Time for Reform? a comparison of Canadian and English Preference Laws

by Sia Vatanchi

Introduction

Picture a small company that is insolvent, just days left before it files for bankruptcy. The chief officer and director knows it cannot satisfy the debts owed to all its creditors. In order to shield a family member who has lent him money from recovering less than she would in bankruptcy, the debtor company fully pays off this creditor at the expense of others. This improper advantage is referred to as a "fraudulent preference." However, in reality not all cases are as straight forward as this example. Things can get rather complicated when larger corporations are the centre of focus, which frequently have dozens of directors and officers. To prevent against these adverse transactions which undermine confidence in the bankruptcy system, most jurisdictions have for centuries implemented provisions to allow for the avoidance of such transactions. Preferences are one of several types of transactions that fall under the broad umbrella of "avoidance" or "claw-back" provisions. The rationale here is really to ensure order, justice and the preservation of the *pari passu* principle when bankruptcy occurs.

Simply explained, a preference is a transaction which takes place shortly prior to bankruptcy whereby the beneficiary creditor has their position improved at the expense of similar ranking creditors.[1] This usually involves a full or partial payment to the creditor, the granting of a security interest to satisfy an unsecured debt, or even entails the transfer of property to satisfy a debt.[2] A "fraudulent" intention on the part of the debtor company is not always required. This is due to the fact that a creditor may still benefit from the transaction, even when there is no fraudulent desire on the part of the debtor.

The laws concerning preferences vary by jurisdiction. An element essential to proving preference in one country is sometimes wholly irrelevant in another. This essay will study the national Canadian and English preference laws, noting the similarities and differences in these two countries.[3] Although both are common law nations, the ingredients needed to establish a preference transaction are not quite the same. Emphasis will be placed upon how the courts have interpreted these provisions and the "defences" they have been willing to read into the bankruptcy statute. Prior to considering this, however, it will be essential to begin by examining the foundational theoretical principles upon which preference law is based. References to other common law jurisdictions and criticisms by renowned bankruptcy scholars will also be raised where applicable. Ultimately it will be established that England's focus on the subjective motivation of the debtor, in addition to the allowance of the defence of commercial pressure, makes its preference regime less desirable and effective than its Canadian counterpart. Such outdated standards have unfortunately created an environment by which its preference laws may be employed to achieve what they are precisely intended to prevent against.

[1] Roy Goode, *Principles of Corporate Insolvency Law*, 4th ed (London: Sweet & Maxwell, 2011) at 572 [*Goode*].
[2] Roderick J Wood, *Bankruptcy & Insolvency Law*, (Toronto: Irwin Law Inc, 2009) at 191 [*Wood*].
[3] In Canada the relevant statutes are the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 [*BIA*] and *Companies' Creditors Arrangement Act*, RSC 1985, c C-36. [*CCAA*]. The English equivalent to these statutes is the *Insolvency Act 1986* (UK), c 45 [*Insolvency Act*].

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Preference Law Theories and Objectives

In order to understand the purpose of anti-preference law, we must first begin by briefly considering the function of bankruptcy law in our economy. Various theories have been put forth over the years to rationalize why we have a bankruptcy regime, the most popular of which are the "Creditor's Bargain" theory and the (Elizabeth) Warren approach. The former theory was put forth by celebrated bankruptcy scholar, Thomas Jackson, which in a nutshell reasons that bankruptcy law at its core is a collectivized debt collection system.[4] It establishes a hierarchy scheme wherein the value of assets is maximized in the face of collective pressures by creditors for individual gain in the face of known insolvency.[5] These competing interests must be balanced in a system so that "grab law" does not prevail at the expense of order.

The Warren approach, in contrast, argues that bankruptcy law is about more than asset value maximization and creditor rights: broader repercussions of how bankruptcy affects stakeholders such as employees, pensioners, and the broader community ought to be considered.[6] Of course, much of Canadian and English law existed prior to the development of these theories from the 1980s: these scholars were merely trying to make sense of them. Most countries in the world today actually do reflect aspects of both schools of thought when analysed closely.[7]

When we consider the rationale for avoiding preference transactions in bankruptcy law, our principal motivation appears to be more aligned with Jackson's approach. The claw-back provisions exist to undo actions which threaten the "Creditor's Bargain." This prevents individual creditors from opting out of the collective proceeding during the phase before bankruptcy.[8] Yet, as comprehensive as the Creditor's Bargain theory may be with respect to preference law, it does not adequately address many of the other underlying objectives for its existence. Generally speaking, there are three broad competing visions which aim to explain the purpose of preference law: the debtor-deterrence model, creditor-deterrence model, and equal-sharing model.[9]

The debtor-deterrence model goes back hundreds of years to Lord Coke's reasoning that the debtor should not set himself as the "lawgiver" by playing favourites amongst his creditors.[10] This is understandably the foundational principle for claw-back provisions in most countries, including Canada and England.[11] Failing to prevent fraudulent and improper transactions by the debtor would lead to the perversion of the bankruptcy system, causing a defect in the law whereby certain creditors are defeated and defrauded at the expense of others. An example of this may be where a company on the eve of bankruptcy decides to unfairly pay out non-arm's length creditors, such as close family or friends, at the expense of arm's length ones. The debtor-deterrence model is reflected in both Canadian and English bankruptcy laws, with reference to the debtor's "view" and "desire" to prefer in each regime respectively.[12]

The creditor-deterrence model has come to existence more recently. Developed by Thomas Jackson, this view focuses on the creditors' behaviour concerning asset distribution prior to

