reasonable person in the creditor’s position would not have suspected that the debtor company was, or would become, insolvent – is assessed on an objective basis.\textsuperscript{155} The second limb of the test – that the creditor did not in fact have reasonable grounds for suspecting, that the company was, or would become, insolvent – “is a question at looking at the commercial circumstances at the time, as the parties perceive them to be, and not with hindsight.”\textsuperscript{156} The test for suspicion is set out by Kitto J in *Queensland Bacon Pty v Rees*:

> A suspicion that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of actual apprehension or mistrust, amounting to ‘a slight opinion, but without sufficient evidence’... a reason to suspect that a fact exists is more than a reason to consider or look into the possibility of its existence.\textsuperscript{157}

For each limb, the creditor’s state of mind is to be assessed at the time when she received the alleged preference.\textsuperscript{158} There is some crossover with the good faith requirement around knowledge of financial difficulties here. For example, the reasons given by the Court of Appeal in *Rapid v Giant Engineering* for a finding of no suspicion of insolvency on both limbs of section

\textsuperscript{152} It was this reciprocal payment agreement that gave rise to the alleged preference, as Rapid received a net benefit under the arrangement. The parties entered into this arrangement for reasons of accounting simplicity and transparency: *ibid* at [13].

\textsuperscript{153} *Ibid* at [18].

\textsuperscript{154} *Corporations Act 2001* (Cth), s 588FG(2)(b).

\textsuperscript{155} *D’Aloia v Federal Commissioner of Taxation* (2004) 51 ACSR 530 (FCA) at [29]-[31]. There is some uncertainty in Australia as to whether this first limb concerns the knowledge of a reasonable person with access to the range of full knowledge and business qualifications of the creditor (See, e.g. the Full Court of South Australia in *Sims v Celcast Ltd* (1998) 71 SASR 142 at 145), or whether the reasonable person is simply an “ordinary person on the Bondi bus” who does not necessarily have the same qualifications and knowledge as the creditor. See, e.g. *Cussen v Federal Commissioner of Taxation* (2004) 51 ACSR 530 (NSWCA) at [30]. This discrepancy has not been addressed in depth judicially in New Zealand, beyond accepting that it concerns “a reasonable person standing in the creditor’s shoes.” (see, e.g. *Giant Engineering v Rapid* at [22]). The issue therefore remains open for debate.

\textsuperscript{156} *Blanchett v McEntee*, supra note 131 at [34].

\textsuperscript{157} *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 (HCA) at 303, cited with approval in *Blanchett v McEntee*, supra note 131 at [33] and in *Jollands*, supra note 125 at [26].

\textsuperscript{158} *Fences & Kerbs* (CA interim), supra note 147 at [86].
296(3)(b) were much the same as those given for the finding of good faith.\textsuperscript{159} As the High Court pointed out in \textit{Meltzer v Allied Concrete}, “a temporary lack of liquidity is generally insufficient for a suspicion of insolvency…apparent cash-flow problems may be explained simply by a habit of delay in payment.”\textsuperscript{160} Ultimately, whether section 296(3)(b) is satisfied will be highly fact specific,\textsuperscript{161} and (as the New Zealand Court of Appeal stated) must be “assessed in accordance with prevailing business practices, the factual matrix of the case and the trading relationship between the parties.”\textsuperscript{162}

\textit{Gave value: section 296(3)(c)}

Perhaps the most contentious aspect of the creditor defence – and the most highly litigated aspect of New Zealand’s preference regime in recent years – is the first part of the third limb of the creditor defence. If a creditor can establish she “gave value” for the property or alleged payment received from the debtor, then section 296(3)(c) will be satisfied. The contentious issue is at what time the creditor must “give value,” a debate that brings the trade-offs between \textit{pari passu} and commercial certainty into sharp relief. As is discussed in part 4.2.2 of Chapter 4, the High Court and Court of Appeal took very different positions on the respective importance of each in voidable preference policy.

\textit{Alteration of position: section 296(3)(c)}

As an alternative to the “gave value” requirement, the creditor may satisfy section 296(3)(c) if she can establish the alteration of position element. First, the creditor must have consciously or

\textsuperscript{159} \textit{Giant Engineering v Rapid, supra} note 149 at [19]-[23]. The Court of Appeal accepted that Rapid honestly believed that Giant’s liquidity problems were temporary, and “primarily logistical and not financial.” The Court held that Rapid honestly believed the payment would not result in any undue preference, and that “a reasonable person standing in Mr Hume’s shoes would believe Giant’s outstanding accounts had been settled and the cash flow problem alleviated.”

\textsuperscript{160} \textit{Meltzer (Windows Holdings Ltd) v Allied Concrete Ltd} [2013] NZHC 977 at [13] [\textit{Meltzer v Allied Concrete}].

\textsuperscript{161} As Chapter 4 discusses, it is often highly uncertain as to whether the requirements in s 296(3)(b) will be met.

\textsuperscript{162} \textit{Giant Engineering v Rapid, supra} note 149 at [19]. For example, in \textit{Blanchett v McEntee}, a creditor (McEntee) issuing a debtor with a stop credit notice and referring the debtor’s account to a debt collection agency was evidence of a subjective suspicion of insolvency, given the parties’ debt collection agency was evidence of a subjective suspicion of insolvency, given the parties’ trading history and in light of evidence that the creditor only took such actions in instances of suspected insolvency. The High Court held the objective limb of the test was also satisfied, stating that “a reasonable person in McEntee’s position would have suspected the Company was insolvent because McEntee itself did so and that is why it referred the matter to a debt collection agency”: \textit{Blanchett v McEntee, supra} note 131 at [40].
deliberately altered her position after receiving the property or money.\(^{163}\) The inquiry as to alteration of position “is essentially one of causation”\(^{164}\) and whether the creditor has acted to her detriment.\(^{165}\) In contrast to the contentious issue of the timing of “giving value” discussed above, it is generally accepted that the conscious alteration of position will occur after receipt of the alleged preference, although alteration of position contemporaneous with receipt of payment will also be sufficient.\(^{166}\) For example, in *Rapid*, the Court of Appeal held that Rapid only discharged its debt to Giant under the reciprocal payment agreement because it was receiving payment contemporaneously from Giant. The detriment suffered was that Rapid could have retained the sum it owed Giant and applied for set-off upon Giant’s eventual liquidation, had Rapid known the payment from Giant might be set aside.\(^{167}\) Secondly, the creditor must establish she would not have altered her position but for receipt of the property or money and a “reasonably held belief” that the transfer was valid and would not be set aside.\(^{168}\) Like the good faith and reasonable suspicion of insolvency requirements, this requires an inquiry into the creditor’s state of mind. A positive finding of good faith under section 296(3)(a) will assist the creditor in establishing the creditor’s belief is “reasonably held.”\(^{169}\)

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\(^{163}\) *Harte v Wood* [2004] 1 NZLR 526 (CA) [*Hart v Wood*], cited with approval by the Court of Appeal in *Giant Engineering v Rapid*, supra note 149 at [25].

\(^{164}\) *Re Bee Jay Builders Ltd* [1991] 3 NZLR 560 (HC); *Giant Engineering v Rapid*, supra note 149 at [27].

\(^{165}\) *Giant Engineering v Rapid*, supra note 149 at [30]. See also *Baker Timber Supplies v Apollo Building Associates (Tauranga) Society Ltd* (1990) 5 NZLC 66,791 (HC) at 66,793 (decided under the very similar section 311A(7) of the Companies Act 1955), where Fisher J stated that the creditor “must have acted to his detriment on the strength of the insolvent company’s payment” and *Harte v Wood*, supra note 163 at [39].

\(^{166}\) *Giant Engineering v Rapid*, supra note 149 at [26]. The New Zealand Court of Appeal in *Farrell v Fences and Kerbs Ltd* stated that “[a]lthough in some cases the alteration of position might occur contemporaneously with receipt of the property, it would typically occur after receipt. The legislation necessarily allows for that possibility.” *Farrell v Fences and Kerbs Ltd* (CA interim), supra note 147 at [86]-[87].

\(^{167}\) *Giant Engineering v Rapid*, supra note 149 at [27]-[28]. Set-off in this situation is permitted under s 310 of the Companies Act 1993.

\(^{168}\) *Re Bee Jay Builders Ltd*, supra note 164 at 566, cited with approval by the Court of Appeal in *Giant Engineering v Rapid*, supra note 149 at [25].

\(^{169}\) *MacMillan Builders Ltd v Morningside Industries Ltd* [1986] 2 NZLR 12 (CA). See also *Giant Engineering v Rapid*, supra note 149 at [31], where the Court of Appeal cited essentially the same factors in support of both s 296(3)(a) and s 296(3)(c).
CHAPTER 4: NEW ZEALAND’S INCOHERENT POLICY POSITION

4.1 INCONSISTENCY OF UNDERLYING RATIONALES

The 2006 amendments to the voidable preference regime were just one part of a larger parcel of sweeping reforms to New Zealand’s insolvency law. At first glance, it appears promoting *pari passu* equality was the main goal of the reforms. In its initial 2001 review of insolvency law, the Ministry of Economic Development (“Ministry”) stated that the “*pari passu* principle is critical to the effective and efficient operation of insolvency law.” Similarly, the Explanatory Note to the Insolvency Reform Bill 2006 stated that “[t]he fundamental principle that underpins insolvency law is the *pari passu* or “equal step” principle” and that “insolvency law provides for equal treatment of all creditors within a particular class.”

A focus on intention was considered to be “at odds with the primary object of voidable preference law, which is to achieve equality between creditors.” The promotion of *pari passu* is further apparent in the wording of section 292, which, as outlined in Chapter 3, ignores issues of intention and focuses on whether the effect of a transfer or payment is to prefer the creditor receiving it. The *pari passu* policy is also supported by the courts. For example, in *Countrywide Banking Corporation v Dean*, the Privy Council stated that the policy of New Zealand’s voidable preference law is “to secure the equal participation of creditors in such of the company's property as is available in the liquidation.”

