UNIFORM LAW CONFERENCE OF CANADA

CIVIL LAW SECTION

REFORM OF
FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES LAW
(Transactions at Undervalue and Preferential Transfers)

PART II: PREFERENTIAL TRANSFERS

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A. Introduction

[1] This paper constitutes Part II of a report on reform of the law of fraudulent conveyances and preferences. Part I, which was delivered to the Conference at its 2007 annual meeting in Charlottetown, discussed the first branch of the subject; namely, transactions of the kind described traditionally as fraudulent conveyances but more accurately as transactions at undervalue, the term adopted for purposes of the report. This part deals with the second branch; namely, fraudulent preferences or, in more current usage, simply preferences or preferential transfers. Part I was accompanied by a general introduction addressed to both topics. This part of the report should therefore be read subject to that introduction. In addition, references are made at various points hereafter to issues and analyses canvassed in Part I that are also relevant in relation to preferential transfers. Since the material passages are not fully reproduced here for reasons of space, readers should consult Part I of the report as indicated.

[2] Most Canadian provinces stand apart from the counterpart jurisdictions to which reference is made in this report in their regulation of preferential payments to creditors.[1] In other countries following English legal tradition the problem arises only in the context of formal insolvency proceedings under which creditors are assigned stipulated rights of payment relative to one another. The bankruptcy and insolvency legislation of these jurisdictions, like Canada's *Bankruptcy and Insolvency Act*,[2] implement the general principle that creditors are entitled to share proportionately or *pari passu* in their debtor's assets, subject to the specified superior rights conferred on secured and preferred creditors. Indeed, one of the primary rationales of bankruptcy law is the collective enforcement of debt according to a legislatively designated scheme of sharing in circumstances in which a debtor's assets are insufficient to satisfy all creditors in full. A payment that enables a creditor to recover proportionately more than other equally ranked creditors and thereby contravenes the legislatively sanctioned distribution scheme is therefore a preference that may, subject to prescribed conditions, be set aside for the

benefit of those entitled to share. Proceedings to that end are ordinarily initiated by the insolvency administrator.[3]

[3] When insolvency proceedings have not been initiated, creditors in jurisdictions other than Canada are not subject to a legislatively imposed sharing scheme. Rather, unsecured creditors recover from their debtors on a first-come-first-served basis.[4] A creditor is entitled to obtain payment in full either extrajudicially or through the judgment enforcement system without regard to the fact that the debtor's other creditors are unpaid, and without any obligation to share the funds or value received from the debtor. The fact that one creditor is consequently "preferred" over the other creditors is not legally relevant. However this is not so in most of common law Canada, where anti-preference legislation is generally in effect.[5]

[4] Provincial preferential transfer legislation is a product of the introduction of creditors' relief legislation during the late 19th century as part of a package of legislation designed to fill the void created by the absence of federal bankruptcy law.[6] Although elements of the provincial package were repealed when the federal government reentered the field with the *Bankruptcy Act* of 1919, the creditors' relief and companion preferences legislation generally continued in effect.

[5] Creditors' relief legislation implements the general principle that a judgment creditor taking enforcement measures against a debtor's property is obliged to share the fruits of the proceedings *pari passu* with other qualifying judgment creditors and, in some jurisdictions, with creditors who provide certificates evidencing debts claimed against the judgment debtor.[7] In effect this means that unsecured creditors have a legal right to share proportionately in the value of a common debtor's assets through the operation of provincial judgment enforcement law, much as they do under bankruptcy law. The corollary is that a creditor who receives a payment or security that gives him or her a greater proportionate recovery than that which may be obtained by other creditors has been preferred and, under the conditions prescribed by provincial fraudulent preferences

legislation, may be obliged to disgorge the benefit through avoidance of the transaction at the instance of a reciprocally disadvantaged creditor.