[4] See Thomas H Jackson, "Avoiding Powers in Bankruptcy" (1984) 36:3 Stan L Rev 725 [*Jackson on Avoiding Powers*]; Thomas H Jackson, *Logic and Limits of Bankruptcy Law*, (Washington, DC: Beard Books, 2001) [*Logic and Limits on Bankruptcy Law*].
[5] See Thomas H Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain" (1982) 91:5 Yale LJ 587; *Logic and Limits on Bankruptcy Law*, *supra* note 4.
[6] See Elizabeth Warren, "Bankruptcy Policy" (1987) 4:3 Chicago LJ Rev 775; see also Elizabeth Warren, "Bankruptcy Policymaking in an Imperfect World" (1993) 92:2 Mich L Rev 336.
[7] See e.g. *BIA*, *supra* note 3, s 81 where super-priority status is given to certain parties, like unpaid suppliers and employees, while s 69.3 imposes a stay on unsecured creditors. The Warren approach is reflected in the former provision, while the Creditor's Bargain theory is demonstrated in the latter.
[8] *Jackson on Avoiding Powers, supra* note 4 at 759.
[9] Anthony Duggan et al, *Canadian Bankruptcy and Insolvency Law*, 3rd ed (Toronto: Edmond Montgomery Publications Limited, 2015) at 247 [*Duggan, Wood & Telfer*]
[10] *Ibid.*
[11] UK, HC, "Report of the Review Committee on Insolvency Law and Practice", cmnd 8558, in *Sessional Papers* (1982) at para 1256 [*Cork Report*].
[12] See *BIA*, *supra* note 3 s 95(1); *Insolvency Act*, *supra* note 3 s 238(4).

bankruptcy.[13] As mentioned already, one of the primary objectives of having bankruptcy laws is to prevent creditors from jumping the queue in a scramble for payment. The motivation to prevent this race to grab the debtor's assets is twofold: (i) preserving the order and integrity of the distribution scheme in bankruptcy and (ii) preventing the premature dismantlement of the estate, as it may be worth more intact than broken up.[14] Thanks to established preference laws, creditors do not have to supervise one another to avoid being "left behind" if there is a race to assemble the assets.[15] This effectively enhances the bankruptcy system by making it more cost efficient, reliable, and predictable.

Finally, there is the equal-sharing model. This view states that preference provisions should exist to ensure creditors are treated as equally as possible, bearing in mind their class and rank in the distribution hierarchy.[16] The concern here is less about the "wrongful" behaviour of the debtor or creditor, and more on the preferential effect of transaction.[17] This objective, even handed approach makes this model highly desirable. The US and Australia employ this preference model to a great extent, while Canada has gradually inched closer to this approach over the years. However, as will be addressed later on in this paper, the strict observance of the equal-sharing view may be too rigid and inflexible given the realities of bankruptcy law and commercial practice. In fact, there are numerous exceptions allowed by the courts that directly go against this model (eg. ordinary course of business preference transactions), even in countries where it is most closely embraced.[18]

In light of the objectives of preference law mentioned above, it is worth noting that the Canadian *BIA* seems to have incorporated these three models to a greater degree than the English *Insolvency Act*. The English system has only marginally embraced the more objective, effects based model of equal-sharing. This has brought criticism from countless bankruptcy scholars that its preference laws are outdated and ineffective. This will be evident in the following pages through the analysis of each regime's bankruptcy statute and case law.

Preference Law in Canada

As mentioned earlier, Canada has two statutes which may be employed by corporations in bankruptcy: the *BIA* and the *CCAA*. Although the latter allows for liquidations, it is primarily designed for larger entities, with liabilities of at least $5 million, which are attempting to restructure.[19] The *BIA*, in contrast, is a less flexible statute geared generally towards bankrupt individuals and small business entities that are seeking to liquidate.[20]

The *BIA* addresses preference transactions under section 95.[21] Interestingly, the *CCAA* does not have its own particular avoidance provisions, but rather imports them from the *BIA* with minor language adjustments.[22] This means that the preference section in the *BIA* is actually from duplicated in the *CCAA*. A trustee or a monitor may avoid a preference transaction if the following conditions are satisfied:

(1) the debtor has transferred property, provided services, given a charge on property, made a payment, incurred an obligation, or suffered judicial proceedings;
(2) the debtor was insolvent at the time of the preference or as a result of the transaction;
(3) the transaction was in favour of a creditor;
(4) the debtor intended to prefer the creditor over other creditors;

[13] *Logic and Limits on Bankruptcy Law*, *supra* note 4.
[14] See John McCoid, "Bankruptcy, Preferences and Efficiency: An Expression of Doubt" (1981) 67:2 Va L Rev 249.
[15] *Duggan, Wood & Telfer*, *supra* note 9 at 247.
[16] *Ibid.*
[17] *Ibid.*
[18] *United State Bankruptcy Code*, USC 11 § 547(c)(2) (2016) [*US Bankruptcy Code*].
[19] *CCAA, supra* note 3, s 3(1).
[20] For a more thorough analysis of the purpose of the *CCAA* in relation to the *BIA*, please see *Re Ted Leroy Trucking [Century Services] Ltd*, 2010 SCC 60.
[21] *Supra* note 3.
[22] See *supra* note 3, s 36.1.

(5) the preference transaction had the effect of giving the creditor a preference;
(6) the preference transaction occurred within the appropriate time before the date of initial bankruptcy.[23]

Of course, in order to fully understand federal Canadian preference laws we need to analyse the conditions listed above in greater detail.

(1) Transactions Constituting a Preference

Preference payments by their very definition must be made in favour of a *creditor*. A preference may take various forms: a full or partial payment to a creditor; the granting of a security interest for a previously unsecured debt; a transfer of property to satisfy a debt, etc.[24] Generally, preference transactions become problematic when made to unsecured creditors as opposed to secured ones. This is due to the fact that certain transactions are deemed immune from attack under the *BIA* (eg. certain payments made to landlords[25] and secured creditors).[26] The rationale for immunity given to certain creditors over others is actually rather simple. If the debt owed to a secured creditor is reduced or discharged, it does not change the company's net asset position: the secured creditor is higher up in the distribution scheme anyways.[27] Obviously, the same does not apply with respect to the unsecured creditor class.