However, a contrasting purpose of promoting creditor deterrence is apparent through the statement in the Explanatory Note that:

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170 These reforms included the repeal of the Insolvency Act 1967 and introduction of the Insolvency Act 2006.
171 Tier One Discussion Documents, *supra* note 97 at 13.
173 *Ibid* at 58.
174 Section 292’s effect-based focus was recognised by the Court of Appeal in *Anzani Investments Ltd v The Official Assignee*. The Court of Appeal stated the purpose of section 292 is: “to prevent one creditor from being given preferential treatment through payment (pre-liquidation) of an amount in excess of that which would have been received had it participated with other creditors of equal rank in the distribution of the proceeds of sale of assets on liquidation.” *Anzani Investments Ltd v The Official Assignee* [2008] NZCA 144 at [6].
175 *Countrywide Banking Corporation Ltd v Dean* [1998] 1 NZLR 385 (PC) at 395.
In the absence of [the pari passu] principle, each creditor would have the incentive to act in their own self-interest, seeking to apply to the court first with a view to recovering everything owed to them, regardless of the consequences for other creditors.\textsuperscript{176}

This indicates a concern to deter creditors from disrupting the liquidation procedure through obtaining preferences. Problematically, a strong policy of creditor deterrence is also apparent in sections 296(3)(a) and (b) of the creditor defence.\textsuperscript{177} As discussed in Chapter 3, section 296(3)(a) requires a creditor to show that she honestly believed that the transaction would not involve any element of undue preference, and involves an inquiry into the creditor’s actual and implied knowledge of the company’s financial position. Section 296(3)(b) focuses on whether the creditor had, or a reasonable person in the creditor’s position would have, suspected that the debtor was or would become insolvent. This is consistent with creditor deterrence. Under a true pari passu regime, preferences would be voidable regardless of the creditor’s intention in obtaining or receiving the preference.

The Government did not specifically acknowledge in any of the relevant discussion documents surrounding the 2006 reforms that the section 296(3) defence would import a strong creditor deterrence policy. Instead, it is likely that the creditor defence was introduced as a means to temper the strict operation of the pari passu principle and introduce more flexibility into the regime. The Ministry stated that defences and exceptions to pari passu are necessary:

\begin{quote}
...to ensure effective challenges cover only the type of transactions which the law is concerned to discourage or reverse...[and] to temper the pursuit of collective justice for creditors as a whole with individual justice for a particular party in the circumstances of each case. There is a risk that, if the law fails to do so, it might impair the free flow of trade by undoing transactions a reasonable New Zealander, aware of the facts known to the trader, would consider normal [emphasis added].\textsuperscript{178}
\end{quote}

Further, one of the overall objectives of the 2006 reforms was to:

\begin{quote}
distribute the proceeds to creditors in accordance with their relative preinsolvency entitlements, unless it can be shown that the public interest in providing greater protection to one or more creditors outweighs the economic and social costs of any such priority [emphasis added].\textsuperscript{179}
\end{quote}

\textsuperscript{176} Explanatory Note, supra note 172 at 1.
\textsuperscript{177} According to a recent Court of Appeal decision, the third limb of the defence (s 296(3)(c)) imports a pari passu policy back into the defence: see Chapter 4, part 4.2.2.
\textsuperscript{178} Tier One Discussion Documents, supra note 97 at 55.
\textsuperscript{179} Explanatory Note, supra note 172 at 2.
As discussed in Chapter 2, some exceptions to promoting *pari passu* are both necessary and desirable in order to accommodate certain other policy objectives, such as deterring creditors from seeking preferences, or enabling distressed debtors to continue trading. On one view therefore, the Government may have implemented the section 296(3) defence in order to “discourage” or deter creditors from intentionally seeking preferences and to ensure that only dishonest transactions were reversed. Indeed, Telfer and Brown argue that through the introduction of the section 296(3) defence, New Zealand preference law has shifted towards a creditor culpability model and away from the *pari passu* model. Intending to promote a policy of creditor deterrence through the creditor defence would be deeply flawed, however. Policymakers must take care to draw a distinction between selecting the underlying policy objective of the voidable preference regime (for example, either promoting *pari passu* OR creditor deterrence) and selecting any exceptions to that underlying policy. The following paragraphs argue that creditor deterrence is neither an appropriate basis for an exception to *pari passu*, nor an appropriate underlying policy of the voidable preference regime as a whole.

**Minimal deterrent effect**

As Chapter 2 argued, there is no evidence that focussing on creditor intent actively deters creditors from seeking preferences. Creditors in New Zealand today are generally more aware of the existence of the voidable preference regime than they were 15 years ago when the initial review of insolvency law was conducted. However, awareness of the regime’s existence does not necessarily equate to deterrence. Preference actions continue to frequently appear before the New Zealand courts, suggesting that many creditors are not being deterred from seeking preferences. This is perhaps unsurprising. As the Court cannot make a section 295 order setting aside a transaction for punitive reasons, there is little to dissuade creditors from seeking a preference. The debtor may never be put into liquidation, in which case the transaction would

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181 In 2001, most small businesses, and some large businesses in New Zealand were unaware of the existence and potential effect of the voidable preference regime: Tier One Discussion Documents, *supra* note 97 at 57. However, due to extensive media coverage, high rates of preference litigation and frequent newsletters and publications in legal and insolvency circles on the operation and implications of New Zealand’s regime, this statement likely no longer holds true.

182 It is of course difficult to draw any solid conclusions on the rate of deterrence, as without extensive empirical evidence, it is impossible to tell how many creditors have not sought preferences.
never be clawed back. Even if the preference is voided and the defence is unsuccessful, the creditor will only be worse off to the extent she expended costs to obtain the preference in the first place, or through any legal costs of contesting the clawback. As Telfer points out, “it is unrealistic to expect creditors who are aware of the debtor’s financial insolvency ‘‘to exercise restraint in the name of the common good.’”\(^\text{183}\)

**Uncertain scope of defence**

The uncertainty introduced by the creditor defence also likely outweighs any individual justice or public interest concerns in protecting “honest” creditors. Focussing on the creditor’s state of mind introduces a deep element of uncertainty into the regime. Yet the legislative history indicates the creditor defence was expected to introduce more certainty into the regime, not less. A major reason behind this expectation of increased certainty was an assumption that the existing Australian jurisprudence would help clarify many of the interpretative issues. The Explanatory Note stated that:

\[
\text{[t]here will be an initial period of uncertainty regarding the meaning of the new [section 296(3)] tests, but this will reduce over time and will be mitigated by basing the new test on an Australian test, allowing the courts to have the benefit of the Australian courts’ experience in interpreting those provisions.}^\text{184}\]

Telfer and Brown, writing about the reforms in 2006, adopted a similar attitude. While acknowledging many of the policy problems with the defence outlined above (including the possibility that the defence may not deter the relevant creditor behaviour\(^\text{185}\)) they stated that “the existing Australian jurisprudence means that some of the knottier issues [regarding the defence] have already been addressed and New Zealand will benefit from the Australian case law.”\(^\text{186}\) History has proven otherwise, however. Despite the existing Australian jurisprudence, application of the creditor defence remains uncertain and problematic for many of the same

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\(^{183}\) Telfer, *supra* note 11 at 81.

\(^{184}\) Explanatory Note, *supra* note 172 at 25.

\(^{185}\) Brown and Telfer, “Plus Ça Change?” *supra* note 10 at 183: (“[a]lthough New Zealand may now have shifted to a new “suspicion of insolvency” test, it remains to be seen whether this new standard will filter out the dismemberment actions that it seeks to deter.”)

\(^{186}\) *Ibid.* Brown and Telfer also stated in a 2006 textbook that “[i]t is suggested that the basis of the law will now be much clearer, in that the “effect” of the transaction, including a series of transactions, can now be adjudged, coupled with a defence which focuses primarily on the creditor’s state of mind.” David Brown and Thomas G W Telfer, *Personal and Corporate Insolvency Legislation: Guide and Commentary to the 2006 Amendments* (Wellington: LexisNexis NZ Ltd, 2007) at 79.
reasons as the old ordinary course of business exception, and has resulted in litigation around many of the same sorts of facts.\textsuperscript{187} For example, in \textit{Acme Engineering}, a payment to a supplier was 60 days overdue. The supplier agreed that the debtor would pay the invoice off through weekly instalments under a payment plan. The debtor was later found to be insolvent, and the liquidator argued that the payment plan and the overdue invoice indicated the supplier was (or should have been) aware of the debtor’s financial woes. However, the judge considered that as this payment plan had “certain industry specific elements to it” and was a “common practice” in the industry, the creditor had no reasonable suspicion of the debtor’s insolvency.\textsuperscript{188} Of course, such an argument could have been equally applicable in the context of the old ordinary course of business exception. Indeed, part of the reason the ordinary course of business exception was so problematic was the uncertainty and difficulties in establishing the creditor’s intention: that is, whether the creditor was carrying on “business as usual” or actively intending to avoid the collective liquidation proceeding.\textsuperscript{189} Yet as Chapter 3 discussed, whether section 296(3)(a) and (b) are satisfied also requires a judicial inquiry into the creditor’s state of mind, and is highly dependent on the particular facts and circumstances of the individuals and transactions involved. The imprecise and vague nature of the “good faith” and “reasonable suspicion” standards adds to the uncertainty as to whether the defence will prevent a particular transaction from being voided.\textsuperscript{190} Even if creditors are aware of the defence’s existence and the terms of its operation, the defence is unlikely to act as a deterrent if creditors are ignorant as to the circumstances in which a transaction will be protected. The defence may even have the perverse effect of encouraging creditors to actively avoid taking any action that might give rise to a reasonable suspicion of insolvency - for example, ceasing to monitor the debtor’s insolvency or ceasing to issue “stop credit” notices.\textsuperscript{191}

\textsuperscript{187} Indeed, in recommending the repeal of the ordinary course of business exception, the Ministry stated that one of the main disadvantages associated with the exception was “the unnecessary costs caused by the uncertainty surrounding what that phrase means in any given situation.” Tier One Discussion Documents, supra note 97 at 59. 