[6] The uniqueness of this system of extra-bankruptcy creditor sharing and associated preference law means that there is no statutory regime in other jurisdictions offering a model for direct comparison or emulation. However, the basic issues and policy questions relating to preferential payments are the same within and outside of bankruptcy, particularly given that the issue arises only when a debtor is insolvent. Since a solvent debtor is able to satisfy all creditors in full a payment or transfer to one of them does not place the recipient in a preferred position relative to others. Thus legislation, scholarship and reform activity relating to the bankruptcy law of Canada and other jurisdictions is relevant to the reform of provincial law and is drawn on throughout this report.

B. Summary of Current Law

[7] As indicated above, payments and the provision of security resulting in satisfaction of a debt owed to one creditor in circumstances in which others of equal rank will be unsatisfied or receive a proportionately smaller amount are regulated in most provinces by provincial legislation and, where bankruptcy or restructuring proceedings have been commenced under federal legislation, by provisions of the *Bankruptcy and Insolvency Act*. Because secured creditors are able to recover through resort to their collateral the concern in both contexts is the equal satisfaction of unsecured debts through enforcement against the debtor's unencumbered assets.[8]

[8] Provincial preferences legislation differs in name and in various points of detail as among jurisdictions and the interpretational overlay added by the judiciary is far from uniform.[9] What follows below is therefore of necessity only an outline of regularly appearing provisions and principles.[10]

1. Provincial Legislation

a. Transactions Regulated by the Statute

[9] The language defining the scope of the Alberta *Fraudulent Preferences Act* is representative of the provincial statutes generally. It provides that "every gift, conveyance, assignment, transfer, delivery over or payment of …. any property, real or personal" made in the circumstances prescribed is "void as against the creditor or creditors injured, delayed, prejudiced or postponed."[11] However, qualifying provisions substantially limit the scope of the legislation by exempting the various transactions described further below from challenge, most notably payments of money to a creditor. Therefore the word "payment" used in relation to the operation of the provincial statutes should be understood to refer to a payment through the transfer of property other than money and to include the transfer of an interest in property by way of security for antecedent debt. A transfer of value through the provision of services or the assumption of an obligation is not subject to challenge.

[10] Only transfers to a "creditor" can be challenged. The statutes provide an expanded definition under which "creditor" includes a surety and the endorser of a promissory note or bill of exchange who may become a creditor on fulfillment of their legal obligations, as well as a *cestui que trust* "or other person to whom liability is equitable only."[12]

b. Requirement of Insolvency

[11] A transfer to a creditor may only be avoided if made by a person who is insolvent or who knows him or herself to be on the eve of insolvency. As indicated above, the assumption is that a payment made by a solvent debtor cannot be a preference because he or she is by definition financially able to satisfy all creditors in full. Whether or not this is in fact so may depend upon the definition of insolvency applied and whether the value of exempt property is taken into account in the determination. The state of insolvency is

not defined in the statute and courts have taken various approaches. However to quote a leading author, "[w]hat must be established is incapacity to pay one's debts."[13]

c. Debtor's Intention

[12] A preferential transfer may be avoided only if it is established that the debtor *intended* to give the recipient creditor a preference.[14] The requirement of intention to prefer has been part of Canadian preferences law since its inception and, as the discussion below indicates, its suitability as the factor determining the legal vulnerability of a preferential payment is the most significant issue in reform of this area of law.

[13] What is required to establish the requisite intention to prefer varies depending the period of time that has elapsed between the date of the challenged transaction and the commencement of proceedings to set it aside. If the challenge is mounted within a prescribed period the debtor is presumed to have intended to prefer the creditor to whom the payment was made if it had the effect of giving that creditor a preference over others, provided the debtor was insolvent or knowingly on the eve of insolvency at the date of the transaction.[15] If action is commenced outside the prescribed time period the plaintiff must bring evidence establishing an actual intention to prefer.

