CUTTING THE GORDIAN KNOT OF INTENTION IN UNFAIR PREFERENCES

The transaction avoidance provisions seek to regulate the permissible conduct of creditors in the run-up towards and post insolvency. In the case of the unfair preference provision, it requires that the company must have been influenced by the desire to prefer the creditor. This article seeks to argue that this requirement is inconsistent with the modern objectives encapsulated in the insolvency regime and that this provision should be reformed to eradicate the need for such a desire and all preferences should, regardless of intention, *prima facie* be deemed unfair.

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In Gordium, by the Temple of the Zeus Basilica, was an ox cart, which had been put there by the King of Phrygia over 100 years before. The staves of the cart were tied together in a complex knot with the ends tucked away inside. Legend said that whoever was able to release the knot would be successful in conquering the East. Having arrived at Gordium it was inconceivable that Alexander the Great would not tackle the legendary "Gordian Knot". His army leaders gathered round as he struggled with the Knot for a few minutes. Then he asked Aristander, his seer, "Does it matter how I do it?" Aristander couldn't provide a definitive answer, so Alexander pulled out his sword and cut the knot through. He went on to become the conqueror of the known world.

Part I: Introduction

1 The basic building block of economic growth is the phenomenon of credit. The insolvency regime is a direct response to the casualties of credit, for it determines the extent of a debtor's obligation to repay his creditors when his assets are insufficient to cover all his

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outstanding debts.[1] In this respect, insolvency law has been most misunderstood perhaps because of its close links to bankruptcy law. Insolvency law does not exist to protect the insolvent company from the clinging hands of its creditors. Instead, most of the insolvency process revolves around the resolution of creditor-distribution issues.

2 This article seeks to examine one particular facet of the creditor-distribution situation, that is, the avoidance of transactions which are deemed to be unfair preferences as encapsulated in s 99 of our Bankruptcy Act (Cap 20, 2000 Rev Ed) ("BA"). In particular, this article takes issue with s 99(4) BA, which defines a transaction as being unfair only if the individual who gave the preference was influenced by a desire to unfairly prefer the creditor. This article argues that such a definition of unfairness is inconsistent with the aims of our insolvency regime and that the time is ripe for legislative amendment.

3 This article will first examine the underlying philosophy of our insolvency law and the rationale behind the unfair preference provision. Second, it will set out how the provision works in practice and the problems it has caused. It will then conclude with suggestions on how the provision can be reformed such that it may better further the aims of our modern insolvency regime. At this juncture, before I proceed any further, I will just clarify that the use of the phrase "insolvency" in this article refers to the winding up regime (of companies) as opposed to its generic meaning which would include the bankruptcy regime (of individuals).[2]

Part II: Aims of insolvency law

4 Modern insolvency law is widely regarded as representing a distinct discipline bound together by a coherent set of principles distinct from other areas.[3] Insolvency law, as a branch of commercial law, is moulded by the pressures of business conditions and shifts according to the changing economic and social values of our society. Indeed, the

1 The essence of the concept of insolvency consists simply of the debtor's ultimate inability to meet his financial commitments. This must be distinguished from a mere refusal or omission by a debtor who has the material means to do so. Refer to Ian F Fletcher, *The Law of Insolvency* (3rd Ed, 2002) for a fuller definition.

2 I will in this article be focusing on the problems relating to the liquidation of companies. My comments should also be relevant and applicable to cases of personal bankruptcy. I will however not comment directly on the bankruptcy position to avoid the use of convoluted phrases.

3 Nick Segal, "An overview of recent developments and future prospects in the United Kingdom", in Jacob S Ziegel, *Current Developments in International and Comparative Insolvency Law* (Oxford Clarendon Press, 1994).

roots of insolvency law developed from bankruptcy law which, in turn, developed from personal property law. In those early days, the law scrutinised the conduct of the person and looked to the person of the debtor for recourse when his assets were inadequate. Thus, the debtor was liable not only to have his property seized, but could himself be subject to imprisonment or even worse.[4]

5 Naturally, with such a backdrop, the traditional view of insolvency law focused on the allocation of the common pool of assets such that the benefits for the creditors are maximised as a whole.[5] This view however, became subject to strong academic criticism. Critics[6] contended that it would be overly simplistic to merely concentrate on maximising returns as the failure of a corporate enterprise affects a wide range of interests, with wide repercussions. These interests include the need for investigation into the conduct of directors so as to protect the public against future misconduct, looking after the interests of shareholders in the protection of their financial investment[7] and the protection of the workforce especially where labour law or tort law is not sufficiently developed to protect them.[8] Further, they argue that even if these interests were subordinate to those of the creditor, this alone is not a sufficient reason to deny them any role in the proceeding.

6 A further criticism attacked the theoretical underpinning of this approach to insolvency law: namely the creditor's bargain.[9] The creditor's bargain postulates an approach that views insolvency as mirroring the system that the creditors would be expected to form among themselves were they able to negotiate such an agreement. However, critics contend that the operation of the concept of creditor's bargain is fraught with difficulty since creditors do not, in practice, act collectively in taking credit decisions which means that it is impossible

4 Ian F Fletcher, *supra*, n 1.

5 Thomas Jackson, *The logic and limits of bankruptcy law* (Harvard University Press, 1986).

6 Dal Pont and Griggs, "A principled justified for business rescue laws: A comparative perspective (Part I)" (1995) 4 IIR 189 and Elizabeth Warren, "Bankruptcy Policy" (1987) 54 Univ of Chicago L Rev 775.