\textsuperscript{188} \textit{Farrell v Acme Engineering Ltd} [2012] NZHC 2874 at [51] [\textit{Acme Engineering}].

\textsuperscript{189} As the Ministry noted in the Tier One Discussion Documents, supra note 97 at 59, “[t]he knowledge of the other party to the transaction is...a factor in establishing whether a payment was made in the ordinary course of business. This has re-introduced the evidential difficulties and cost associated with proving such an element.”

\textsuperscript{190} See the discussion in Chapter 5, part 5.2 on the uncertainties associated with standard-based legislative provisions.

\textsuperscript{191} For example, as discussed at note 162 above, in \textit{Blanchett v McEntee} (supra note 131), the creditor’s issue of a stop credit notice was found to be a key indication that the creditor had a reasonable suspicion of the debtor’s insolvency.
Creditor defence as a means of enabling a distressed debtor to continue trading?

On another view, the creditor defence may have been intended to prevent the strict operation of the *pari passu* policy from unduly interfering with the continued provision of credit to financially distressed debtors. The second part of the policy statement at note 178 above indicates an intention to preserve the “free flow of trade” through protecting transactions that “a reasonable New Zealander…would consider normal.” This policy is very similar to that underlying the old ordinary course of business exception. As Duggan and Telfer observe, one of the main justifications for an ordinary course of business exception in a voidable preference regime is to encourage creditors to do business on a credit basis with a financially distressed debtor. As part 2.1.3 of Chapter 2 discusses, without protecting “ordinary” or “normal” transactions, creditors would withhold credit from distressed debtors, and inevitably drive more debtors deeper into insolvency. An ordinary course of business exception enables both creditors and debtors to be better off. Tabb succinctly summarises the argument as follows:

> [e]ven if the debtor does file [for liquidation], it will be in a stronger financial condition when it does so because of the operation of the incentive effect [of the ordinary course exception]…the basic notion is that even though some creditors are paid a larger percentage share of their claim than others, every creditor ultimately recovers more total dollars because the total asset pie is larger.

However, for the reasons stated above, the ordinary course of business exception in the pre-2006 Companies Act 1993 was deeply uncertain and problematic, and was therefore repealed. It is possible therefore, that in amending the section 296(3) defence to its current form, New Zealand policymakers were merely looking for a clearer formulation of the same basic policy. This is supported by the Ministry’s admission in 2001 that the ordinary course of business exception and the section 296(3) defence are “somewhat difficult to reconcile.” As the above example of *Acme Engineering* illustrates, each provision involves very similar inquiries into the creditor’s intention and knowledge of the debtor’s insolvency. Another good example of the similarity between the two provisions is *Giant Engineering v Rapid*, where Giant Engineering was found to be acting in good faith under section 296(3)(a), as its principle reason in granting the preference and continuing to do business with the debtor was to assist the debtor through liquidation

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193 Tabb, “Rethinking Preferences” *supra* note 5 at 1021.
194 Tier One Discussion Documents, *supra* note 97 at 67.
difficulties suffered as a result of a damaging fire to its premises.\textsuperscript{195} It is therefore plausible that the Ministry intended the amended section 296(3) (together with the running account principle) to replace the ordinary course of business exception.\textsuperscript{196} This would allow the policy behind the ordinary course of business exception to be continued into the post-2006 regime, without importing any of the exception’s associated uncertainties and problems.\textsuperscript{197} This conclusion is supported by the Ministry’s statement that “some form of defence provision is necessary” to prevent a “strictly effects-based test [from removing] protection afforded by the ordinary course of business to recipients of transactions in situations where it might be unjust to require repayment.”\textsuperscript{198}

In summary, while the creditor defence appears to import a problematic policy of creditor deterrence, this may not necessarily have been intended by policymakers. However, the wording of the defence not only fails to clearly articulate an intention to preserve “ordinary course” transactions, it is also so broad and ambiguous that it reintroduces many of the same problems in undermining commercial certainty inherent in the old ordinary course exception. Chapter 5 therefore suggests that the defence is reformed.

\section*{4.2 PROBLEMS STEMMING FROM AN INCOHERENT POLICY BASIS}

These inconsistencies with the policy underlying the creditor defence are symptomatic of a deeper underlying policy incoherence in New Zealand’s voidable preference regime as a whole. In the remainder of this Chapter, I analyse certain problematic aspects of the regime that illustrate that policymakers and the judiciary have failed to carefully identify, analyse and consider the competing policies at stake. I argue that the New Zealand voidable preference regime fails to strike an appropriate balance between achieving \textit{pari passu} equality, promoting commercial certainty and enabling a distressed debtor to continue trading, and that as a result the

\begin{footnotesize}
195 See \textit{Giant Engineering v Rapid}, supra note 149, and the discussion of the applicability of the creditor defence to the case at part 3.2.5 above.
196 As the Ministry argued, “if the ordinary course of business exemption were replaced with either a “running account” or similar principle…the defence in section 296(3) would again be relevant”: \textit{Ibid} at 67.
197 As discussed above, it was expected that the creditor defence would be far more certain and easy to apply than the ordinary course exception, mainly due to the existing Australian jurisprudence.
198 \textit{Tier One Discussion Documents}, supra note 97 at 67.
\end{footnotesize}
policy underlying New Zealand’s voidable preference regime is perhaps best described as “incoherent.”

4.2.1 Long clawback period

Perhaps the most problematic statutory provision in terms of undermining commercial certainty is the overlong clawback or “specified” period. As discussed in Chapter 3, depending on the method by which the debtor company is put into liquidation, a transaction may be voidable up to two years after it was made. A long clawback period is consistent with the pari passu principle, and may be described as a “super-equality” rule, as it attempts to place all equally-ranking creditors on an equal footing during liquidation through clawing back as many payments as possible. However, this lengthy clawback period greatly destabilises commercial certainty and is detrimental to the ordinary flow of commerce. For example, Graham Burke, president of the New Zealand Specialist Trades Contractors Federation, commented in 2013 that the long clawback period “flies in the face of natural justice” and that:

[The law as it stands is ridiculous…We can't have this situation, where you're working for a company and you've got no way of knowing they're trading insolvently... and you have no certainty over those payments for a period of two years.

One typical response from liquidators is that commercial players negotiating this lengthy clawback period should ensure that they are paid in advance for their services rendered, so that they never actually extend credit. While that may seem plausible in theory, in practice it is impossible for many businesses to receive payment upfront, particularly in industries where

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199 In particular, the construction, engineering and trade supplying industries are especially vulnerable to the long clawback period. The players in those industries generally supply their services first and are only paid afterwards, therefore customarily operating with sporadic levels of liquidity. The sectors are also prone to more failures than others: Catherine Harris, “Alarm at 'absurd' clawback decision” Stuff.co.nz (17 October 2013), online: <www.stuff.co.nz>.

200 Ibid.


202 See, e.g. Liquidator Damien Grant of Waterstone Insolvency, who stated: “If you supply goods and services to a company and you get paid for those services at the time you supply them there will be no claw-back; even if you know that the company was in trouble at the time. The claw-back only applies to the repayment of old debt….The work provided by the contractor could be set-off against the income received.” Kevin Pitfield made a similar comment: “Such commercial risk can be mitigated by creditors taking appropriate action prior to supplying goods and services on credit…. where the dollars are significant enough, all things are possible”: see the comment section of Stephen Franks, “Suppliers Beware” The National Business Review (17 October 2013), online: <http://www.nbr.co.nz>.
services are sub-contracted out. Yet, as Burke notes above, it is equally difficult for suppliers to determine whether a company is insolvent. Of course, protecting creditors from clawbacks where the creditor is ignorant of the debtor’s insolvency is precisely what the creditor defence is attempting to address. However, the creditor defence becomes even more problematic in light of the long clawback period: creditors are less likely to be deterred from obtaining or receiving a preference when the prospect of the debtor’s liquidation (and the clawback) may lie up to two years away in the future.

### 4.2.2 “Gave value” limb of the section 296(3) defence as an example of New Zealand’s incoherent preference policy

As Chapter 3 indicated, the third limb of the creditor defence requires the creditor to prove she “gave value” for the property or alleged payment received from the debtor. The contrasting positions taken by the High Court and Court of Appeal as to which point in time the creditor must “give value” are a striking illustration of the incoherent and uncertain state of the policy behind the section 296(3) defence.

In late 2012 to early 2013, the High Court held in four separate decisions that value given by the creditor to the debtor prior to receiving the alleged preference will be sufficient to satisfy the “gave value” requirement in section 296(3)(c). In each case, the High Court placed significant weight on the fact that “prior value” is the position in Australia, despite the fact that the New

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203 Maria Slade, “Companies fight against claw-back law” The New Zealand Herald (12 September 2010), online: <www.nzherald.co.nz>.