i. Proof of Intention Outside the Prescribed Time Period

[14] Proof that the debtor knows he or she is insolvent when a creditor is paid may be accepted as proof of an intention to prefer, since the necessary consequence of the payment is that the recipient creditor is advantaged relative to those who cannot be satisfied.[16] However there is little doubt that any such inference is rebuttable, since the courts will not find an intention to prefer when it is established that the debtor acted pursuant to another dominant motive.[17] Thus a debtor who responds to a creditor's pressure to pay will likely not be regarded as having acted with the requisite intention to prefer, on the view that the payment is not truly voluntary.[18] Similarly a preferential payment made by a debtor in the genuine hope of staying in business may not be subject

to avoidance. The difficulty of proving the debtor's intention to prefer along with uncertainty over what will be accepted by the courts as an exculpatory motive and the evidence required to establish it has severely limited the ability of creditors to successfully use the provincial statutes to set aside a payment that has preferential effect.

ii. Proof of Intention within the Presumptive Time Period

[15] In most provinces the presumption of intention to prefer arising from the preferential effect of a payment operates when it is challenged through the commencement of litigation within 60 days of the date the payment was made, though in Alberta the period is a full year.[19] In Ontario the presumption is "*prima facie*" so it may be rebutted by evidence proving a contrary motive, though not on the basis of pressure exerted by the benefiting creditor.[20] In the western provinces the presumption is explicitly irrebuttable.[21] In jurisdictions in which the statutory language is ambiguous the presumption will likely be regarded as rebuttable.[22]

d. Intention of Preferred Creditor

[16] Under the terms of the statute, the state of mind of a creditor receiving a preferential payment is irrelevant. Nevertheless the courts have protected creditors by refusing to set aside a transfer if the recipient did not in some fashion participate in or at least known of the debtor's intention to confer a preference. Judicial proclivity to impose a dual intention requirement varies as among jurisdictions, and one province has explicitly abolished it as a relevant consideration.[23] This inconsistency in judicial approach is exacerbated by uncertainty over the degree of creditor participation required to warrant avoidance of a transfer.[24]

e. Standing to Challenge a Transfer or Payment

[17] Since a preferential transfer is void as against "the creditor or creditors injured, delayed, prejudiced or postponed,"[25] only a person who is a creditor at the time it occurs

has standing to challenge a transfer under the statute. The expanded definition noted under heading "a." above applies in this context, but the weight of authority indicates that the holder of an unliquidated or contingent claim is not otherwise a creditor.[26] Although a secured creditor is a "creditor" in the strict sense such a creditor is ordinarily not adversely affected by a preferential payment and will not have standing under the statute, except to the extent the debt is unsecured.[27]

f. Protected Transactions

[18] The law of all jurisdictions in some way shelters preferential transfers that are regarded as legitimate or that for reasons of commercial stability should not be disrupted, regardless of the intention of the debtor in making them. The statutes differ slightly in their definition of transactions that are above challenge, and the terms by which the exceptions are defined are generally far from clear. However the range of such transactions includes, along with payments of money noted earlier, those listed below, cast in language sprinkled liberally throughout with references to "bona fides" and good faith:[28]

- Transactions involving an exchange in which the money paid or property transferred bears a "fair and reasonable relative value to the consideration for it," in the form of:
    - A sale or payment made in the ordinary course of business to an "innocent" party,
    - A conveyance or delivery of property in exchange for a reciprocal sale or delivery of goods or other property or a money payment, or
    - A transfer by way of security for a present advance of money.

- A payment given to a creditor who has in good faith given up a security, unless the value of the security is restored.

- The provision of one form of security in substitution for another.

- A security given for pre-existing debt that induces a further advance intended to enable the debtor to carry on business and satisfy creditors in full.

- An assignment made for the purpose of paying creditors rateably.