7 Although this is submitted to be minimal given that where liquidation is imminent shareholders can rarely expect to ever receive anything back.

8 As is the position in Singapore.

9 This was postulated in the seminar article of Thomas H Jackson, "Bankruptcy, Non Bankruptcy and the Creditors' bargain" (1982) 91 Yale LJ 857; and Jackson and Scott, "On the nature of bankruptcy: An essay on bankruptcy sharing and the creditors' bargain" (1989) 75 Virginia L Rev 155.

to determine what are the factors that they would consider.[10] In addition, the creditor's bargain model postulates that each creditor acts with perfect information as to the actions of the other creditors, another fact clearly absent in reality.[11] Hence, critics contend that the role of corporate insolvency laws cannot be constructed in the abstract and the extent to which the law of a country adheres or deviates from the principle of collective maximisation of returns are related to its pre-insolvency social and economic policy.[12]

7 Given the above criticisms, it is perhaps no surprise that today, insolvency law has gone beyond viewing liquidation as just being a method of asset recovery for creditors. Indeed, there has been a gradual shift towards using the various methods of corporate restructuring as an alternative to liquidation.[13] This has arisen from the recognition that the termination or liquidation of a business has wider social repercussions beyond just the insolvent company and its creditors. Other interests such as the company's suppliers, employees, customers and society in general are also affected.[14]

8 Thus it can be said that insolvency law today primarily aims to:

> … relieve and protect where necessary the insolvent … from any harassment and undue demands by his creditors whilst taking into consideration the rights which the insolvent ... should legitimately continue to enjoy; [and] at the same time; to have regard to the rights of creditors whose own position may be at risk because of the insolvency".[15]

Further, there are other subsidiary goals of insolvency law such as ensuring the division of the debtor's assets rateably among all his

10 Axel Flessner, "Philosophies of Business Bankruptcy Law: An international overview", in Jacob S Ziegel, *supra*, n 3; and Thomas Jackson, "Corporate Reorganization and the treatment of Diverse ownership interests: A comment on adequate protection of secured creditors" (1984) 51 Univ of Chicago L Rev 97.

11 Jose M Garrido, "The distributional question in insolvency: Comparative aspects" (1995) 4 IIR 25.

12 In this regard, it is recognised that this criticism is valid to the extent that there is a lack of empirical evidence in support of the position and that more research would be a boon. I would also comment that civil law jurisdictions tend to be more debtor oriented than common law jurisdictions and place greater emphasis on workers' rights and the importance of preserving the enterprise.

13 Axel Flessner, *supra*, n 10.

14 Insolvency Law and Practice Report of the Review Committee, Cmnd 8558 (London, HMSO, 1994 Reprint).

15 *Ibid*.

creditors in an honest and competent manner[16] and to prevent conflicts between individual creditors.[17]

9 This does not then mean that insolvency law no longer considers the rights and interests of creditors. Instead, one of the key recurring dilemmas is that insolvency law still centers around maximising the returns of creditors. The point here is that a system based upon individual creditor remedies will invariably decrease the pool of assets for the creditors as a group when there are insufficient assets to go round.[18]

10 In other words, what this means is that in the absence of rules regulating the equitable division of assets among creditors, there would be a perverse incentive on the part of individual creditors to get in line immediately for if they failed to do so, they would run the risk of getting nothing. Such a cut-throat first come, first served environment would only do more harm than good for the business community when viewed as a whole and similarly for individual cases. In fact, it might actually hasten a company's descent into insolvency since all creditors would be ready to recall their loans at the first sign of trouble. Further, the pursuit of individual remedies for creditors would only lead to increased costs for creditors as a group, benefiting no one. Simply put, it is a classic example of the game theorist's "prisoner's dilemma".[19] The central thesis of a prisoner's dilemma is that rational individual behaviour, in the

16 Richard H Mclaren, "Voidable transactions in Bankruptcy: The Canadian Perspective", in Jacob S Ziegel, *supra*, n 3.

17 See the Insolvency Law Report, *supra*, n 14, where the committee noted in addition to the abovementioned aims, others such as: (1) to realise the assets of the insolvent which should properly be taken to satisfy his debts with the minimum of delay and expense; (2) to distribute the proceeds of the realisations amongst the creditors in a fair and equitable manner, returning any surplus to the debtor; (3) to recognise that the effects of insolvency are not limited to the private interests of the insolvent and his creditors, but that other interests of society or other groups in society are vitally affected by the insolvency and its outcome and to ensure that these public interests are recognised and safeguarded; (4) to provide means for the preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country; and (5) to ascertain the causes of the insolvent's failure and if and insofar as his conduct or in the case of a company, the conduct of its officers or agents, merits criticism or punishment to decide what measures if any, require to be taken against him or his associates, or such officers or agents.