205 See, e.g. Associate Judge Christianson in *Fences & Kerbs* (HC) stated “[i]t was the purpose of the 2006 amendment to rely on the closely related insolvency positions of Australia and New Zealand. It seems unlikely in that context that there would have been a deliberate endeavour to distinguish the jurisdiction of those Courts… If that is the purpose of s 296(3) then it is immaterial whether value is given before or after the property or payment is received. The transaction should be viewed as a whole and the equitable foundations of s 296(3) should prevail”: *Fences & Kerbs* (HC), supra note 204 at [62]-[65]. Similarly, in *Meltzer v Hiway*, Toogood J suggested that the “arguably different position between the New Zealand defence and the Australian defence was unintentional, in that the drafters of the New Zealand legislation did not fully appreciate the arguable significance of applying the temporal element of the defence to all three limbs”: *supra* note 204 at [34].
Zealand and Australian provisions differ slightly in wording.\textsuperscript{206} Significant weight was also placed in each case on issues of equity and justice for the parties involved. Justice Toogood argued in \textit{Hiway Stabilisers} that requiring advance value would have an “absurd” effect, as there was “no reason in either logic or policy” why a supplier should be disadvantaged just because it had provided its services ahead of being paid - as most suppliers do.\textsuperscript{207} Similarly, Associate Judge Christenson in \textit{Fences and Kerbs} argued that excluding a creditor’s “prior value” from being “value” under section 296(3) would unfairly advantage the debtor in the transaction:

\begin{quote}
[e]quity would not permit the debtor company to keep what it has received and to also recover what it paid for it, in order to increase the distribution to creditors who have provided value but received no payment.\textsuperscript{208}
\end{quote}

The liquidators in \textit{Fences and Kerbs} appealed to the New Zealand Court of Appeal. The Court of Appeal took an opposite view to the High Court decisions.\textsuperscript{209} In its judgment handed down in March 2013, the Court held that the giving of value must be proved to have occurred \textit{at or after} the time the transfer was received from the debtor, and “does not include value given to the company at the time the antecedent debt was created.”\textsuperscript{210} The Court of Appeal rejected the arguments made at the High Court level that allowing prior value is “equitable” and “fair,” stating that:

\begin{quote}
the objective and effect of the voidable preference regime is not to do justice or achieve fairness between a particular creditor and the debtor company…. the objective is to achieve fairness amongst all creditors inter se.\textsuperscript{211}
\end{quote}

This fairness is, in the Court of Appeal’s opinion, achieved by only allowing current or future value to count as “value.” The Court held that “value” means something that has a real and substantial value and is of real worth to the debtor.\textsuperscript{212} The Court therefore reasoned that:

\begin{quote}
\textsuperscript{206} See, e.g. \textit{Taylor v White} (1964) 110 CLR 129. Under the equivalent Australian provision (\textit{Corporations Act 2001} (Cth), s 588FG(2)(c)), the creditor must show she “has provided valuable consideration under the transaction or has changed his, her or its position in reliance of the transaction.”
\textsuperscript{207} \textit{Meltzer v Hiway}, supra note 204 at [35].
\textsuperscript{208} \textit{Fences & Kerbs} (HC), supra note 204 at [64].
\textsuperscript{209} \textit{Fences & Kerbs} (CA interim), supra note 147; and \textit{Farrell v Fences & Kerbs} [2013] NZCA 329 [\textit{Fences & Kerbs} (CA final)]. The Court of Appeal gave a later (final) judgment after the initial (interim) judgment in order to address some outstanding issues of law (such as whether forbearance of a creditor to sue constituted “giving value” (discussed at note 212). The two judgments should be read together.
\textsuperscript{210} \textit{Fences & Kerbs} (CA interim), supra note 147 at [86].
\textsuperscript{211} \textit{Fences & Kerbs} (CA final) supra note 209 at [6].
\textsuperscript{212} \textit{Ibid} at [27-28]. The Court of Appeal also held that, in some cases, the creditor may satisfy the requirement to give real or substantive value through forbearing to sue the debtor at the time of payment. However, the creditor
the object of the avoidance provisions under the [Companies] Act is to swell the pool of funds available to the company to be shared rateably amongst all creditors of the same class in accordance with the pari passu principle. The mere receipt of payment in satisfaction of a debt due to a creditor does nothing to swell the pool of available funds for creditors. Rather, it has the effect of diminishing the company’s creditors to the extent of the payment while reducing the company’s assets by the same amount.

The Court of Appeal distinguished the Australian position on the grounds that “[t]he best guide to statutory intention is the language used” and New Zealand had “deliberately adopted different language” to Australia. The Court of Appeal therefore rejected allowing “prior value” as value under section 296(3)(c).

With respect, the reasoning at both High Court level and at the Court of Appeal is somewhat flawed. I address each in turn.

*High Court*

The High Court did not adequately consider the policy implications of its decision. Allowing value to include “prior value” significantly widens the ambit of the defence. Provided the good faith and suspicion of insolvency requirements are met, liquidators would virtually never successfully claw back a transaction. Creditors will almost invariably have given “prior value” for a payment or transfer of property received from a debtor - otherwise they would not be a creditor (for example, through the creditor supplying goods or services to the debtor and advancing credit in the first place). The High Court failed to recognise that this would significantly undermine pari passu policy. While (as argued above), a wide application of the defence could be justified on creditor deterrence grounds, or in order to encourage creditors

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213 *Fences & Kerbs* (CA final), *supra* note 209 at [8]. The Court of Appeal’s emphasis on encouraging a real or substantial addition to the asset pool is apparent in its statement at [27] that “the mere receipt of a payment by a creditor in satisfaction of an antecedent debt does not constitute the giving of value for the purposes of s 296(3) of the Act. New value which is real and substantial must be given. Whether and, if so, to what extent, new value is given at the time of receipt of the payment will be a question of fact in each case.”

214 *Fences & Kerbs* (CA interim), *supra* note 147 at [78].
(acting in good faith) to continue supplying credit to financially distressed debtors, the High Court did not consider this in any of its decisions on the issue. Finally, and as the Court of Appeal criticised, it was inappropriate for the High Court to rely so heavily on arguments of individual fairness and justice for creditors. In the context of insolvency law and the collective remedy of liquidation, the impact on creditors as a whole should be assessed.

_Court of Appeal_

While the Court of Appeal’s judgment recognised the importance of _pari passu_ policy in the context of voidable preferences, it too failed to adequately consider the policy implications of its decision. The Court of Appeal’s judgment had the opposite effect to the High Court decisions, in that it significantly narrowed the application of the creditor defence. Even if the good faith and no suspicion of insolvency requirements were met, creditors will rarely “give value” to a debtor _after_ receiving payment from the debtor under section 296(3)(c). Creditors would not be creditors without supplying goods and services to debtors _prior_ to receiving payment for those goods and services. Essentially, the Court of Appeal’s ruling nullifies the power of the defence to protect creditors. Yet this surely would not been the legislative intention. Otherwise, the defence would not have been included in the regime in the first place. Unsurprisingly, creditors and suppliers in New Zealand were deeply dismayed at the outcome and the consequences for certainty of transactions, with one commentator describing the Court of Appeal’s ruling as “absurd…uncertain, and dangerous.”

The Court of Appeal’s narrow interpretation of section 296(3)(c) therefore undermines commercial certainty, as it brings New Zealand’s preference regime much closer to becoming a strict liability _pari passu_ regime, particularly given the overly long clawback period.

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216 The Court of Appeal did make some attempt to introduce some flexibility into the defence, holding that: “For practical purposes…[the assessment of when value is given] need not be made at the precise moment in time when property is received, such as the time funds were credited to the payee’s bank account. For example…the actual supply of further goods or services might precede the actual date of payment by a short period…A realistic commercial approach is required to make the legislation work.”: _Fences & Kerbs_ (CA interim), _supra_ note 147 at [90]. Again, however, it is likely that many creditors would not receive payment so close to when the goods or services are supplied, and this “commercial approach” is unlikely to have any practical effect in widening the scope of the defence.
The Court of Appeal argued that a narrow application of the defence and stricter application of the *pari passu* policy was offset by the fact that the running account test “at least partially recognised” the policy behind the ordinary course of business exception “to assist creditors who engage in ongoing business relationships with a company that ultimately becomes insolvent.”

However, the Court of Appeal did not recognise that the creditor defence may have been introduced as a means of encouraging creditors to continue ordinary trading with distressed debtors. As the running account principle only applies to “continuing business relationships,” the defence serves an additional purpose of protecting creditors who fall outside of that relationship, yet who would still deal with distressed debtors in the ordinary course of business. One-off suppliers, for example, would be protected by the defence but not by the running account. The Court of Appeal’s narrow interpretation of the defence, paired with New Zealand’s excessively long clawback period, has therefore led to an inappropriately strict application of the defence that does not adequately account for the need to assist distressed debtors to continue trading.

The Court of Appeal decision in *Farrell v Fences and Kerbs* and the High Court cases of *Allied Concrete v Hiway Stabilisers* and *Meltzer v Allied Concrete* are currently the subject of a joint appeal to the Supreme Court of New Zealand.

While the Supreme Court hearing took place in March this year, the judgment was reserved, and is not expected to be handed down until the end of this year: too late to be considered in this paper.

### 4.2.3 Applicability of peak indebtedness rule

The debate around whether the peak indebtedness rule applies to the section 292(4B) running account principle illustrates another failure by both legislators and the judiciary to address the problem on a careful and coherent policy basis. As discussed in Chapter 3, while a recent spate of New Zealand High Court cases have approved the *Air Services v Ferrier* approach of rejecting...
the peak indebtedness rule in favour of “assessing the overall effect of all of the transactions making up the running account,” the applicability of the rule remains highly contentious.

Significantly, neither the Australian nor the New Zealand courts referred to the *pari passu* policy when considering the issue. However, from a policy perspective, the peak indebtedness rule clearly undermines the *pari passu* rationale. For example, consider two equally ranking creditors (A) and (B), who each have a continuing business relationship with their debtor (C) for the supply of widgets, and who now face a voidable preference action. Creditor A gave ten monthly supplies of $10,000 to C, and in return received 10 monthly payments of $10,000 from C over the same period. This is the classic running account scenario, and under either the peak indebtedness approach or the *Air Services* approach the net position would be zero, and no preference would have occurred. However, creditor (B) gave a one-off supply of $100,000 to C, and received ten payments of $10,000 from C over the next ten months. In that case, under the peak indebtedness rule (where the liquidator would be able to manipulate the start date of the running account to exclude the one-off supply), C’s $100,000 payment would be voidable. Yet under the *Air Services* approach, the initial one-off supply would be included, and the net account would be zero. The *Air Services* approach is thus clearly more consistent with the *pari passu* policy than the peak indebtedness rule. In each case, the overall effect of the transaction is identical, and neither creditor has been “preferred” over the other.