With this mentioned, this does not mean payments to secured creditors cannot ever be avoided. The secured creditor may actually be preferred by the debtor under a few circumstances, such as if the payment exceeded the value of the collateral or if the security interest was subordinate to that of the trustee's.[28]

(2) Insolvency of the Debtor

This part of the test is rather straightforward. The trustee or monitor bears the onus of proving that the debtor was insolvent on date of the alleged preference transaction, or thereafter, as a result.[29] Under the *BIA* both the cash-flow and balance sheet tests may be used to establish insolvency, which is defined under section 2 of the act.[30]

(3) Transactions in Favour of a Creditor

As noted earlier, preference transactions by their nature must be made in favour of a creditor. Who qualifies as a "creditor" is interpreted broadly here to include a surety or guarantor—as noted in section 95(3).[31]

(4) The Debtor Intended to Prefer

Under section 95(1)(a) of the *BIA*, the debtor must have entered into the transaction "with a view" to preferring a particular creditor over the rest.[32] The court will look to see whether the position of the creditor has been improved as a result of the transaction relative to what he would have recovered under the distribution scheme.[33] The creditor need not have a concurrent or parallel intention to that of the debtor for there to be preference—only the debtor's motivation is relevant.[34]

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[23] *BIA*, *supra* note 3, s 95.
[24] *Wood, supra* note 2 at 191.
[25] *Kisluk v BL Armstrong Co* (1984), 40 OR (2d) 167 (Sup Ct (Bank & Ins Div)).
[26] For more details regarding immune parties and secured creditors under the *BIA*, please refer to Llyod W Houlden, Geoffrey B Morawetz & Janis P Sarra, *The 2016 Annotated Bankruptcy and Insolvency Act* (Toronto: Carswell, 2016) at 567.
[27] *Wood, supra* note 2 at 193.
[28] *Re Royal City Chrysler Plymouth Ltd* (1995), 30 CBR (3d) 178 (Ont Sup Ct (Bank & Ins Div)).
[29] *Re Van der Liek* (1969), 13 CBR (NS) 28 (Ont Sup Ct (Bank & Ins Div)).
[30] *Supra* note 3.
[31] *Ibid.*
[32] *Ibid.*
[33] *Wood, supra* note 2 at 193.
[34] *Hudson v Benallack*, [1976] 2 SCR 168.

Unsurprisingly, this is one of the more controversial aspects of the *BIA*'s preference provision.[35] The ambiguity concerning the establishment of what may be equated to a "guilty mind" has been litigated frequently in the past.[36] The rationale for such language in the federal preference law of Canada can be traced back to the nation's English colonial roots. As will be examined later on, English avoidance laws developed primarily from the debtor-deterrence model: the goal was merely to prevent *fraudulent* and *improper* transactions by the debtor, not innocent or blameless ones. The focus on the debtor's intention continues to be a factor that requires consideration under both regimes, although to different degrees.

In Canada the *BIA* preference law has been amended and interpreted in ways which have minimized the debtor's intention to a large extent. For instance, the courts have applied an *objective* test to infer whether preferential intent existed at the time of the transaction.[37] This more balanced and predictable approach diminishes uncertainty in legal proceedings. It also lowers the threshold for establishing a preference to a more reasonable level, which is the standard in Canadian civil law generally. This aspect of the section 95 is actually one of the chief features that make Canadian preference law more desirable and "modern" than its English counterpart.[38] England's subjective based approach will be dealt with in greater detail in the coming pages.

(5) The Presumption of giving a Preference

Another major difference between two nations is that in Canada, preference is actually *presumed* if the transaction had such an effect.[39] This is often referred to as a "preference in fact." When such a transaction exists, there will no longer be a need for the trustee to demonstrate that an intention to prefer existed. The onus will then shift to the preferred creditor to rebut the presumption, and this option only exists if the creditor is at arm's length.[40] Since the 2009 amendments, if a preference in fact is established between the debtor company and a non-arm's length creditor, it is automatically void against the trustee with no rebuttable presumption.[41]

The preference in fact provision under section 95(2) reflects the equal-sharing model's principles in Canadian bankruptcy law.[42] Preferential transactions which occur on the eve of bankruptcy are effectively caught without the trustee having prove the demanding intent element. This approach is sensible given that preference in fact transactions deserve greater scrutiny to prevent an abuse of the bankruptcy process and ensure the *pari passu* principle endures. The *BIA* strives to balance out the broad, oversimplifying effect of section 95(2) on arm's length creditors by allowing this presumption to be rebutted. This helps achieve a medium whereby exceptions to preferences are allowed.

Under the English law, there is only a rebuttable presumption if a preference is given to a non-arm's length party.[43] The subjective desire to prefer analysis would still apply, however, if the creditor was at arm's length. The English preference law clearly sets a higher bar for the office-holder to meet, which is actually more favourable to the debtor company generally. When compared to other major common law countries (eg. US, Australia, and Canada), the English approach to preference transactions is the clearly the outlier of the bunch. The restriction of rebuttable presumptions to only non-arm's length transactions and the use of a subjective-based intent analysis for arm's length cases

[35] *Wood, supra* note 2 at 194.
[36] *Ibid*.
[37] *Ibid* at 195; *St Anne-Nackawic Pulp Co (Trustee of) v Logistec Stevedoring (Atlantic) Inc*, 2005 NBCA 55 [*Logistec*].
[38] *BIA*, *supra* note 3.
[39] *Ibid*, s 95(2).
[40] *Salter & Arnold Ltd v Dominion Bank*, [1926] SCC 621.
[41] *Piikani Nation v Piikani Energy Corp*, 2013 ABCA 293 at para 16 [*Piikani Nation*].
[42] *BIA*, *supra* note 3.
[43] *Insolvency Act* ss 239(6), 340(5).

have been criticized by many as key contributing factors to the dysfunctional preference law of England.[44]

Before looking at the final element of preference under the *BIA*, it is briefly relevant to note that there are numerous commonly accepted rebuttals or “defences” to the presumption under section 95(2).[45] I believe it is best to explore these rebuttals at length after English preference law has been adequately introduced, especially given that many of these defences are applicable in both jurisdictions.