18 Thomas Jackson, *supra*, n 5.

19 See generally Duncan R Luce & Howard Raiffa, *Games & Decisions* (John Wiley and Sons, 1957); and Anatol Rapoport & Albert Chammah, *Prisoner's Dilemma*, (University of Michigan Press, 1965). Other examples of prisoner's dilemma can be seen in the Texas oil fields or advertisements in the cigarette business. See D Glasner, *Politics, Prices and Petroleum* (1985) and S McDonald, *Petroleum Conservation in the United States: an Economic Analysis* (1971).

absence of co-operation with other individuals, leads to a sub-optimal decision for the group as a whole. Here, unless each creditor attempts to "beat" the other creditors, they will individually fare worse. However, if everyone gets in line, it defeats the entire purpose of getting in line since everyone will have to incur costs to monitor the debtor for no additional benefit.[20]

11 Insolvency thus offers a way out of this unfruitful race by imposing a collective regime of debt collection on all the creditors.[21] It further enhances the maintenance of commercial morality by ensuring the fulfilment of financial obligations.[22] In this regard, insolvency law is often described as an economically efficient alternative to the piecemeal dismemberment of an insolvent debtor's estate[23] which eliminates the benefits that flow to the debtor, the creditor and the community from the existence of an ongoing business.[24]

12 I now turn to the doctrine of unfair preferences and the role that this doctrine plays in relation to insolvency law as a whole.

13 The cornerstone of this doctrine is the *pari passu* doctrine.[25] This principle essentially encapsulates the ideal of equal treatment for all that are similarly placed.[26] This can only be attained by taking into consideration transactions that occur prior to the commencement of the liquidation petition, for to disregard these transactions would encourage

20 A situation aptly put by Lewis Carroll in *Through The Looking Glass*, Chapter Two, "The Garden Of Live Flowers" that: "Now here, you see, it takes all the running you can do to keep in the same place! If you want to get somewhere else you must run twice as fast!"

21 Thomas Jackson, *supra*, n 5.

22 Insolvency Law Report, *supra*, n 14.

23 Jacob S Ziegel, *supra*, n 3.

24 James A MacLachlan, *Handbook on the Law of Bankruptcy* (1956).

25 V Countryman, "The Concept of a Voidable Preference in Bankruptcy" (1985) 38 V and L Rev 713; CJ Tabb, "Rethinking Preferences" (1992) 43 South Carolina L Rev 981.

26 However in practice, the general notion of equality among all creditors has been modified by the cumulative effects of judicial and legislative interventions which have resulted in a stratified system of distribution whereby defined groups of creditors are accorded preferential status or otherwise enjoy some kind of privilege. Creditors who fall within this privileged category enjoy improved prospects of recovering repayment of their debts by comparison with the general body of creditors. It is however not within the scope of this article to deal with this practical nullification of the *pari passu* doctrine.

a flurry of pre-liquidation activity (as earlier mentioned) amongst creditors[27] and engender the practice of favouritism by the debtor.[28]

14 It is this pre-petition relationship that the avoidance provisions seek to address.[29] In particular, unfair preference focuses on the debtor's relationship *vis-à-vis* different creditors.[30] It is essentially a rule designed to prevent individual creditors from jumping the gun and supplanting others in the priority queue[31] or converting their position from being unsecured to secured creditors.[32] By doing so, the unfair preference rules attempt to eliminate any advantages a creditor might gain from opting out of the collective regime.[33]

15 As such, it can be seen that the unfair preference provisions perform two roles in maintaining the insolvency regime: first maximising and augmenting the total pool of assets available for distribution to creditors;[34] and second, maintaining the order of priorities of the creditors.[35] These roles are a reflection of the moral principles that underlie society's treatment of the creditor-debtor relationship which include the notions of fairness and even-handedness.[36]

16 These roles are executed through a system of incentives to participate in the collective proceedings, and disincentives to engage in

27 Especially because a debtor's insolvency does not normally occur at one instance but rather is a gradual process. Hence it would be common for creditors to obtain notice of the impending insolvency first (especially where the creditors are related in some way to the management of the company) and thereby take advantage of this notice to satisfy their own claims and thereby opt out of the collective proceedings. See Thomas Jackson, *supra*, n 5, for a more in-depth discussion.

28 Seligson, "The Code and the Bankruptcy Act" (1967) 42 NYU L Rev 292.

29 Thomas Jackson, *supra*, n 5.

30 D D Prentice, "The effects of insolvency on pre-liquidation transactions", in BG Pettet, *Company Law in Change: Current Legal Problems* (Stevens & Sons, 1987).

31 McCoid, "Bankruptcy Preferences and efficiency: An expression of doubt" (1981) 67 Vand L Rev 249; "Preferential Transfers and the value of the insolvent firm" (1978) 87 Yale LJ 1449; and A Keay, "The Recovery of Voidable Preferences: Aspects of Restoration" (2000) CFILR 1.

32 RC Clark, "The Duties of the Corporate Debtor to its Creditors" (1977) 90 Harv L Rev 505.

33 Thomas Jackson, *supra*, n 5.

34 Ian F Fletcher, "Voidable transactions in Bankruptcy: British Law Perspectives", in Jacob S Ziegel, *supra*, n 3; and D D Prentice, *supra*, n 30.

35 Roy Goode, *Principles of Corporate Insolvency Law* (2nd Ed, 1997).

36 RC Clark, *supra*, n 32.

voidable transactions. By doing so, the law further seeks to instil greater confidence in the credit system upon which our entire economic structure is based, by encouraging higher standards in commercial lending ethics.[37]

17 Thus, it has been said that the law of preference is the most significant contribution of bankruptcy to commercial law, not merely because it promotes equitable distribution in bankruptcy, but also because it weakens incentives to profit from a race of diligence and promotes sound commercial practices.[38]