2. Preferences Subject to Challenge under the BIA

[19] The BIA provisions under which preferential transfers may be challenged apply in the context of reorganizations under the BIA and the *Companies' Creditors Arrangement Act* as well as in traditional bankruptcy proceedings.[29] Like the provisions addressing transactions at undervalue, those dealing with preferences are in a transitional state.[30] Amendments to the current provisions have been enacted as part of a broader package introduced under a 2007 statute generally referred to by those familiar with the ongoing and complex process of bankruptcy law reform simply as Statute c. 36.[31] Although the portions of the statute dealing with preferences and transactions at undervalue remain unproclaimed at the date of writing, members of the professional insolvency community expect that they will come into effect in the coming months. The following therefore surveys both the provisions currently in effect and those that would become operative with proclamation of the Statute c. 36 amendments. As was noted in Part I in relation to transactions at undervalue, the trustee in bankruptcy may also invoke provincial law to attack payments that fall outside the scope of the BIA provisions.

a. Current Provisions

[20] Although the anti-preference provisions of the BIA are broader than those of provincial law in terms of the type of transactions falling within their scope their

operation is narrowed by the limited time frame within which those transactions are subject to challenge. Section 95 avoids as against the trustee in bankruptcy "every transfer of property, every charge made on property, every payment made, every obligation incurred and every judicial proceedings taken or suffered by any insolvent person in favour of any creditor or of any person in trust for any creditor with a view to giving that creditor a preference over other creditors..." falling within a defined period prior to bankruptcy. The period is 3 months where the transaction involves a recipient that is not related to the bankrupt. Where the recipient is a person related to the bankrupt, it is one year.[32] In both cases a transaction that has preferential effect is presumed to have been made with a view to giving a preference.[33] However the presumption may be rebutted by evidence establishing what is accepted by the judiciary as a legitimate alternative motive, subject to the qualification that the transaction cannot be supported by evidence of pressure to pay exerted by the creditor.[34]

[21] The requirement of intention has been interpreted such that payments may stand on the basis that they were made in the ordinary course of business of the debtor, rather than with the objective of preferring the recipient. In particular, payments made in the reasonable hope of ensuring the continuation of the debtor's business through the maintenance of a source of supply or to secure favourable payment terms may be sheltered under this approach.[35] Further, while pressure as such is not grounds for upholding a transaction courts have given effect to what has been called a "diligent creditor" defence. That is, a debtor who acts in response to demands for payment may be found not to have acted with the intention of preferring the recipient creditor if the payment was thought necessary to keep the business in operation.[36] Although a payment can be set aside regardless of whether the creditor intended to receive a preference, the creditor's knowledge of the payor's insolvency may be material in the determination of whether a payment is sheltered as an ordinary course transaction.[37]

b. Statute c. 36 Amendments

[22] The material changes introduced by Statute c. 36 are as follows:

- The categories of transaction subject to challenge are expanded to include the provision of services.

- Where the recipient creditor is not dealing with the debtor at arm's length a transaction occurring within 12 months of bankruptcy that has the effect of giving the creditor a preference is void as against the trustee, regardless of the debtor's intention.

[23] The significant feature of the amendments is their treatment of the issue of intention to prefer. The current requirement that the debtor must have intended to confer a preference and the provisions relating to proof of intention are retained for purposes of arm's length transactions (as is the three month time period). However the requirement of intention is abandoned where the transferee is not an arm's length party. Although related persons[38] are generally deemed not to deal with each other at arm's length, that presumption is rebuttable for purposes of section 95.[39] This means that a transaction involving a person related to the debtor will fall subject to the ordinary requirements if the creditor can prove that the parties were in fact dealing with each other at arm's length, notwithstanding the proximity of their relationship.

[24] The revised approach to the requirement of intention is consistent with recommendations advanced to Industry Canada by the Insolvency Institute of Canada - Canadian Association of Insolvency and Restructuring Professionals Joint Task Force on Business Insolvency Law Reform.[40] In its initial 2002 report, the Task Force recommended that the current test of intention be retained to "protect good faith transactions where there was no intention to defeat the claims of creditors."[41] This was qualified in its supplemental 2005 report, which advanced the recommendation that the statute "(p)rovide generally for more effective remedies with respect to payments, conveyances and other transactions involving non-arm's length parties that reduced the value of the debtor's estate." To that end, the task force recommended that non-arm's

length creditors should not be allowed to rebut the presumption of debtor intent with respect to preferential transfers occurring within a year of bankruptcy.[42]