It would have been desirable for the Australian and New Zealand courts to consciously consider the effect of the *Air Services* approach on promoting the policy objectives of commercial certainty and enabling a distressed debtor to continue trading. Provided a running account or continuing business relationship is already in existence, the *Air Services* approach would encourage creditors to extend repeat credit to a distressed debtor, as creditors would be more confident that their entire transaction history with the debtor will be taken into account, rather than just one or two isolated insolvent payments. In addition, following the *Air Services* approach increases the commercial certainty around the start and end dates of the running account period, as the dates would not be left up to the liquidator’s discretion. Had the New Zealand High Court actively expanded its argument to acknowledge the benefits of the *Air

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220 See Chapter 3 at 3.2.2; and *Z Energy*, supra note 134 at [25].
Services approach to promoting pari passu, commercial certainty, and a distressed debtor’s ability to continue trading, their decisions would have been more convincing.

4.2.4 Uncertainty around relevance of creditor and debtor intention to running account

If the policy underlying New Zealand’s voidable preference law were more clearly apparent, it would also be much clearer whether creditor and/or debtor intent is relevant to determining the starting and end points of a running account under section 292(4B). In Australia, a running account will no longer exist where it is shown that a creditor or a debtor consciously intends to grant or obtain a preference. The majority of the High Court of Australia, discussing the running account principle in Airservices Australia v Ferrier, stated that:

[i]f the payment is part of a wider transaction or a “running account” between the debtor and creditor, the purpose for which the payment was made and received will usually determine whether the payment has the effect of giving a creditor a preference, priority or advantage over other creditors.  

This focus on the purpose and intent of the parties was followed in the New South Wales Supreme Court case of Sutherland v Eurolinx, where Santow J held that a continuing business relationship will end where it is apparent that a creditor or debtor is “looking backwards rather than forwards; looking to the partial payment of the old debt rather than the provision of continuing services.” In New Zealand, it is unclear whether the intention of the debtor and/or creditor is relevant to the running account principle. In Shephard v Steel, the High Court approved the approach in Airservices Australia and Sutherland, stating “the purpose for which the payment was made and received will usually determine whether the payment has the effect of giving the creditor a preference over other creditors.” However, the High Court did not elaborate further on the relevance of the respective intentions or purpose of the creditor and debtor. Adding to the confusion, the New Zealand courts have taken slightly different approaches as to when the continuing business relationship begins, albeit without considering

221 Ferrier, supra note 130 at 622-623.
222 Sutherland v Eurolinx (2001) 37 ACSR 477 (NSWSC) at [148].
223 Shephard v Steel, supra note 117 at [34].
224 Ultimately, the High Court looked at the problem in terms of the applicability of the peak indebtedness rule, and whether, taking into account the “wider context of all the transactions forming part of the relationship,” a “continuing business relationship” existed: ibid at [35].
whether intention is or should be a factor.\textsuperscript{225} The issue therefore remains open to be determined by a higher court.

However, without a clear legislative articulation of the policy underlying New Zealand’s voidable preference regime, it is difficult to predict which way a court would decide. If creditor deterrence is the main underlying policy of New Zealand’s preference regime, then to be consistent, creditor intention (though not necessarily debtor intention) should be relevant to the running account principle. If one of the main aims of a voidable preference regime is to assist a distressed debtor to continue trading, the intentions of both creditor and debtor would be relevant to determining the beginning and end of the running account, in line with the approach in \textit{Airservices Australia} and in \textit{Sutherland}. This would be consistent with a policy of encouraging creditors to continue doing business with distressed debtors - as the creditors and debtors will be protected where their main objective is to continue trading in the ordinary course of business (rather than to pay off existing debt). If promoting \textit{pari passu} equality is the main underlying goal of the regime, then intention of both the creditor and debtor would be irrelevant, and only the overall effect of the transaction would be examined. Focussing on the overall effect of the transaction would avoid inquiry into subjective, uncertain issues of intention. It would also still uphold the policy objective of supporting distressed debtors, as creditors would still be protected from the clawback mechanism, provided the transaction occurred within the overall context of the continuing business relationship.

\subsubsection*{4.2.5 Liquidators’ use of the voidable preference provisions}

Another problematic feature of New Zealand’s voidable preference regime contributing to the incoherence of its underlying policy is the arguably widespread misuse of the statutory procedures for bringing preference actions. As discussed in the preceding Chapter, in order to launch a preference action, a liquidator issues a notice to a creditor under section 294: no court proceedings are necessary. The creditor can challenge the liquidator’s notice and prevent the transaction being automatically set aside through sending a notice of objection. However, if the liquidator deems the transaction voidable even in light of the objection notice, the creditor will still need to defend the transaction in court.

\textsuperscript{225} See text at note 135 above.
As Telfer and Brown point out, this procedure is useful in that it avoids many of the difficulties faced in other jurisdictions with funding proceedings.226 Yet the procedure is often criticised as encouraging liquidators to send “blanket” notices to all creditors, regardless of the merits of the particular case and without any legitimate analysis of whether the potential benefits of recovery for creditors generally.227 This effect is exacerbated by the fact that under Schedule 7, section 1(1)(a) of the Companies Act 1993, liquidators’ fees are the first to be paid out in the waterfall of payments upon the debtor’s liquidation.228 The secured and unsecured creditors and other costs are therefore only paid out of the debtor’s estate once the liquidator(s) have been paid. As the liquidator increases the size of her fees by electing to take a preference action further, there may be little to dissuade liquidators from commencing preference actions regardless of the underlying merits of the creditor’s objection letter. Yet this would prevent the voidable preference regime from operating properly and achieving its policy objectives. While high repayment rates of voided transactions may appear to increase pari passu equality between creditors, in reality many of those creditors may never receive any part of the returned funds. And where transactions are repaid that should not have been voided, this actually undermines pari passu equality between creditors. Indeed, Kevin Pitfield, a New Zealand insolvency practitioner, recently commented that:

it is…worth considering the "enthusiasm" of certain insolvency practitioners to utilise the voidable preference provisions, in many cases purely as a means of maximising recoveries to fund their own fees, rather than as a means of reaching an equitable result amongst all creditors. Clearly there is a need to maintain some level of voidable preference legislation. There is also a responsibility on the insolvency industry to use the provisions judiciously.229

Pitfield’s criticism is similar to the arguments put forward by Schwartz and McCoid, that the inefficiencies and costs associated with preference actions indicate that the preference regime should be repealed altogether. First, litigating to recover preferences (whether or not the action is meritorious or successful) is inefficient, as the associated (prior ranking) liquidators’ fees and other legal, and administrative costs reduce the debtor’s estate, leaving less for the remaining

227 Telfer, supra note 11 at 78.
228 Companies Act 1993, schedule 7, s 1(1)(a).
229 Franks, supra note 202.
unsecured creditors. Thus, even where an objection notice is meritorious and a creditor may have a good chance of defending the action, many creditors may elect to repay the voidable payment rather than risk losing the case and incurring legal expenses and liquidators’ costs. Secondly, an increased rate of preference actions due to liquidators misusing the provisions and sending out blanket notices may increase the risk of lending, as uncertainty around finality of payments increases. In turn, this increases the costs of borrowing and reduces the availability of credit. McCoid takes this argument a step further, arguing that abolishing voidable preferences is the most efficient way by which to reduce the uncertainty costs associated with preference actions. As Schwartz aptly puts it, "the [avoiding] powers appear to function primarily to decrease the value of the bankrupt firm rather than to increase it."

4.3 CONCLUSION

In sum, the policy of creditor deterrence imported by the creditor defence is highly inconsistent with the pari passu rationale. Not only have the New Zealand policymakers and judiciary failed to carefully consider the consequences of introducing the creditor defence, they have also failed to adequately consider how best to promote the competing policy objectives of commercial certainty and assisting a distressed debtor to continue trading. As a result, it is difficult to pinpoint any single cohesive policy underlying New Zealand’s voidable preference regime, rendering numerous aspects of the regime contentious and uncertain. The final Chapter in this paper puts forward some suggestions for reform of New Zealand’s preference regime, which aim to promote pari passu while still achieving an appropriate degree of commercial certainty and assisting distressed debtors to continue trading.

230 McCoid, supra note 8 at 266; Schwartz, “Normative Theory,” supra note 22 at 26.
231 McCoid, supra note 8 at 270.
232 Schwartz, “Normative Theory,” supra note 22 at 6. Whether these concerns are sufficient to justify repealing the voidable preference regime altogether is discussed below in Chapter 5, part 5.1.
CHAPTER 5: SUGGESTIONS FOR REFORM

5.1 SHOULD THE REGIME BE REPEALED?

One method of dealing with the problematic nature of New Zealand’s voidable preference regime would be to repeal it altogether. McCoid and Schwartz suggest that repealing voidable preferences would be desirable in terms of increasing efficiency and enhancing the value of the debtor’s estate.\(^{233}\) As McCoid points out, abolition would also address the “unfairness” to creditors of preference law’s retrospective application.\(^{234}\) Abolishing preference law would also allow creditors to be rewarded for active and diligent monitoring of their debtor’s financial situation, without risk that their diligence in obtaining priority payment be punished.

This paper does not advocate for abolishment of the regime. Keay observes that in considering whether to abolish the preference laws, “one should consider whether the avoidance of preferences is desirable from a policy perspective.”\(^{235}\) As this paper has argued, the benefits of preference law’s ability to preserve pari passu equality among similarly ranked creditors and discourage creditors from engaging in a “debilitating “race to the courthouse”\(^{236}\) are clear. Fisher J summarised these benefits nicely in Re Modern Terrazzo, observing that without a preference regime:

> each creditor [would] try and steal a march on the others. It would promote immediate enforcement by each creditor in circumstances when time to pay might otherwise secure the company’s future, and hence the full payment of all. Those who lacked inside knowledge of, or special connections with, the company would be placed at an anomalous disadvantage. Time and energy would be spent upon a communally unprofitable race to see which creditors would carry off the carrion first.\(^{237}\)

These benefits outweigh any arguments that creditors should be rewarded for their diligence in obtaining payments from debtors, particularly as excessive monitoring of debtors is costly and inefficient.\(^{238}\) Preference law’s “unfair” retrospective application can be mitigated by exceptions to the effects-based test, and through (as is suggested below) shortening the clawback period. In

\(^{233}\) McCoid, supra note 8 at 270. See discussion at Chapter 4, part 4.2.4.
\(^{234}\) Ibid; See also Weisberg, supra note 2 at 136.
\(^{236}\) Tabb, “Panglossian Preference Paradigm?” supra note 16 at 420.
\(^{237}\) Re Modern Terrazzo Ltd [1998] 1 NZLR 160 (HC) at 174.
\(^{238}\) McCoid, supra note 8 at 246.
addition, the reforms suggested below around regulation of liquidators, establishing a materiality threshold, and strengthening the powers of liquidation committees should address many of the concerns around the over-litigation, costs and inefficiencies associated with litigating preferences. There are therefore sufficient policy justifications to retain New Zealand’s preference regime.