(6) The Transaction Occurred within the Appropriate Time

The trustee will determine the relevant time period by working backwards from the initial date of bankruptcy.[46] The phase considered will vary depending on whether the parties were arm’s length or not:[47] the former is 3 months, while the latter is 12 months.[48] Although section 95 uses the term “arm’s length,” the *BIA* does not define precisely what constitutes an “arm’s length” relationship.[49] The ambiguity surrounding this term is exacerbated within the context of large corporate entities which frequently employ hundreds of employees. To deal with this dilemma, the courts have interpreted the definition of this concept in conjunction with the element of “control,” which is the legal right to bind the corporation.[50] A recent decision by a Canadian appellate court actually clarified that the word “related persons,” which is defined in the *BIA*, may be interpreted synonymously with the word “arm’s length” as used in the *Income Tax Act*.[51] The similarities in the underlying principles for the two terms were deemed sufficient to allow for cross application. The court went on to clarify that a director who is also a creditor of the company may still be acting at arm’s length, and the presence of such a connection is not a *prima facie* indicator of a non-arm’s length relationship.[52]

Preference Law in England

The English law is regarding preferences is actually quite similar to Canada’s. This is not surprising given the fact that Canada was a former colony of England and both are common law jurisdictions. With this mentioned, the slight differences that do exist in the preference law matter. The *Insolvency Act* governs both consumer and corporate bankruptcies in England. Corporate preference transactions are primarily dealt with under section 239.[53] In order to avoid a preference transaction, the office-holder (ie. trustee) must prove each of the following:

(1) the company must be in liquidation or bankruptcy;[54]
(2) the transaction was entered into at the relevant time;[55]
(3) the recipient of the preference was a creditor, surety, or guarantor;[56]
(4) the preference was suffered by the company;[57]
(5) the insolvent was influenced by a desire to improve the position of the preferred party;[58]

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[44] Andrea Keay & Peter Walton, *Insolvency Law: Corporate and Personal*, (Bristol: Jordan Publishing Ltd, 2012) at 627 [Keay]; Adrian Walters, “Preferences” in John Armour & Howard Bennett, ed, *Vulnerable Transactions in Corporate Insolvency* (London: Hart Publishing, 2003) 123 at 137 [*Adrian Walters*].
[45] *Supra* note 3.
[46] *Ibid*, s 95(1).
[47] See *Ibid*, s 4; *Piikani Nation*, *supra* note 41.
[48] *BIA, supra* note 3, s 95(1).
[49] *Supra* note 3.
[50] *Ibid*, s 4(2); Kevin McElcheran, *Commercial Insolvency Law in Canada*, (Markham: LexisNexis, 2012) at 119 [McElcheran].
[51] RSC 1985, c1 (5th Supp), s 251(2); *Piikani Nation*, *supra* note 41.
[52] *Piikani Nation*, *supra* note 41 at para 39.
[53] *Insolvency Act*, *supra* note 3.
[54] *Ibid*, s 239.
[55] *Ibid.* The look back period is six months for arm’s length transactions (section 240(1)(b)) and two years for non-arm’s length (section 240(1)(a)). The legislation uses the term “connected person” to refer to non-arm’s length parties, but the core idea largely remains the same in both nations—see section 249 for definition of who is regarded as a “connected person.”
[56] *Ibid*, s 239(4)(a). There is no significant difference here from the Canadian *BIA*.
[57] *Ibid*, s 239(4)(b). Similar to the Canadian law, the transaction must have placed the preferred party in a better position at the expense of other creditors.
[58] *Ibid*, s 239(5). As in the Canadian *BIA*, it is solely the debtor’s motive we are concerned with.

(6) the company was insolvent within the definition of the act at the time, or in consequence, of entering into the transaction.[59]

Aside to the longer claw-back period, the law is in many ways similar to the *BIA*. It is principally the way in which the word "desire" is interpreted under the English regime that makes its preference law problematic—as addressed in the next section below.

If the substantive elements to establish a preference are made out, English courts have rather broad authority to restore the *status quo ante*. Under section 241 the court may make an order it sees fit to remedy a preference transaction.[60] With respect to payments to secured creditors, the English law is identical to the Canadian approach for reasons noted earlier: adequate payment to secured creditors for a reduction or discharge of debt will not constitute a preference given that the value of the assets available for junior creditors will remain unchanged.[61]

The Problematic Interpretation of "Desire" in England

The leading authority on section 239(5) is *Re MC Bacon Ltd*.[62] This case involved a company which gave a floating charge to a bank in return for an overdraft. Things got complicated after the business became bankrupt shortly after the transaction. When legal proceedings commenced, the office-holder argued that the transaction should be set aside as a preference. The ultimately court ruled against this though, noting that the company had no desire to prefer the bank over other creditors: it only agreed to the charge so that it could have prolonged the survival of the business.[63] Millet J went on to assert how the word "desire" ought to be interpreted after "intention" was dropped from the *Insolvency Act* in 1986 due to amendments. The following famous passage from the judge has been frequently cited to clarify the difference between the two terms:

> A man is taken to intend the necessary consequences of his actions, so that an intention to grant a security to a creditor necessarily involves an intention to prefer that creditor in the event of insolvency. The need to establish such intention was dominant was essential under the old law to prevent perfectly proper transactions from being struck down. Desire has been substituted. That is a very different matter. Intention is objective; desire is subjective. A man can choose the lesser of two evils without desiring either. It is not, however, sufficient to establish a desire to make the payment or grant the security which is sought to avoid.[64]

Precisely how objective the English system was prior to the 1986 re-enactment of the *Insolvency Act* has been disputed; some are convinced that it was likely not as objective as Millett J seems to suggest.[65] The emphasis placed on the "fraudulent" aspect of preference laws prior to the mid-twentieth century in many common law jurisdictions makes this critique compelling.