C. Policy Considerations in the Regulation of Preferential Transfers

[25] A great deal has been written on the theoretical incoherence and resulting uncertainty of the preferences provisions of bankruptcy law in Canada and other jurisdictions.[43] In Canada, both federal and provincial law demonstrate the unresolved conflict of competing policies for which preferential transfer law is criticized, particularly when the interpretive case law is taken into account. Features of each system are designed to protect routine commercial transactions and preserve the finality of payment. The requirement that the debtor's intention to confer a preference be proven, combined with the protection of *bona fide* ordinary course payments and transfers through various statutory and interpretive devices, means that it is very difficult to successfully challenge a preferential transfer. On the other hand, the presumptions of intention provided by both statutory regimes reflect the underlying goal of promoting equal treatment as among creditors through application of a limited effects-based test.

[26] The various policy considerations that might be taken into account in the formulation of reformed legislation are outlined below. Fundamentally, the design of preferences law must balance two broad and often opposing policies. The foundational policy supporting preferences law is that of equal creditor sharing. However, strict adherence to that policy interferes with the stability of routine commercial transactions. Concern for the latter is generally cast in terms the protection of ordinary course transactions or the finality of payments. Whatever the rubric, it is widely accepted that some transfers should not be subject to challenge even though they have the effect of enabling the recipient creditor to recover proportionately more than other creditors. The difficulty lies in articulating the factors that properly define that category.

1. Equal Creditor Sharing

[27] It is a truism under both federal and provincial law that creditors are not equal. Both systems confer superior rights of satisfaction on secured creditors and on unsecured creditors whose claims are regarded as especially meritorious on the grounds of their social significance.[44] Secured creditors who have taken the requisite formal steps are entitled to realize against the property subject to their security interests in priority to other claimants. Unsecured creditors may be given special rights of recovery through the statutory declaration of a priority in their favour or through the creation of property interests in the form of liens, deemed security interests and deemed trusts. These devices are recognized to varying degrees both in bankruptcy and under non-bankruptcy law. It is therefore inaccurate to say that Canadian law is premised on a general policy that creditors are equally entitled to satisfaction from the property of their debtors. Nevertheless that policy is an entrenched value in relation to unsecured creditors who do not enjoy special rights. The principle of equal creditor sharing in this qualified sense is the foundation of anti-preference law.

[28] As was noted in the introduction to this paper, the principle of equal sharing is advanced in bankruptcy by the rule that unsecured creditors are entitled to recover on a *pro rata* basis from the value of the assets remaining after satisfaction of priority claims. Under provincial law it is advanced by creditors' relief legislation, which is based on the general principle that the fruits of judgment enforcement measures must be shared among creditors whose claims are established by judgment or a certificate of debt meeting statutory requirements.[45] Law regulating the disproportionate payment of creditors by an insolvent debtor is essential to preservation of the principle of equal sharing embodied in this law, since it allows assets devoted to the satisfaction of an advantaged creditor to be recovered by those not so favoured.

[29] The statutory policy of equal sharing may be justified on functional grounds as well as on the basis of theoretical principles of distributive justice. The non-payment of a particular creditor, particularly one with limited economic strength and correspondingly

limited bargaining power, may contribute to the creditor's own financial collapse, creating broader social and economic costs.[46] While empirical evidence is lacking, one may reasonably speculate that the assurance of *pro rata* recovery also promotes the provision of goods and services on unsecured credit terms and (perhaps to a lesser extent) the availability of unsecured loans, particularly where the debtor's financial position is uncertain. A third argument sometimes advanced in support of an equal sharing regime is that creditors who know that they will be paid on a *pari passu* basis will refrain from preemptive enforcement action that may contribute to the debtor's financial decline and ultimate failure.[47] This argument is somewhat less compelling in a non-bankruptcy context, since creditors are generally obliged to take steps to procure judgment in order to qualify in a distribution under provincial creditors' relief law. However, they may refrain from initiating judgment enforcement measures if they have some assurance that the debtor's estate will not be depleted by the debt recovery actions of others who are permitted to retain the entire benefit of payments or security procured.