Part III: The provision

18 Any unfair preference provision necessarily involves the notion of transaction avoidance.[39] Since any such retrospective application of the proprietary effects of insolvency entails an impairment of rights previously vested in other individuals,[40] an effective unfair preference provision must take into consideration the fact that any transactional avoidance will have an impact on the business dealings of possibly innocent parties and undermine the certainty of contract. Yet, while one may sympathise with the innocent creditor who accepts payment in good faith, it must be recognised that the transaction is at the expense of other creditors, each of whom is equally, if not more, innocent.[41] In order to achieve the harmonious balance between the competing notions of fairness and certainty,[42] there is a necessity for the process to be governed by some powerful controlling principle, applied in a way which is consistent with notions of justice and fairness.[43]

19 In Singapore, this principle is encapsulated in s 99 BA which reads as follows:

37 Richard H Mclaren, *supra*, n 16.

38 James A MacLachlan, *supra*, n 24.

39 The idea here, being that there are social policies which are regarded as outweighting the need for freedom of contract. See M Eisenberg, "The Bargain Principle and its Limits" [1982] 95 Harv L Rev 741 for limitations on freedom of contract and MR Cohen, "The Basis of Contract" [1933] 46 Harv L Rev 553 and RL Hale, "Bargaining, Duress and Economic Liberty" (1943) 43 Colum L Rev 603 for a discussion on the economic justifications for the enforceability of contracts.

40 Ian F Fletcher, *supra*, n 34.

41 Richard H Mclaren, *supra*, n 16.

42 Rebecca Parry, *Transaction Avoidance in Insolvencies* (Oxford University Press, 2001).

43 Ian F Fletcher, *supra*, n 34.

> (1) Subject to this section and sections 100 and 102, where an individual is adjudged bankrupt and he has, at the relevant time (as defined in section 100), given an unfair preference to any person, the Official Assignee may apply to the court for an order under this section.
>
> (2) The court shall, on such an application, make such order as it thinks fit for restoring the position to what it would have been if that individual had not given that unfair preference.
>
> (3) For the purposes of this section and sections 100 and 102, an individual gives an unfair preference to a person if —
>
> > (a) that person is one of the individual's creditors or a surety or guarantor for any of his debts or other liabilities; and
> >
> > (b) the individual does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the individual's bankruptcy, will be better than the position he would have been in if that thing had not been done.
>
> (4) The court shall not make an order under this section in respect of an unfair preference given to any person *unless the individual who gave the preference was influenced in deciding to give it by a desire to produce in relation to that person the effect mentioned in subsection (3)(b).*
>
> (5) An individual who has given an unfair preference to a person who, at the time the unfair preference was given, was an associate of his (otherwise than by reason only of being his employee) shall be presumed, unless the contrary is shown, to have been influenced in deciding to give it by such a desire as is mentioned in subsection (4).
>
> (6) The fact that something has been done in pursuance of the order of a court does not, without more, prevent the doing or suffering of that thing from constituting the giving of an unfair preference.
>
> [emphasis added]

20 The key portion of s 99 BA provides that a debtor is deemed to have given an unfair preference to a person if the debtor does anything or allows anything to be done which has the effect of placing his creditor/surety/guarantor into a better position, in the event of his insolvency, as compared to if that thing had not been done. This is then followed by the requirement that a preferential transaction is voidable

only if the debtor who gave the preference was influenced by a desire to unfairly prefer that creditor.[44]

21 This provision was the result of legislative reform. The old version, s 53(1),[45] provided that a preferential transaction was voidable only if the person making the preference did so with a *dominant* intention to give the creditor an unfair preference.[46] The current legislation does away with the requirement that it be a dominant intention and only requires that the debtor was influenced by a desire to unfairly prefer.

22 For the avoidance of confusion, I would just point out here that s 99 BA applies to the insolvency regime by virtue of the operation of s 329(1) of the Companies Act (Cap 50, 1994 Rev Ed)[47] ("CA") which reads as follows:

44 The importance of this second limb was stated in *Lin Securities Pte v Royal Trust Bank (Asia) Ltd* [1995] 1 SLR 97 where LP Thean JA stated that "the mere fact of a preference is not, without more, tantamount to proof that the debtor has acted "with a view" to prefer."

45 Bankruptcy Act (Cap 20, 1985 Rev Ed) which states:

Avoidance of preferences in certain cases

(1) Every conveyance or transfer of property or charge thereon made, every payment made, every obligation incurred and every judicial proceeding taken or suffered by any person unable to pay his debts as they become due from his own money in favour of any creditor or any person in trust for any creditor, with a view to giving such creditor or any surety or guarantor for the debt due to such creditor a preference over other creditor, shall, if the person making, taking, paying or suffering the same is adjudged bankrupt on a bankruptcy petition presented within three months after the date of making, taking, paying or suffering the same, be deemed fraudulent and void as against the official assignee.

(2) This section shall not affect the rights of any person making title in good faith and for valuable consideration through or under a creditor of the bankrupt.

46 See *Re Libra Industries Pte Ltd* [2000] 1 SLR 84 and *Re MC Bacon Ltd* [1990] BCLC 324 for an analysis of how the law on this point has evolved.

47 Although it is not within the ambit of this article, I would just mention that the incorporation of the Bankruptcy Act provisions into the Companies Act *via* this mechanism is not without its critics as problems arise in adapting a provision designed for the bankruptcy of individuals to the winding up of companies: in particular see Lee Eng Beng, "The avoidance provisions of the Bankruptcy Act 1995 and their application to companies" [1995] SJLS 597; Lee Eng Beng, *Annual Review of Singapore Cases* (2002), Chapter 14 on "Insolvency Law" and the case of *Show Theatres Pte Ltd v Shaw Theatres Pte Ltd* [2002] 4 SLR 145, where Chao Hick Tin JA noted that the "UK legislation … is clearer as it does not suffer from the drafting complexity arising from importing and adapting rules governing individual bankruptcy into the regime of corporate insolvency."