5.2 RULE OR STANDARD BASED REFORMS?
As indicated in Chapter One, whether a preference regime should impose formal and precise mechanical rules or open-ended normative standards is a source of great contention in the preference debate.²³⁹ Jackson notes that preference law “has never been comfortable with any balance between a rule and a standard.”²⁴⁰ In many ways, this tension between rules and standards reflects the broader underlying tensions around the need for finding an appropriate balance between achieving commercial certainty and achieving pari passu equality in New Zealand’s voidable preference regime. Therefore, before discussing specific options for reform, this section considers whether it would be more appropriate for the reforms to be rule-based or standard-based.

On the one hand, objective, detailed and precise rules increase certainty for creditors, as they allow creditors to more accurately predict the scope and ambit of preference law and the associated risk that any payments they receive will be clawed back. This partly explains the excessive length of New Zealand’s clawback period. In its 2001 review, the Ministry acknowledged that the two-year clawback period is often criticised as being “arbitrary and lengthy,” but responded by stating that:

[i]nvariably any time-frame is likely to be somewhat arbitrary…The benefits of establishing an arbitrary timeline is that it increases certainty and reduces the costs involved in proving the date of technical insolvency in every case.²⁴¹

However, the downside of a clear, certain rule tends to be uniform and/or arbitrary application of that rule. As the Ministry noted, “simple rules may not cover every situation that arises, with the

²³⁹ Weisberg, supra note 2 at 5.
²⁴¹ Tier One Discussion Documents, supra note 97 at 65.
result that wrong decisions may be reached in some cases.” For example, the presumption of insolvency in the six month restricted period under section 292(4A) is often difficult to displace, especially as creditors (unlike liquidators) do not have full access to the debtor’s financial records. This could theoretically lead to some transactions being avoided even though they were made when the debtor company was still solvent. However, the benefit afforded by replacing an uncertain standard (insolvency) with a certain rule (the six month period) likely outweighs the risk that a wrong result is reached. Where precise rules are chosen over standards, great care must be taken to ensure rules are unambiguous and carefully drafted. For example, it is unlikely that the policymakers behind the 2006 reforms ever expected much controversy to arise around the “gave value” limb of the section 296(3)(c) creditor defence. Yet, due to a failure by legislative drafters to clearly define the temporal nature of “value,” what could have been a straightforward and easily interpreted rule has been litigated up to the highest level of New Zealand’s court system.

On the other hand, normative, open-ended standards are often argued to be more desirable. Broad standards allow scope for judicial interpretation to more appropriately fit and adapt to the particular circumstances of a case. Their flexibility in application also allows them to better reflect the underlying policy objectives. As Brown and Telfer note, “standards are a short-form way of expressing a larger policy that underlines a statutory provision.” However, open-ended standards are far less certain in their application and enforcement. Hence, they are often litigated, and are far more costly to enforce than clear rules. These disadvantages were a major reason behind the repeal of both the pre-1993 “intention to prefer” test under the Companies Act 1955, and of the pre-2006 ordinary course of business exception. In respect of the ordinary course of business standard, the Ministry stated that:

> “The advantages of flexibility offered by the ‘ordinary course of business’ exception are considered to be considerably outweighed by the disadvantages associated with it, particularly the

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242 Ibid at 59.
243 Telfer, supra note 11 at 62.
244 Brown and Telfer, “Plus Ça Change?” supra note 10 at 162.
245 Jackson, “Avoiding Powers,” supra note 13 at 130.
246 See Chapter 3, part 3.1 above.
unnecessary costs caused by the uncertainty surrounding what that phrase means in any given situation.\(^{247}\)

Yet, as the previous Chapter has argued, the section 296(3) creditor defence, with its intention-based standards of “good faith” and “reasonable suspicion” is equally indeterminate. Writing at the time of the 2006 reforms, Telfer observed 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 with an exception that is based upon creditor suspicion of insolvency.\(^{248}\)

Unfortunately, it appears that Telfer’s fears have been realised. Weisberg observes that there is a “historical cycle” common to most voidable preference regimes, where regardless of whether a rule or standard based regime is chosen, that regime is “quickly undone” by judicial and legislative “tinkering.”\(^ {249}\) The nature of this cycle is summed up well by Brown and Telfer:

> [w]hen standards are adopted, critics claim that standards are uncertain and incapable of precise definition. Uncertain standards lead to calls for more certain rules. Where rules are inconsistently applied, there is an inevitable demand for a more open-ended standard.\(^ {250}\)

The New Zealand regime, with its unsettled legislative history and constant substitution of legislative standards, is a typical example of this historical cycle. Unless a clear consensus among policymakers is reached as to what the underlying policy of New Zealand’s voidable preference regime should be, it is unlikely this tension will be resolved, and Weisberg’s “historical ritual breakdown” of New Zealand’s preference legislation may be doomed to continue. The reforms suggested below aim to break that cycle. In accordance with the arguments advanced in this paper, they aim to promote a coherent policy of *pari passu* while still accommodating the goals of achieving commercial certainty and assisting a distressed debtor to continue trading. Wherever possible, clear rules have been preferred over normative standards, as the need for certainty in an insolvency law context is often (although not always) more urgent than the need for flexibility, particularly as any litigation costs erode the value of the debtors estate to the detriment of the remaining unsecured creditors.

\(^{247}\) Tier One Discussion Documents, *supra* note 97 at 59.

\(^{248}\) Telfer, *supra* note 11 at 81.

\(^{249}\) Weisberg, *supra* note 2 at 10.

\(^{250}\) Brown and Telfer, “Plus Ça Change?” *supra* note 10 at 162.
5.3  SUGGESTIONS FOR REFORM

5.3.1  Shorter clawback period

As discussed in Chapter 4, New Zealand’s two-year clawback period is too long, especially when compared to other similar jurisdictions. Australia’s clawback period is six months,\(^{251}\) and the clawback periods in both the United States\(^{252}\) and Canada\(^{253}\) are just three months.\(^{254}\) Although the clawback period under the English voidable preference regime is also two years, the English regime is debtor-deterrence based.\(^{255}\) As the requisite debtor intention (and a successful preference claim) is more difficult for a liquidator to establish,\(^{256}\) the long clawback period therefore is not such a great impediment to the English regime’s ability to achieve its underlying policy (debtor deterrence) while still achieving commercial certainty.

New Zealand’s clawback period, on the other hand, should be shortened significantly. I support the recommendation put forward by the Ministry in 2001 that the restricted and specified periods be combined into a single “vulnerability” period.\(^{257}\) As the Ministry observed, aligning the presumption of insolvency directly with the clawback period is attractive, as a single six-month vulnerability period is both easier and simpler to apply, and is more likely than the two-year clawback period to coincide with the debtor’s period of actual insolvency.\(^{258}\) The length of this period should be, at the very most, six months. However, a three-month vulnerability period may well be more appropriate, particularly if the proposal below to introduce a longer period for “insider creditors” is adopted, and the creditor defence is reformed. A period shorter than three months would be undesirable, as there is a risk that, if the clawback period is too short, a creditor may manipulate her relationship with the debtor to delay the inevitable liquidation, and avoid a transaction being caught within the clawback period.\(^{259}\)

\(^{251}\) Corporations Act 2001 (Cth), a 588FE(2).
\(^{252}\) Bankruptcy Code 11, § 547(b)(4)(A).
\(^{253}\) BIA (CA), supra note 1 at s 95(1)(a).
\(^{254}\) Though as is discussed below, each of Australia, Canada and the United States have longer clawback periods for transactions with “insider creditors” that do not occur at arm’s length.
\(^{255}\) See Insolvency Act 1986 (UK), c 45, s 239; Duggan and Telfer, “Canadian Preference Law Reform,” supra note 3 at 667.
\(^{256}\) See text at note 97 above.
\(^{257}\) Tier One Discussion Documents, supra note 97 at 65. It is unclear why this proposal was not ultimately adopted in the legislative provisions.
\(^{258}\) Ibid.
\(^{259}\) This is an example of the danger associated with the use of an arbitrary rule to achieve a policy goal: as Weisberg puts it, “[t]here is an inherent circularity in using technical rules to describe the boundaries of ethical commercial
While a shorter clawback period will reduce the risk to creditors that a payment will be voidable, it will not necessarily make it easier for creditors to quantify that risk. As Weisberg argues, the certainty ostensibly provided to creditors by a fixed clawback period “is only after-the-fact…No creditor taking a transfer can know at the time he receives it whether it will prove voidable.”260 However, a shorter clawback period would significantly reduce the risk to creditors that a payment received from a debtor will fall within the clawback period. It would also achieve a more appropriate balance between promoting commercial certainty and promoting pari passu equality through the section 292 effects-based test. There is therefore a strong argument for a shorter “vulnerability” period, combining both the specified and restricted periods, of between three and six months.