The other issue Millett J addressed was whether the debtor's desire to improve the creditor's position ought to be a *primary* consideration. He stated that the correct approach is to establish that the desire be only *one* factor among many (as opposed to the sole motivation).[66] This reasoning is preferable given the commercial realities of bankruptcy, where the debtor may be influenced by various overlapping incentives to prefer a creditor over others. Millett J concluded his analysis by

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[59] "Insolvency" is defined under *Insolvency Act, supra* note 3, s 123. Under this section, the company may be cash-flow or balance sheet insolvent.
[60] *Insolvency Act, supra* note 3.
[61] For a more thorough analysis on secured creditors and preference transactions in England, please see *Goode*, *supra* note 1 at 584-585.
[62] [1990] BCC 78 (Eng (HC)) [*Re MC Bacon*].
[63] *Ibid* at 335-36.
[64] *Ibid.*
[65] See especially *Adrian Walters*, *supra* note 44 at 161: *New, Prance & Garrard's Trustee v Hunting*, [1897] 2 QB 19
[66] *Re MC Bacon*, *supra* note 62 at 335-36.

asserting that the necessary desire must exist at the time the decision to enter transaction was made, not when the transaction occurred.[67] This is a question of fact depending on the case.

The *Re MC Bacon* decision has been consistently applied since the 1990s.[68] Since then, the controversy surrounding the subjective motivation of the debtor has persisted. To establish the debtor's subjective desire is certainly difficult, especially as he or she will often attempt to "play down" their intent—truthfully or not.[69] The subjective standard imposed here is more akin to the criminal *mens rea* standard than what is the norm in corporate law. This is made more complicated in the context of corporate entities, where directors and officers exercise decision making power. Predictably, exploring the mind of the corporation has been somewhat of a difficult issue at times for the courts.

Although the courts have repeatedly suggested that the debtor company's state of mind may be inferred from the circumstances of the case, which appears to be the most practical option under the present English law, in reality they have nevertheless steered clear of making such an inference. This principle seems to somewhat closely mirror the criminal law doctrine of identification theory.[70] This doctrine, and its modern variants, have been used to make out the "directing mind" by equating the will of its senior management to that of the corporation's.[71] The current English law with respect to the accountable corporate mind was actually developed by Lord Hoffmann in *Meridan Global Funds Management Asia v Securities Commission.*[72] It is known as the "rule of attribution" and is quite similar to the identification theory in certain respects. It provides a framework which can be used to analyse a case based on relevant statutes and contexts, and refutes the assumption that the person with whom a corporate offence is identified with must inevitably be its "directing mind." The purpose of this rule is eloquently noted by Lord Hoffmann himself in the decision:[73]

> The rule of attribution is a matter of interpretation or construction (...) Given that it (the particular substantive rule) was intended to apply to a company, how was it intended to apply? Whose act (or knowledge, or state of mind) was *for this purpose* intended to count as the act etc. of the company? One finds the answer to this question by applying the usual canons of interpretation, taking into account the language of the rule (if it is a statute) and its content and policy.

Lord Hoffmann reasoned that in the case of small companies, the ability of the court to identify the desire on the part of the company will not be overly difficult: those who *control* it will almost always be making the business decisions.[74] The test is more difficult when larger and more complex corporations are considered. The analysis in *Meridan Global Funds* appears to suggest that the court may look to the responsibilities of particular members of the management team as opposed to the entire board in investigating relevant decisions. In reality, this problem of pinpointing the "human agent" responsible has actually not been prevalent in English bankruptcy—this may perhaps be due to the fact that preference transactions under English law are rarely challenged in general due to other obstacles, which will be elaborated on shortly.

Aside to the issues that may arise in identifying the corporate mind noted above, the subjective standard remains problematic for more simple reasons. For instance, many preference transactions may be completed without a desire to improve the position of one creditor over another: an "innocent" transaction, but nonetheless preferential in effect. Even if there was intent to prefer,

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[67] *Ibid*; *Green (Re Stealth Construction Ltd) v Ireland*, [2011] EWHC 1305.
[68] See e.g. *Re DKG Contractors Ltd*, [1990] BCC 903; *Re Living Images Ltd*, [1996] BCC 112; *Re Agriplant Services Ltd*, [1997] BCC 842 at 848-849 [*Agriplant Services Ltd*].
[69] *Keay*, *supra* note 44 at 625.
[70] See e.g. *Re Beacon Leisure Ltd*, [1991] BCC 213*; Re Fairway Magazines Ltd*, [1992] BCC 924 [*Re Fairway Magazines*].
[71] See Criminal Code, RSC 1985, c C-46*,* s 22.1 for the relevant Canadian law; see *Tesco Supermarket Ltd v Nattrass*, [1971] AC 153 (HL(Eng)) and *Bolton Engineering v TJ Graham & Sons*, [1957] 3 ER 624 (QB(Eng)) for applicable English law.
[72] [1995] AC 942 (PC(NZ)) [*Meridan Global Funds*].
[73] *Ibid* at 506.
[74] See e.g. *Re Agriplant Services Ltd*, *supra* note 69; *Ibid* at 505-512.

directors and management may avoid admitting to this. There will generally be no evidence from the minute book to prove otherwise, so the office-holder will have a very hard time establishing desire.[75] The fact that courts have been reluctant to infer the debtor's state of mind from the circumstances does not help the cause of the office-holder.[76] Moreover, certain defences available to the debtor in light of the preference transaction (eg. the creditor pressure defence) will make the subjective motive even more difficult to prove.