By way of illustration, I would just point out two problems. First, s 329 CA uses the words "void or voidable" while s 99 BA does not actually use these words in that while the court is granted a wide power to do what it thinks just, there is actually no express power granted to the court to declare the transaction void or voidable.

> Subject to this Act and such modifications as may be prescribed, any transfer, mortgage, delivery of goods, payment, execution or other act relating to property made or done by or against a company which, had it been made or done by or against an individual, *would in his bankruptcy be void or voidable under section* 98, *99* or 103 *of the Bankruptcy Act 1995* (read with sections 100, 101 and 102 thereof) shall in the event of the company being wound up be void or voidable in like manner. [emphasis added]

Part IV: Effect of the provision

23 The unfair preference provisions can be divided into two limbs. The first limb focuses on transactions which have the effect of favouring one creditor over another. It is objective in nature because it is not concerned with the intention of either the debtor or the creditor.[48] Rather, the only question to ask is – did the particular transaction have the *effect* of putting one creditor in a better position over the other, *ie* did the transaction constitute a preference?[49]

24 The second limb is subjective in its approach. It is concerned with whether a preference is unfair. It effectively defines a preference as unfair when the company giving the preference was influenced by a desire to do so. The desire to unfairly prefer cannot be inferred from the simple fact that an advantage had been received.[50] Hence, subjective evidence of the debtor's motivations is required if a transaction is to be

Thus, on a strict statutory interpretation, it can thus be argued that s 329 CA does not actually incorporate s 99 BA: see also the case of *Buildspeed Construction Pte Ltd v Theme Corp Pte Ltd* [2000] 4 SLR 776 where this issue was highlighted. Second, the concept of associate does not really operate well in the context of a company, although reg 4 of the Companies (Application of Bankruptcy Act Provisions) Regulations tries to deal with the problem: see the case of *Show Theatres Pte Ltd v Shaw Theatres Pte Ltd* [2002] 4 SLR 145 where the interpretation of this regulation was discussed.
See also the case of *Re Tiong Polestar Engineering* [2003] 4 SLR 1 which considered the question of whether a liquidator had the *locus standi* to bring an action under s 99 BA as a further example of the problems faced by the incorporation of bankruptcy provisions *via* this mechanism.

48 Ian F Fletcher, *supra*, n 34.

49 As such, payments to secured creditors have never been considered preferential (except where the preference exceeds the value of the security) as the any payment merely increases the remaining security available to the debtor. See *National Australian Bank Ltd v KDS Construction Business Pty Ltd* [1988] LRC (Comm) 19 for an illustration.

50 *Re MC Bacon Ltd* [1990] BCC 78, as followed locally in the case of *Re Libra Industries Pte Ltd*, *supra*, n 46.

avoided.[51] The evidence does not need to be direct evidence as desire may be inferred. However, it is insufficient that the debtor actually had a desire to benefit the creditor, unless this desire actually influenced the decision to prefer the creditor.

25 In practice, one normally seeks to rely upon the rebuttable presumption of being so influenced by the desire to prefer by showing that the preference has been given to a person who was an associate of the debtor. Once the presumption arises, it becomes incumbent upon the recipient to disprove the presence in the debtor's mind of any motive of preferring the creditor.[52] This thus relieves office holders of the difficulties of establishing an intention of the desire to prefer.[53]

26 By benchmarking the standard of culpability to that of a desire to prefer, this creates the ironic situation where payments that were made out of a sense of moral obligation are rendered vulnerable[54] while those made under pressure are not.[55]

27 This, in effect, makes it in the creditor's best interest to pressurise his debtor into making payment at least so long as the pressure is kept within the permissible limits of the law. This approach finds support in Millet J's decision in *Re MC Bacon Ltd*[56] as he states that bargained for advantages which come about through orthodox commercial processes, are an acceptable means of defending a creditor's position especially where his willingness to maintain or increase his exposure in the event of the debtor's failure to crucial to the latter's efforts to stave off that very possibility.[57]

51 *Per* LP Thean JA in *Lin Securities Pte v Royal Trust Bank (Asia) Ltd* [1995] 1 SLR 97 who cited Lord Greene MR in *M Kushler Ltd* (1943) Ch 248 that "a state of mind is as much a fact as a state of digestion and the method of ascertaining it is by evidence and inference …"

52 For an illustration, see *Re Tiong Polestar Engineering* [2003] 4 SLR 1.

53 For illustrations, see *Weisgard v Pilkington* [1995] BCC 1108; *Re Exchange Travel Ltd* [1996] BCC 933; *Re Corfe Joinery Ltd*, The Times, 21 January 1997; and Rebecca Parry, "*Weisgard v Pilkington*" (1996) 18 Insolvency Lawyer 15.

54 Reflected in *Harman v Fishar* (1774) Lofft 472.

55 Reflected in *Alderson v Temple* (1768) 4 Burr 2235.

56 *Supra*, n 50. This case was subsequently followed locally in the case of *Re Libra Industries Pte Ltd*, *supra*, n 46, and considered in the cases of *Soh Gim Chuan v Koh Hai Keong* [2002] 4 SLR 212 and *Buildspeed Construction Pte Ltd v Theme Corp Pte Ltd* [2000] 4 SLR 776.