5.3.2 A longer clawback period for “insider creditors”

In order to better uphold the pari passu policy, a longer clawback period for “insider creditors” should be introduced. Currently, all creditors under the New Zealand regime are subject to the same clawback period. However, other jurisdictions typically include a longer period during which transactions with “insider creditors” can be reversed. For example, in the United States, the three-month clawback period can be extended to between three months and one year in respect of an insider creditor,261 and in Canada, the three-month clawback period is extended to 12 months in respect of creditors who are not dealing at “arm’s length” with the insolvent debtor.262 In Australia, the six-month clawback period is extended up to four years in respect of creditors related to the debtor company’s director.263

An “insider creditor” can be generally described as a creditor who does not deal with the debtor behavior when the actor will have the power to keep his action just within the boundary”?: Weisberg, supra note 2 at 135.


261 Bankruptcy Code 11, § 547(b)(4)(B). The definition of “insider creditor” is set out at §110(31).

262 BIA (CA), supra note 1 at s 95(1)(b). Sections 4(1)-(5) sets out when persons or entities are deemed not to be dealing with each other at arm’s length.

263 However, the Australian equivalent requires the transaction to be an “unreasonable director related transaction”, and is somewhat more complicated to apply than the United States and Canadian provisions. See Corporations Act 2001 (Cth), ss 588FE(6A) and 588FDA.
company on arm’s lengths terms, for example, if she is in a special relationship with the debtor. Insiders are generally considered to be better able to observe a debtor company’s financial precariousness at a far earlier time than independent creditors, by virtue of their special relationship with the debtor. They are thus better able to take advantage of that knowledge through seeking and obtaining preferences, to the detriment of the remaining unsecured creditors. Their close relationship with the debtor may also enable them to exert influence over a debtor to grant a preference. Introducing a longer clawback period for insider creditors can therefore be justified on pari passu grounds, as it would increase the value of the debtor’s estate available for distribution to creditors. As Ponoroff argues, while a shorter clawback period “probably captures a majority of the extraordinary transfers to outside creditors, too many ‘contemplation of bankruptcy’ transfers to insiders would escape avoidance without a longer preference period.” Indeed, it was on the basis of a pari passu policy that the Ministry recommended in 2001 that the clawback period for insiders remain at two years (rather than six months). While the Companies Act 1993 does include some provisions specifically targeting insiders, these provisions do not necessarily capture preferential payments to insiders. There is therefore a gap in New Zealand’s voidable preference law in this respect.

Telfer argued in 2003 that New Zealand voidable preference regime should target insider creditors, through “either extending the pre-liquidation review period or [through] the creation of a separate test specific to insiders.” The former option is more desirable than imposing a separate test that would likely involve introducing standard-based provisions, requiring a case-by-case assessment of whether the insider creditor had knowledge of the debtor’s insolvency and

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264 Telfer, supra note 11 at 81; Tier One Discussion Documents, supra note 97 at 67.
265 Ponoroff, supra note 42 at 1519.
266 Ibid.
267 The Ministry stated: [t]he pari passu rule is based on the proposition that all creditors in a like position should be treated equally, but clearly there will be occasions where insiders will not be in the same position as other unsecured creditors. The Ministry therefore considers that insiders’ intimate knowledge of the financial position of the company or person is sufficient justification in terms of the pari passu principle to justify a different rule.” Tier One Discussion Documents, supra note 97 at 67.
268 For example, section 298 of the Companies Act 1993 allows transactions between the debtor company and certain insiders for inadequate or excessive consideration to be challenged during a 3-year period immediately before the liquidation (regardless of whether the debtor company was insolvent). However, a preferential payment is typically given for good consideration, and thus will not come within the ambit of section 298. Section 299 is similarly limited in scope, as it only allows challenge of a charge or security entered into between a company and an insider. Preferential payments in the form of cash or other value are excluded from the ambit of the section.
269 Telfer, supra note 11 at 81.
intended to secure an unfair advantage over other creditors. While such a test may more precisely identify and remedy insider preferences, as argued above, the downside of this increased flexibility is increased costs and uncertainty in application. A fixed time period of between one to two years targeting insiders, on the other hand, would be easier and less costly to apply. For consistency, and to further increase certainty in applying the provision, the definition of “insider” should be aligned with the existing provisions in the Companies Act 1993 targeting insiders.

5.3.3 Materiality threshold

In order to reduce the inefficiencies associated with excessive litigation of preferences and to mitigate the alleged practice of liquidators sending out “blanket” notices to creditors and forcing them to settle, a materiality threshold for setting aside transactions should be introduced. The United States Bankruptcy Code includes such a threshold: as of August 2014, all (non-consumer) preference actions brought under the code must be worth at least US$6,225. Preference actions worth less than this amount would not be subject to avoidance. A similar provision should be introduced in New Zealand. This would help limit the problems (outlined above) associated with over-litigating preference actions. While it would effectively repeal the preference laws for small preference cases under the Companies Act 1993, this would not greatly undermine New Zealand’s preference policy. As Tabb observed in respect of the US regime:

[i]t is just not worth fighting over small sums...Equality is not seriously compromised by allowing transfers of less than [$6,225] to stand, and only in very small preference cases would a “race to the courthouse” over amounts of less than [$6,225] risk driving the debtor out of business.

Empirical research would need to be conducted to establish an appropriate minimum threshold amount in the New Zealand context, and to establish the number of preference actions that would be affected. However, an amount comparable to the United States regime of around NZ$6000

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270 Ponoroff, supra note 42 at 1519.
271 See Companies Act 1993, ss 298(1)(a)-(d) and 299(1)(a)-(d).
272 Bankruptcy Code 11, § 547(c)(9). The section provides that the trustee may not avoid under this section a transfer-- where the aggregate value of all property that constitutes or is affected by such transfer is less than $6,225. However, this only applies to debtors whose debts are not primarily consumer debts (i.e. corporate debtors). A much smaller threshold of $600 applies to individual debtors whose debts are primarily consumer debts: § 547(c)(8).
273 Tabb “Panglossian Preference Paradigm?” supra note 16 at 421. Tabb made these observations in 1997, when the minimum threshold was US$5000: since then the amount has risen.
may well be appropriate. It would also be useful to conduct empirical research on the costs of voidable preference litigation in comparison to the value of the contested transactions, to determine the likely impact of such a provision.

5.3.4 Increased regulatory oversight of liquidators

Unlike many other comparable jurisdictions such as Australia\textsuperscript{274} and the United Kingdom\textsuperscript{275} there is virtually no private or public professional regulation of liquidators in New Zealand. This means that almost anyone can become a liquidator in New Zealand, regardless of skills, qualifications, or experience.\textsuperscript{276} In order to better ensure that the policy goals of the voidable preference legislation are carried out in practice and are not thwarted by over-zealous liquidators, liquidators in New Zealand should be regulated and held to a higher professional standard. There have been various reform proposals to regulate insolvency practitioners in New Zealand in one form or other, ever since the Law Commission first raised concerns with the conduct of insolvency practitioners in a 2001 paper.\textsuperscript{277} While a draft bill entitled the “Insolvency Practitioners Bill” was tabled in Parliament in April 2010, it has made slow progress through Parliament, only passing its second reading in November 2013.\textsuperscript{278} An in-depth analysis of the reforms proposed by this Bill, and their potential impact on addressing liquidators’ rent-seeking behaviour in preference actions, is beyond the scope of this paper. The Bill is an improvement on the status quo, as it requires all insolvency practitioners (including liquidators) to be registered in order to accept insolvency appointments, and prohibits certain people from becoming registered, for example where that person is personally insolvent, or is disqualified from becoming a director of a company.\textsuperscript{279} However, the Bill has been criticised by some

\begin{itemize}
\item \textsuperscript{274} See Corporations Act 2001 (Cth), s 1282(2).
\item \textsuperscript{275} See Insolvency Act 1986 (UK), s 390.
\item \textsuperscript{276} There are some limited restrictions on who can become a liquidator: one must be over 18, not bankrupt or subject to the Mental Health Act, not related to the company, and not have a dishonesty conviction in the past 5 years: Companies Act 1993, s 280.
\item \textsuperscript{277} See ch 13 of NZLC, Promoting Trust and Confidence, supra note 31. See also Ministry of Economic Development Draft Insolvency Law Reform Bill: Discussion Document (2004) online: <www.med.govt.nz> at 5, and, for a more recent proposal for self regulation put forward by two industry bodies, see: New Zealand Institute of Chartered Accountants and Insol New Zealand, Consultation Document: Insolvency Practitioner Regulation (June 2013), online: <www.insol.org.nz>.
\item \textsuperscript{278} Bill 141-2, Insolvency Practitioners Bill, 49th-50th Parl, 2010 (Second reading 7 November 2013).
\item \textsuperscript{279} Ibid, s 7A “s 316F - Eligibility for Registration.” The Bill also grants the Registrar of Companies enhanced oversight of liquidations and access to greater enforcement mechanisms, including the power to deregister substandard or delinquent liquidators: s 7A “s 316M - Cancellation of Registration.”
\end{itemize}
industry members as falling “woefully short” of what is needed to address the issues with liquidator misconduct. Among the concerns raised is that the Bill does not require liquidators to hold any minimum qualifications or skill level, does not include any “fit and proper” test that must be met to qualify for registration and that it falls well below the standard of upcoming regulation proposed for Australia’s insolvency practitioner industry. A supplementary order paper proposing further amendments to the Bill is expected to be released for consultation later this year. It is hoped that the Bill will appropriately address these concerns.

5.3.5 Reform of powers of liquidators committee

In addition to mandatory registration and minimum professional standards for liquidators, the provisions in the Companies Act 1993 around the powers and duties of a liquidation committee should be strengthened and reformed.