The Cork Report, an investigation aimed at modernizing English insolvency laws prior to the enactment of the most recent legislation, recognized that as "difficult and unsatisfactory" of an inquiry it is to establish the subjective motive of the debtor, preference law should be used only to set aside "really improper" transactions.[77] This sentiment reflects the old, more primitive debtor-deterrence approach to bankruptcy law where the fraudulent intent of the debtor was of prime consideration. As Professor Robert Weisberg explains, motive was introduced back in the eighteenth century because the notion of credit was still subject to profound mistrust and bankrupts were frequently viewed as criminals.[78] Times have changed since then, however. The role of credit in the economy and how commercial trade is conducted naturally differs from what it was 250 years ago. English preference law needs to evolve to reflect this.

Today, England is the "outsider" when compared to other major common law regimes. The trend the past century has clearly been towards the embracement of the equal-sharing model. In light of the clear advantages of emphasizing the *effects* of transactions as opposed to the debtor's motives, countries like the United States and Australia followed this approach rather closely.[79] Even Canada, which takes into consideration the debtor's intent, minimizes the role of this element. This is achieved primarily in two ways: the utilization of an objective based motive analysis and the automatic avoidance of preference in fact transactions, subject to rebuttal by the creditor. England may find it wise to follow in the footsteps of its sister regimes. Such complications from the subjective approach have not only led to growing criticism from legal scholars,[80] but the ineffectiveness of the present law seems to have deterred many creditors from bringing actions against bankrupt debtor companies.[81]

Defences to Preference Transactions

In order to prevent the avoidance of a transaction, there are numerous "defences" which may be relied upon. Aside to the defence of commercial pressure, which has been prohibited under the *BIA*, the defences available in both Canada and England are largely similar.[82] It is more so the *method* by which the defence is employed, in addition to how it is labelled or characterized, that the two jurisdictions really differ. In Canada, for instance, a defence is generally used to *rebut* the presumption of preference under section 95(2).[83] This is due to the operation of a more objective system, where preference is assumed if the transaction had such an effect. The onus to rebut the presumption will be placed on the creditor in Canada—even though we are concerned with the objective intent of the debtor.[84] On the other hand, there is only a rebuttable presumption under the English model when we are dealing with "connected parties."[85] Under other general circumstances the defence will be pleaded once the desire of the debtor is considered, where the office-holder bears

[75] *Adrian Walters*, *supra* note 44 at 162-163.
[76] *Re Fairway Magazines*, *supra* note 70.
[77] *Cork Report*, *supra* note 11 at para 1256(a).
[78] "Commercial Morality, the Merchant Character, and the History of the Voidable Preference" (1986) 39 Stanford LR 3, 11-16.
[79] See *US Bankruptcy Code*, *supra* note 18, s 547; *Corporations Act 2001* (Cth), s 588FA. The defences to preference transactions differ somewhat in these countries to complement their alternative approach (eg. "Good Faith Defence" in Australia).
[80] See e.g. Rizwaan J Mokal, *Corporate Insolvency Law*, (New York: Oxford University Press Inc, 2005) [*Mokal*].
[81] *Adrian Walters*, *supra* note 44 at 136-138.
[82] *Supra* note 3.
[83] *Ibid*, s 95(2).
[84] *Ibid.*
[85] *Insolvency Act*, *supra* note 3, s 239(6).

the onus. These are the chief differences in the manner by which defences are utilised under the two regimes.

A brief analysis of some the most frequently employed defences will take place below. Then, I will turn my attention to considering the viability of the commercial pressure doctrine, which is yet another aspect of English preference law that sets it apart from other regimes. The permissibility of this defence has gathered a lot of scholarly attention throughout the decades, which is why I believe it deserves to be studied at greater length than other defences.

(1) Frequently Employed Defences

In most common law countries, including the two we are concerned with, the defences utilised to avoid preference are largely identical and similar in nature. In Canada, the "ordinary course of business" and "transactions necessary to stay in business" are two of the most widely used techniques to rebut the presumption.[86] The former is employed when the debtor made a transaction to its creditor that follows the "usual pattern" of business with no major alterations.[87] This may be established, for instance, by demonstrating that the debtor promptly paid for shipments to a particular creditor regularly in the past.[88] Alternatively, it may be argued that the transaction made good commercial sense and it was in the best interest of all stakeholders.[89] The ordinary course of business defence is somewhat flexible by nature.

The defence of necessary transactions to continue business is the other popular method by which the statutory presumption under section 95(2) may be rebutted.[90] The creditor here may defend the debtor's intent, which is judged through an objective lens, by showing that the preferential payment was needed for continued operation of the business. This may be proven by demonstrating that the creditor was a critical supplier whose continued, uninterrupted deliveries were required.[91] If the goods were readily available by others, the presumption would obviously not be rebutted.[92]

In England, the two defences mentioned above would fall under the broad umbrella of "proper commercial considerations."[93] This is a relatively vague phrase has not been defined by the courts, but serves as a shield by which the desire to prefer may be challenged. The office-holder will only be successful in avoiding the transaction if it is shown that the debtor was influenced by something other than solely proper business considerations.[94]

Another defence that may fall under the scope of proper commercial considerations is the desire to obtain of new financing.[95] This was the case in *Re Fairway Magazines Ltd*, after the company issued debentures to raise cash was challenged by the office-holder.[96] This boost allowed the company to stay afloat longer and was therefore not deemed improper by the court. The search to secure new financing may be paralleled to the Canadian defence of "transactions necessary to stay in business." Although the two defences may be labelled and employed somewhat differently, they ultimately serve the same function.