57 For an example of acceptable commercial pressure, refer to the cases of *Lin Securities v Royal Trust Bank (Asia) Ltd* [1994] 2 SLR 168 and *ECRC Land Pte Ltd v Wing On Ho Christopher* [2004] 1 SLR 105, although I would just add that the latter case is being appealed against at the time of writing.

Part V: Problems

28 The main problem with the way that the provision operates is that the net effect of the provision is at odds with the modern philosophy of corporate insolvency[58] because it differentiates between those transactions influenced by an intention to prefer and those where a creditor has obtained payments as a result of aggressive debt collection tactics.[59]

29 In particular, the objectives of insolvency law are jeopardised when individual creditors are allowed to fish unilaterally from the pool of assets without paying sufficient regard to the interests of other creditors.[60] Further, if a creditor who is found guilty of unfair preference can retain the right to claim for the debt in winding up and only forfeit the amount the preference given, then a creditor has much to gain and little to lose by engaging in the unseeming race.[61]

30 Further, the law must protect certain classes of creditors such as employees or the tax authorities who are often not in a position to engage in any such race of diligence and would hence, be disadvantaged by an inflexible policy which only rewards the fleet of foot.[62]

31 In dealing with this, two considerations arise. On one hand the creditors of a company in financial difficulty should spare no effort in striving to ensure that their debts are fully paid,[63] lest they themselves fall foul to the same fate as their debtor. On the other hand, squeezing a company that is facing liquidation would inevitably result in a diminution of the pool of assets available for division among all the other creditors and thereby undermine the *pari passu* principle.[64]

32 A further problem arises from the need to prove that the transaction was influenced by a desire to so advantage the beneficiary, as it may present evidential difficulties to the liquidator, thereby making it

58 W Ewing, "Insolvency – Growth and separatism" (1985) 1 ABB 4897 and Jackson, "Translating assets and liabilities to the bankruptcy forum" (1985) 14 Journal of Legal Studies 73.

59 Rebecca Parry, *supra*, n 42.

60 Roy Goode, *supra*, n 35. See also Herzberg A, *Voidable Preferences in Bankruptcy and Company Liquidation* (Monash University, 1981).

61 McCoid, *supra*, n 31.

62 Rebecca Parry, *supra*, n 42.

63 Andrew Keay, *McPherson: The Law of Company Liquidation* (4th Ed, 1999).

64 Andrew Keay, *ibid*; and Herzberg A & Von Nessen PE, "Voidable Preferences and Guarantor Officers" (1987) 16 Melbourne University Law Review 49.

difficult for avoidance proceedings to be successfully brought.[65] After all, as Bowen LJ so aptly put it: [66]

> If we are to consider whether amongst all of the shadows which pass across a man's mind, some view as well as the dominant view influenced him to do the act, we shall be embarking on a dark and unknown voyage across an exceedingly misty sea.

33 In fact, from a practical perspective, it has been suspected that most preferences are not even recovered given the difficulties of proof encountered by a liquidator or trustee under the present legislative scheme and the cost of litigating a claim for a preference.[67]

Part VI: Reform

34 Thus, it can be seen that the existing position is at odds with the general principles behind asset recovery insolvency regimes. Further, the present preference rules subvert the collective nature of insolvency law and also raise a number of technical legal issues which increase costs and create uncertainties. This is because the existing preference rules appear to be predicated on the assumption that the purpose of the legislation is not to preserve the *pari passu* principle, but rather to avoid voluntary transfers which are not made in good faith.[68] This can be seen in how the legislation looks not to the fact of preference or loss of value, but to the intention of those entering into the transaction under attack. Indeed, our present system of preference law still reflects medieval attitudes to defaulting debtors where what seemed objectionable was the intentions of the debtor in attempting to determine the manner in which his assets should be distributed.[69]

35 Thus, if there is to be any real prospect of improving the position of unsecured creditors, it is necessary to substitute an objective test for the existing subjective test. The test for preference avoidance should thus look to whether the transaction resulted in the creditor receiving a greater repayment than would be available to him or her in the event of a bankruptcy occurring at the time of the transaction[70] and

65 *Peat v The Gresham Trust* [1934] AC 252.

66 *Ex Parte Hill* (1883) 23 Ch D 695.

67 The Law Reform Commission, Report No 45, General Insolvency Inquiry, vol 1 (Australian Government Publishing Services, 1988).

68 Roy Goode, *supra*, n 35.

69 R Weisbery, "Commercial morality, the Merchant Character and the History of the Voidable Preference" (1989) 39 Stanford L Rev 3.

70 Andrew Keay, *supra*, n 63.

nothing more. There should not be an additional requirement of "dominant influence" or improper motivations.

36 Following on from that, I would submit that the suggested reform should take the mode of rendering all transactions voidable if they take place at a relevant time and have preferential effect, regardless of intention of desire. In short, the intentions of those entering into the transaction should be irrelevant. The court should only be concerned with the *effect* of the transaction, that is, whether a creditor has been given an advantage.[71] Radicalism must, of course, be tempered with practicality by introducing reasonable exemptions for transactions on reasonable commercial terms in the ordinary course of business and the exclusion of payments made in good faith and in the ordinary course of business.[72]

37 This approach is not completely new. The Australian position[73] is similar in that what matters there is not the alleged preferred party's position in relation to the other creditors but rather whether it can be said that the preferred party finds himself in a better position than he would otherwise have been in, but for the transaction, on an immediate