In New Zealand, creditors in a liquidation may establish a liquidation committee to act with a liquidator. However, the liquidators’ committee powers and duties are very limited, and may not necessarily address any concerns as to the liquidator’s approach in dealing with preference actions. A liquidation committee has the power to assist the liquidator (as appropriate) in the conduct of the liquidation, call for reports from the liquidator on the liquidator’s progress, and inspect the accounts and records of the liquidation and the debtor company. However, although the liquidator must pay regard to the views of a liquidation committee when carrying

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280 See, e.g. Shaun Adams, head of restructuring and insolvency at KPMG and a member of the industry committee INSO, quoted in Maria Slade, “Insolvency bill ‘woefully short’” The New Zealand Herald (5 March 2014), online: <www.nzherald.co.nz>.  
281 Ibid. See also Murray Tingey et al, “Insolvency Practitioners Bill inches closer” The National Business Review (2 October 2013), online: <www.nbr.co.nz>.  
282 Since the New Zealand Insolvency Practitioner Bill passed its second reading, Australia has begun undergoing a process of tightening its regulation of insolvency practitioners. The Insolvency Law Reform Bill 2013 was introduced in December 2012 to promote a high level of practitioner professionalism and competency, enhance transparency and communication between insolvency practitioners and stakeholders and promote increased efficiency in insolvency administrations. It is hoped that New Zealand policymakers will look to the Australian suggestions for reform in informing their policy decisions on the Insolvency Practitioners Bill: see Australian Government: the Treasury Exposure Draft: Insolvency Law Reform Bill (2013), online: <www.treasury.gov.au>; and Cheryl Weston and Guy Harris, “Insolvency Law Reform Bill 2013 aims to harmonise regulatory framework for insolvency practitioners” CBP Lawyers (25 February 2013) online: <www.cbp.com.au>.  
283 Murray Tingey et al, supra note 281.  
284 Companies Act 1993, s 314.  
285 Companies Act 1993, s 315(2)(d)  
286 Ibid, s 315(2)(a)  
287 Ibid, s 256(1).
out her functions and duties, the liquidator is not bound to act in accordance with those views.\textsuperscript{288} While a liquidation committee may apply to the court for an order or direction relating to the conduct of the liquidation,\textsuperscript{289} as a general rule, the court will not give directions on whether a proposed court proceeding (such as a preference action) should be brought.\textsuperscript{290}

In contrast, a creditor committee (members of which are known as “inspectors”) in Canada plays a much more active role in supervising a liquidation, and is much better equipped to remedy any misconduct or rent-seeking behaviour by liquidators (who are referred to Canada as “trustees”).\textsuperscript{291} In contrast to the New Zealand position, which only allows liquidation committees to give guiding advice, a trustee in Canada must obtain specific permission from the inspectors before exercising certain powers.\textsuperscript{292} Relevantly, the trustee must obtain permission to start or defend legal proceedings relating to the property of the debtor,\textsuperscript{293} and to compromise claims made by or against the debtor’s estate.\textsuperscript{294} Unlike in New Zealand, the inspectors have a fiduciary relationship to the general body of creditors, and are required to act in good faith and in the best interests of the creditors.\textsuperscript{295} Creditors’ committees in the United States also have greater powers than liquidation committees in New Zealand in terms of consulting and acting with the trustee.\textsuperscript{296}

In sum, the powers, duties and supervisory function of liquidation committees in a liquidation should be strengthened so that the Companies Act 1993 provisions are more aligned with the equivalent provisions in Canada and the United States. Not only would this help address the difficulties with liquidators’ conduct in the context of litigating preferences outlined above, but it would ensure the interests of creditors are promoted generally during the liquidation process (rather than the liquidator’s own interests, or the interests of the most powerful creditors who

\textsuperscript{288} Ibid, s 258(d).
\textsuperscript{289} Ibid, s 284.
\textsuperscript{290} Farrar and Watson, supra note 10, at 915.
\textsuperscript{291} A board of inspectors is usually appointed at the first meeting of creditors in a liquidation: BIA (CA), supra note 1, ss 115 and 116. The creditors may also agree to not appoint inspectors.
\textsuperscript{292} Ibid, s 30. A majority vote of inspectors is required in order to exercise these powers: section 116(3).
\textsuperscript{293} Ibid, s 30(d).
\textsuperscript{294} Ibid, s 30(i). In addition, section 120(3) confers specific duties on the inspectors, including a duty to verify the bank balance of the estate and examine the trustee’s accounts.
\textsuperscript{295} Wood, supra note 4 at 226.
\textsuperscript{296} See Bankruptcy Code 11, § 1103.
may be in possession of preferential payments). In particular, the liquidator should be required to obtain permission from the liquidators’ committee before taking certain actions, and the liquidation committee should have a fiduciary relationship to the general body of creditors. Finally, New Zealand should also follow Canada’s example in adopting modest maximum fee caps in respect of the remuneration payable to each liquidation committee member. In Canada, depending on the net value of the debtors’ estate, these fees range from a minimum of CAD$10 per meeting to CAD$40.297 Introducing low fees should encourage the appointment of more liquidation committees, as it would reduce the costs of the committee to the unsecured creditors.298

5.3.6 Clarify running account start and end points
As discussed above, where possible, clear rules are to be preferred over broad standards. To that end, the continuing business relationship standard in section 292(4B) should be amended to clarify the starting point of the running account. The legislation should indicate whether the running account begins when the balance of the running account is zero, or at the same time as the specified period begins.299 The latter option is likely preferable in terms of enhancing certainty as it is a fixed and identifiable period. The legislation should also clearly signal that the peak indebtedness rule does not apply, and that the continuing business relationship should be examined in the context of the overall effect of the transaction. As argued above, the peak indebtedness rule is inconsistent with enhancing pari passu policy. Certainty around the length of the running account period would also encourage trade with distressed debtors. Finally, section 292(4B) should be amended to make it clear that the intention of the creditor and debtor are not relevant to determining the start and end points of the running account, for the reasons stated in Chapter 4.

297 Bankruptcy and Insolvency General Rules, CRC, c 368, s 135.
298 The remuneration of the members of the liquidation committee is met directly out of the debtor’s estate, and (like the liquidators’ fees) is ranked highly in the waterfall of payments in Schedule 7. Therefore, any costs associated with the establishment and remuneration of the liquidation committee will diminish the value of the total returns paid out to secured creditors: Companies Act 1993, s 314(1) and Schedule 5.
299 See note 135 above.
5.3.7 Amendment to creditor defence?

As argued above, the creditor defence is highly problematic, particularly in terms of promoting a policy of creditor deterrence and undermining commercial certainty. While it may well have been introduced in order to protect creditors who, acting in good faith, extend credit to distressed debtors, this policy is not immediately apparent in the wording of the defence, and requires a thorough examination of the legislative history of the provision. In any case, regardless of the underlying policy of the provision, the Court of Appeal’s narrow interpretation of the defence has effectively emasculated its application. Indeed, Stephen Franks, a leading solicitor and commentator in New Zealand, bluntly called the Court of Appeal’s ruling “stupid.”\(^{300}\) If the upcoming Supreme Court decision does not reverse the Court of Appeal’s decision, the third limb of the defence should be rewritten so that it is clear that “prior value” is included as “value” in section 296(3)(c). In addition, the first part of the defence should be carefully amended, so that the policy behind the creditor defence moves away from one of creditor deterrence, and closer towards its “real” policy of protecting creditors who, acting in good faith, continue providing credit to a distressed debtor. While this paper does not suggest a full return to the old “ordinary course of business” exception, amending the defence to more accurately reflect this objective is highly desirable.

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\(^{300}\) Franks, supra note 202.
CHAPTER 6: CONCLUSION

This paper has argued that New Zealand’s existing voidable preference regime is deeply problematic, and that this problematic nature stems from the incoherence of the regime’s underlying policy basis.

The legislative history leading up to New Zealand’s incumbent voidable preference regime is chequered at best, and schizophrenic at worst. The underlying rationales of the regime have shifted regularly, from a debtor-deterrence based regime until 1993, to a largely pari passu based regime until 2006, to the regime in its current form. As Chapter 4 has argued, the current regime fails to reach a coherent or principled balance between the competing policy considerations at stake. The excessively long clawback period, the uncertain and highly litigated nature of the running account exception and the creditor defence, and the troubling behaviour displayed by liquidators taking actions under the regime are an unfortunate consequence of an inability on the part of policymakers, the judiciary and the wider industry to reach an appropriate consensus as to what a desirable and workable preference regime should look like.

Yet, as Duggan and Telfer argue, “[m]eaningful reform is impossible unless we decide what we want preference laws to achieve.”301 This paper has argued that New Zealand’s voidable preference regime should be founded upon a careful and systematic policy balancing exercise. Achieving pari passu equality should be acknowledged as the overriding policy goal of preference law, yet the need for equality should be balanced against the need for commercial certainty and the need to encourage creditors to assist a distressed debtor to continue trading. A strict pari passu regime is undesirable. Only when an appropriate balance between these competing policies is reached will Weisberg’s historical cycle of continual amendment and litigation around the preference provisions come to an end. As Keay observes:

…unless the courts recognise the underlying reason(s) for such provisions they will not be able to discern the parameters of the provisions. If the courts do not acknowledge the rationale there is a danger that the courts will fail to interpret the legislation which

regulates pre-liquidation transactions correctly.\textsuperscript{302}

It is equally important that the legislature and policy makers identify the appropriate underlying rationales. Yet, finding the “right” or appropriate balance between these competing policies is not easy. The Court in \textit{Re Anntastic Marketing} recognised these difficulties, stating that there was a “fine line between impairing the free flow of trade by undoing transactions and allowing favoured creditors to make off with more than their own share of the assets of this insolvent business.”\textsuperscript{303} Some commentators, such as Ponoroff, are doubtful that it will ever be possible for a preference regime to be formulated that can adequately “capture…all of the fine nuances that together combine to form a prevailing commercial ethos.”\textsuperscript{304} However, through careful analysis of the competing policy issues at stake, this paper has identified a range of possible reforms that would achieve an appropriate balance between the underlying policy goals of promoting \textit{pari passu} policy, increasing commercial certainty, and assisting financially distressed debtors. If adopted, these reforms would go a long way towards achieving a coherent, workable and desirable voidable preference regime for New Zealand.

\begin{flushright}
\textsuperscript{302} Keay, \textit{supra} note 235 at 56.
\textsuperscript{303} \textit{Re Anntastic Marketing Ltd} [1999] 1 NZLR 615 (HC) at 617.
\textsuperscript{304} Ponoroff, \textit{supra} note 42 at 1485.
\end{flushright}
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