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[86] *Re Canadawide Fruit Wholesalers Inc* (1998), 30 ACWS (3d) 261 (Que(CA)).
[87] *Logistec*, *supra* note 37.
[88] *Re Paquet* (1977), 51 Alta LR (3d) 247 (QB).
[89] See e.g. *Logistec, supra* note 34. Here, the court did not avoid the transaction even though it only allowed the debtor to carry-on business for *one* extra day. The transaction was deemed in the best interest of all parties as it helped maximise asset value.
[90] *BIA*, *supra* note 3.
[91] *Sino Trucking ltd (Trustee of) v Western Tire Service Ltd* (1992), 99 Sask R 246 (QB).
[92] *Ibid.*
[93] *Re MC Bacon*, *supra* note 62 at 336.
[94] *Ibid.*
[95] *Re Fairway Magazines*, *supra* note 70 at 930.
[96] *Ibid.*

(2) Critique of the Commercial Pressure Defence

This controversial defence has been available to debtors since the eighteenth century.[97] The underlying rationale for this principle is that pressure negates the "free will" of the debtor.[98] With the absence of free will, the "desire to prefer" that is at the heart of English preference law will be weakened. This defence may seem reasonable and effective on its surface; however, it has been widely criticised by bankruptcy scholars throughout the years and was actually abolished in Canada 100 years ago when the *BIA* was reformed.[99]

One of the chief criticisms of the commercial pressure defence is that encourages "grab law" and goes against the collective process of bankruptcy law.[100] The permissibility of this defence allows—even encourages—creditors to harass the debtor prior to bankruptcy in hopes of recovering whatever possible. Ironically, the foremost motivations for the existence of preference law are to "counter the incentives possessed by creditors to act individualistically in pursuing their claims" and prevent a flood of claims against the insolvent company on the eve of bankruptcy.[101] Thinking back to the Creditor Bargain theory, the foundational aims of bankruptcy law ought to be the preservation of order and maximum value for creditors. Tearing apart of the company to on a first-come, first-serve basis does not achieve this; rather, the commercial pressure defence flies in the face of both of these principles. Instead of preventing chaos and a race to the assets, this defence promotes precisely the opposite. Furthermore, it appears to be more advantageous to larger, more sophisticated creditors (eg. the banks) than smaller ones.[102] This is due to the fact that they generally have a better understanding of the legal system and more extensive resources to pressure effectively. The continued availability of this defence is antithetical to the underlying purpose of bankruptcy and preference law. The English Parliament should take a page out of Canada's book, as recommended by many bankruptcy scholars, and do away with this principle.

(3) The Puzzling "Diligent Creditor" Defence in Canada

The commercial pressure defence may no longer be available in Canada as per section 95(2),[103] but it appears to have been reincarnated in a weaker form through the "diligent creditor" defence.[104] Canadian courts have read this doctrine into the statute as a means by which the preferential intent of the debtor may be rebutted,[105] with the creditor bearing this onus.[106] The rationale for this defence by the Canadian courts seems to be that they are reluctant to punish creditors for mere diligence.[107] It is unclear, however, precisely who qualifies as a "diligent creditor."

As some Canadian academics have noted, the diligent creditor has not been adequately defined and the courts have been all over the map establishing who qualifies as such.[108] For starters, there is no redline which separates this defence from that of the commercial pressure doctrine.[109] In *Re Hewston & Thornton*[110] the diligent creditor was one which pressed more vigorously than other creditors—this sounds a lot like what section 95(2) is actually attempting to avoid.[111] In a subsequent case, the bar was set higher: the defence was relevant only if the creditor's actions posed an

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[97] *Butcher v Stead*, [1875] LR 7 (HL) at 846.
[98] *Ibid.*
[99] See e.g. *Mokal, supra* note 80 at 336-338; *Keay*, *supra* note 44 at 628-629.
[100] *Ibid.*
[101] *Mokal, supra* note 73 at 337.
[102] *Keay*, *supra* note 44 at 629.
[103] *BIA*, *supra* note 3.
[104] *Wood, supra* note 2 at 197.
[105] *Re Houston & Thornton* (1973), 18 CBR (NS) 102 (Ont HCJ) [*Re Houston & Thornton*].
[106] *Ibid; Re Norris* (1994), 23 Alta LR (3d) 397 (QB) [*Re Norris*].
[107] *Re Totem Painting Co* (1960), 1 CBR (NS) 38 (BCSC).
[108] Anthony Duggan & Thomas GW Telfer, "Canadian Preference Law Reform" (2007) 42:3 Tex Int LJ 661 [*Duggan & Telfer*].
[109] *Ibid* at 675.
[110] *Re Houston & Thornton*, *supra* note 105 at 103.
[111] *BIA*, *supra* note 3.

"imminent threat of crisis" if not addressed.[112] Some have pointed that his seems like an offshoot or sub-variant of the transactions necessary to continue business defence.[113]

Today, the diligent creditor defence remains an uncertain, unclear doctrine under Canadian law. Fortunately, it has not been utilised frequently by creditors to rebut the presumption of preference. This may partly be due to anxiousness on the part of creditors given the wording of section 95(2), which explicitly prohibits commercial pressure, and the ambiguity surrounding the exact scope of the diligence defence.[114] It seems that some degree of creditor pressure is in fact permitted under the other two popular defences discussed.[115] For instance, a creditor who is refusing to ship vital goods until he is paid for earlier deliveries is exerting commercial pressure on the debtor. This is allowed by the courts under the umbrella of the transactions necessary to continue business doctrine.