71 Roy Goode, *supra*, n 35.

72 I would further submit that the suggested amendment would not result in a scenario where creditors will now seek to wind up all companies that they think are flirting with insolvency. Any suggestion that creditors who previously would have been deterred from winding up the company by the fact that they would be entitled to keep any payments demanded from the debtor company, would no longer be so deterred is in my opinion misguided. First, where the pressure exerted is of the threat of winding up the company, such a threat is indefensible and there is no reason to protect a creditor who makes such a threat. In any case, to say that creditors would now wind up the company solely because they are unable to keep the proceeds of their demands is to take too simplistic an approach towards the mindset of creditors. In choosing to wind up a company, there are often several competing considerations, chief of which is the notion that they would recover more in winding up than in allowing the business to continue in the ordinary course. This factor may not necessarily be affected by the suggested amendment. Second, where the pressure exerted is the refusal to supply further goods and services to the company in the ordinary course of business, then any payments made to the creditor would be protected under my proposed exemptions. Thus, this would not affect the position of creditors. Third, if the only reason that a debtor makes payment to the company is because of the threat of winding up, then this clearly plays into the unseeming race, the foundation of which is clearly against the principles of insolvency law. As such, if the necessary effect of adopting this policy is that creditors would be more aggressive in seeking winding up proceedings, then it is submitted that this would be a cost that would have to be accepted. In any case, this is not an observation supported by any empirical evidence from the jurisdictions that have adopted similar amendments.

73 Corporations Law s 588 FA; Dennis Rose, *Lewis' Australian Bankruptcy Law* (11th Ed, 1999).

liquidation.[74] The key provision is s 122(1) of the Bankruptcy Act (Cth) 1966 which provides that "the effect of the transaction was to confer on that person a preference, priority or advantage over other creditors in the winding up."[75] There is no requirement of intention to prefer. It then further provides for certain qualifications to the general rule such as the exclusion of payments made in good faith,[76] for valuable consideration and in the ordinary course of business.[77]

38 The advantage of the Australian position is that it dispenses with what has earlier been termed a "difficult and unsatisfactory inquiry"[78] into "the shadows which pass across a man's mind".[79] This is essentially done by a reversal of the burden of proof by the introduction of the presumption of preference[80] which would then require the alleged preferred party to show that he comes within one of the exceptions as opposed to the present situation of requiring the liquidator to show that there was preference.[81]

39 This is also the American position.[82] Under the American Bankruptcy Code,[83] the state of mind of the debtor and the preferred

74 Louis G Doyle, *Insolvency Litigation* (Sweet & Maxwell, 1999).

75 Dennis Campbell, *International Corporate Insolvency Law* (Butterworths, 1992).

76 An objective test is applied to determine whether the payment is made in good faith, being the hypothetical manner of business which provides the standard by which the good faith of the transaction is to be judged. See *Downs Distributing Co v Associated Blue Star Stores Ltd* (1948) 76 CLR 473.

77 Insolvency Law Report, *supra*, n 14.

78 *Ibid*.

79 *Ex Parte Hill* (1883) 23 Ch D 695.

80 Illustrated by *Weisgard v Pilkington* , *supra*, n 53; *Re Exchange Travel*, *supra*, n 53; *Re Corfe Joinery Ltd* [1997] BCC 511; *Re Agriplant Ltd* [1997] BCC 842; *Re Barton Manufacturing Ltd* [1998] BCC 827 and *Re Brian D Pierson Contractors* [1999] BCC 26, but contrast with the approach taken in *Re Beacon Leisure* [1990] BCC 213 and *Re Fairway Magazines Ltd* [1992] BCC 924.

81 The law as it stands now means that the office-holder's efforts to impeach a given transaction may be unsuccessful on account of the nature and quality of the evidence available to put to the court. Which means that if the statutory requirement on the specified desire cannot be established, then the recipient of the advantage will be entitled to retain it despite the consequences for the other unpaid creditors. Such an unsatisfactory scenario would be avoided under the proposed amendment.

82 Bankruptcy Code §547.

83 Title 11 of the United States Code.

creditor is irrelevant.[84] Instead, every *de facto* preferential transfer by the debtor is voidable[85] and can be recaptured upon the filing of bankruptcy.[86] The American position then balances the competing tensions of practical necessity by a long list of exceptions including transfer intended to be a contemporaneous exchange for new value given to the debtor and which was in fact substantially a contemporaneous exchange, payments in ordinary course of business and debt incurred in the ordinary course of business and made according to ordinary business terms.

40 I would further note that this approach is already present to some extent in our current legislation, but only where the beneficiary is an associate.[87] In such a scenario, the burden of proof is reversed as the giver of the preference is presumed to have been influenced by a desire to so prefer the beneficiary. Given this scenario, it does not seem too far a jump to place the burden of proof on all beneficiaries and not just those beneficiaries who are associates. After all, the beneficiary has in both cases by his actions, deprived all creditors of the benefits of a controlled liquidation process, while still being able to claim for any remaining debts owed, thereby having his cake and eating it too. Where it is deemed beneficial to bring all creditors within a collective process for the common benefit of creditors, then it must be equally beneficial to require creditors as a class to co-operate fully as a part of a wider class of beneficiaries.[88]

41 In any case, the principal difference practically speaking, between the existing approach and the proposed approach, really only goes to the behaviour of a creditor who, suspecting that the debtor is in or is near insolvency, then brings pressure to obtain recovery.[89] Where previously the creditor was able to defend his "preferred transaction" from the prying arms of the liquidator by his cries of "he did it under pressure and not to prefer me", under the new regime, such a creditor must now bear the burden of showing that the transaction falls within any of the exceptions. This approach must be correct in light of the aims of an enlightened insolvency regime. After all, mere reference to the *pari*

84 Morris G Shanker, "The American Bankruptcy Preference Law: Perceptions of the past, the transition to the present and ideas for the future", in Jacob S Ziegel, *supra*, n 3.