Given the above, it appears that the Canadian courts are open to some forms of commercial pressure but not others. Established defences like ordinary course of business or transactions necessary for continued business have embedded in them the very principle of commercial pressure. What seems to be the primary consideration is the *degree* and *type* of pressure exercised. In fact, in a recent case the court unanimously noted that distinguishing inadmissible evidence of creditor pressure from admissible evidence of commercial imperative is an exercise in characterization, one which reasonable people can disagree upon.[116] Going forward, it would be a positive development if the diligent creditor defence is extinguished. It goes against the *pari passu* principle underlying preference law and some of the very core objectives of bankruptcy law. On the bright side, until that day arrives the diligent creditor defence will be a weaker version of its sister (ie. the commercial pressure doctrine) even on its "best" day. For this, the Canadians have section 95(2) to thank.[117]

Should the length of the Claw-Back Period be amended?

As noted earlier, the period of time allowed for challenging preference transactions (ie. the "twilight" period) is twice as long in England as in Canada.[118] This logically leads us to the question of whether the Canadian claw-back period is too short, and if so, how preference transactions under the *BIA* are affected. Interestingly, the length of the twilight period in the national legislation in both countries has not been critiqued at length by insolvency experts. This may *prima facie* suggest that the length under either regime is not particularly problematic for parties going through the bankruptcy process. What is more, the duration of the recovery period in both countries is quite similar to other key common law jurisdictions, such as the United States and Australia.[119]

Of course, a longer claw-back period certainly has its advantages and disadvantages. The primary purpose of the establishment of this period is to ensure legal certainty, particularly for creditors.[120] The shorter the length, the less likely that a transaction may be challenged as a preference. This may lead to lower litigation costs, helping maximise value for creditors in turn. With these benefits noted, there is the flip-side of the coin to consider. The extension of the claw-back period may help prevent fraud as more transactions will be caught by the trustee. This may facilitate the maximisation of the assets available for distribution, which results in a bigger pie for creditors. The positive effects of such a twilight period, however, will be hampered by increased creditor and legal

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[112] *Re Norris*, *supra* note 106.
[113] See e.g. *Wood, supra* note 2 at 197.
[114] *BIA*, *supra* note 3.
[115] *Duggan & Telfer*, *supra* note 108 at 676.
[116] *Orion Industries Ltd (Trustee of) v Neil's General Contracting Ltd*, 2013 ABCA 330 at para 31.
[117] *BIA*, *supra* note 3.
[118] Under *BIA*, *supra* note 3, s 95 the trustee may challenge arm's length transactions up to 3 months prior to the initial bankruptcy date, with this period extending to 12 months in the case of non-arm's length transactions.
The English twilight period is exactly twice as long as this.
[119] Under the *US Bankruptcy Code* the claw-back period is 3 months for arm's length parties and 1 year for non-arm's length parties; in Australia, the *Corporations Act 2001* calls for a 6 month look back period for arm's length parties and 4 years for non-arm's length.
[120] UNCITRAL, Supp No 17, UN Doc A/55/17 (2005).

costs. Undeniably, the trick is to find the right balance between cost minimisation, legal and commercial certainty, as well as value utilisation.

The United Nation's *Legislative Guide on Insolvency Law* recommends that the duration of the twilight period be kept "reasonably short" to achieve the objectives noted in the previous paragraph.[121] A maximum period of two years is recommended for avoidance transactions generally.[122] With this stated, most countries have a shorter twilight period for preference transactions as opposed to transfers at undervalue. This is due to the fact that once the debtor company realises that bankruptcy is a likely outcome, managing directors will have more incentive to give certain (connected) parties preferences as opposed to others.[123] This is more likely the scenario with respect to smaller companies, where junior creditors may be disproportionately the debtor's family and friends.

With the rationale and justifications for employing a claw-back regime established, is it wise for Canada to extend its twilight period to match that of England's? There is no definite yes or no answer here. The current framework seems to be working fine in both countries. The lack critical analysis of present data, combined with the negligible attention paid by the insolvency community to this issue, seems to suggest that the length of the claw-back period is not a major problem. England's problems appear to be less-so centred on the length of its look-back period, and more about *how* the office-holder must establish preference. On the other hand, Canada's overall more robust preference regime may stand to benefit from a slightly longer look-back period—particularly with respect to non-arm's length transactions. The *BIA*'s 12 month look-back phase is half of other major common law countries. Going forward, Canadian scholars may find it worthy of their time to study this matter at greater length.

Conclusion

This paper has compared and contrasted the national English and Canadian preference provisions in detail. It was established that although both nations are common law countries and share a similar history, the currently state of preference law in London is less effective and sensible than Ottawa's. The emphasis on the subjective motivation of the debtor has proven to be a challenging task for the office-holder to demonstrate, particularly when combined with the defence of commercial pressure. These features have helped to manufacture a regime whereby the *pari passu* principle underlying preference law is not realised as best possible. Until Parliament institutes reforms aimed at developing a more objective and effects focused system, which requires a greater embracement of the equal-sharing model, English preference law will remain outdated and ineffective.

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[121] *Ibid* at 400.
[122] *Ibid;* Aurelio Gurrea-Martinez, "The Avoidance of Pre-Bankruptcy Transactions: An Economic and Comparative Approach" (2017) Harvard Law School: Instituto Iberoamericano de Derecho y Finanzas (IIDF) Working Paper 10/2015 [*Gurrea-Martinez*].
[123] *Gurrea-Martinez*, *supra* note 122 at 22.