85 *Supra*, n 82.

86 Report of the Commission on the Bankruptcy Laws of the United States, July 1973 pt 1. See also *Blumenstein v Philips Insurance Center Inc* [1971] 490 P 2d 1213.

87 Section 99(5) BA.

88 Roy Goode, *supra*, n 35.

89 Insolvency Law Report, *supra*, n 14.

passu doctrine does not explain why it is acceptable for a particular creditor to gain an advantage by threatening or bullying the company into making payment, but yet not acceptable if the company makes the payment voluntarily to a creditor out of moral obligations.[90]

42 It is further submitted that the proposed amendment would not form too strong a disincentive to institutional lenders to continue their commercial activities even if they were required to prove to the court's satisfaction that the benefit had been received under commercially defensible circumstances. In fact, the good faith exception would encourage lenders and borrowers to adopt a more candid and realistic approach in their dealings with each other. Further, it would probably be in the best interests of all parties who are destined to suffer loss in the event of insolvency that lenders should be induced to err on the side of caution when the odds are realistically against the debtor trading out of current difficulties without resorting to some type of formal procedure under the auspices of the insolvency law.[91]

43 As such, while it is recognised that the law rewards the vigilent and not the indolent,[92] all that this means is that the creditor who is active in obtaining payment of his own debt ought in principle, to be allowed to retain the fruits of his diligence and not be made to refund them for the benefit of his less diligent peers. This does not go so far as to say that the law must recognise all forms of creditor's pressure, especially where there is no commercial benefit to be served by responding to the creditor's demands.[93]

44 At this juncture, I would just add that the Cork Committee had in 1982, examined this particular issue and decided against the removal of the subjective test.[94] They had stated that without an intention to prefer, the element of impropriety on which the existing statutory provisions were based was missing and creditors who were active in the pursuit of payment should be allowed to retain the fruits of their diligence. With due respect to the learned members of the Cork Committee, I would submit that their emphasis on the need for impropriety was misplaced.

90 Roy Goode, *supra*, n 35.

91 Ian F Fletcher, *supra*, n 34.

92 "*Vigilantibus non dormientibus subvenit aequitas*" *per Smith v Clay* (1767) 3 Bro CC 639.

93 Louis G Doyle, *supra*, n 74.

94 Insolvency Law Report, *supra*, n 14.

45 After all, bearing in mind that the object of the rules as to preferences is to prevent a creditor from gaining an unfair advantage by concluding a transaction with the company during the twilight period which precedes winding up, it is now incongruent to require this need for impropriety before the court can act.[95] Furthermore, the fundamental notion behind insolvency law is the imposition of an economically efficient alternative to the piecemeal dismemberment of an insolvent debtor's estate.[96] The maintenance of this collective proceeding does not require the imposition of moral standards *via* the requirement of the element of impropriety.

46 Additionally, arguments based on the requirement for impropriety circumvents the fact that the company is insolvent. As such, there is again no necessity to reward diligence given that the company is insolvent. To argue otherwise would not reflect a principled approach to the issue of equitable distribution in insolvency.[97] This argument can be attacked even further. It can be said that the parties to a preference have usually done nothing dishonourable. After all, the debtor has merely paid a debt and the creditor only accepted what is his due.[98] To then say that a sub-class of these debtors and creditors would be prejudiced would be merely a challenge to the means as opposed to the ends. As such, I would submit that the Cork Committee's earlier objection to replacing the subjective test with an objective test is no longer applicable especially in today's corporate rescue culture.

Part VII: Conclusion

47 Insolvency law is not an exact science and it is not possible to design a set of rules which will be valid at all times.[99] This does not however mean that we should retain our existing provisions merely because they have served us adequately till today. Reform is nothing new to insolvency law. Australia and American have not been alone in coming to terms with insolvency law reform. Key common law jurisdictions such as Canada and the United Kingdom have been reforming their legislation.[100] Similarly, a number of continental

95 See the US position in Thomas Jackson, *supra*, n 5.

96 Jacob S Ziegel, *supra*, n 3.

97 Roy Goode, *supra*, n 35.

98 Robert Morris Jr, "Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens" [1970] 54 Minn L Rev 737.

99 Insolvency Law Report, *supra*, n 14.

100 Department of Trade and Industry, A revised framework for Insolvency Law, Fe 1984, at para 2.

European jurisdictions have undertaken insolvency law reforms in recent years.[101] The existence of countries embarking on simultaneous programmes of reform is not a coincidence. It is the result of pressure asserted by practical experiences as evidenced by the spectacular corporate collapses of which Enron and Asia Pulp & Paper are but two obvious examples. A continual examination of our insolvency laws is necessary to maintain our status as a premier place to do business, of which, an examination of the unfair preference provisions forms but one small, although key, component of any review that has to be conducted. The time for review is now and the scorching summer of the creditor's application of unfair pressure will not pass until there is a revitalising autumn of reform.

101 Such as Germany's *Entwurf einer Insolvenzordnung*, Bundestags Drucksache 12/2443 which is explained in Reinhart, "Germany's Insolvency Bill" (1993) 2 International Insolvency Review 29.