[30] Whatever the social and theoretical merits of the principle of equal sharing the fundamental policy choice is really beyond debate because it has been made by the legislation that preferences law is designed to support. There would be no need for preferences law were it not for the equal sharing policy implemented by the BIA and provincial creditors' relief legislation. Since the *raison d'être* of preferences law is protection of the legislatively entrenched policy of equal sharing it should be formulated in the manner that best achieves that policy.

[31] It is often pointed out that strict adherence to the policy of equal sharing would require the adoption of legal rules under which any payment or transfer directed to the satisfaction of unsecured debt that has the effect of enabling the recipient creditor to recover proportionately more than others would be subject to challenge. However strong countervailing policies explain the fact that no system of law and no recommendations for reform adopt an unmitigated effects-based test. Nevertheless, since the policy of equal sharing is the foundational rationale for the very existence of preference laws there

is much to be said for the view that any payment or transfer that has the effect of creating a preference should be *prima facie* subject to challenge.

2. Countervailing Considerations

a. The Intention of the Debtor

[32] The debtor's intention to prefer one creditor over others was established as the basis of preferences law in England well over a hundred years ago,[48] and remains the determining factor under Canadian provincial and federal preferences law as well as in the United Kingdom.[49] The survival of the debtor intention test may be a product of the perception that it prevents the disruption of ordinary course transactions by sheltering from challenge those payments and transfers that are regarded as routine in the sense that they were not directed to the exceptional purpose of advancing the interests of one creditor over others. Responding to the movement of several jurisdictions to an effects-based preferences system in their insolvency legislation, the IIC – CAIRP Joint Task Force advocated retention of a debtor intention test for fear that an effects-based test would result in the avoidance of all transactions within the review period having preferential effect.[50] Although it did not explicitly so state, it seems that the Task Force's underlying concern was that creditors who have received ordinary course payments or transfers from an insolvent debtor should be protected. The debtor intention test was perhaps regarded as a means to that end.[51]

[33] Whatever the objectives of its proponents, a system of law that bases avoidance on the debtor's intention to prefer inherently bases the availability of a remedy on essentially ethical rather than functional considerations; that is, it represents the view that it is simply wrong for a debtor to intentionally advance the interests of some creditors over others and, conversely, that a preferential payment is acceptable when it is otherwise motivated.[52] Such an approach is inconsistent with the intrinsically functional objective of preferential transfer law. A payment or transfer that enables one creditor to recover proportionately more than others violates the equal sharing principle regardless of

whether the debtor's motive in making it was to advantage the recipient. In fact a legislative focus on the ethical quality of the debtor's conduct often undermines the statute's functional goal by allowing preferential transfers to escape challenge where an intention to prefer cannot be proven. A debtor intention test is not likely to deter insolvent debtors from engaging in preferential practices, since the debtor suffers no penalty if the transaction is set aside. Rather, the recipient creditor is deprived of the value of the preference received.

[34] Although the protection of ordinary course transactions may justify incursion on the policy of creditor sharing an attempt to implement that policy through use of a debtor intention test is difficult to defend. The routine quality of a payment or transfer is not determined by the debtor's state of mind. Whether a debtor intended to allow one creditor to recover more than another is tangentially relevant at best to the question of whether the *creditor* should be deprived of the benefit of the transaction. In effect, a debtor-intention system penalizes creditors on the basis of the debtor's state of mind rather than on the basis of the inherent nature of the transaction or the creditor's ability to recognize its potential consequences.

[35] A further criticism of systems based on the debtor's intention is that intention to prefer is notoriously difficult to prove, with the result that preferential transfers often go unchallenged and the success of the challenges that are mounted is difficult to predict. Provincial and federal legislation offer a partial response to this concern through the inclusion of provisions under which the requisite intention is in specified circumstances presumed from the preferential effect of a transaction. However, an irrebuttable presumption simply amounts to the implementation of an effects-based test while a rebuttable one leaves open the fundamental question of why the debtor's intention is the determining consideration.

[36] In view of these criticisms it is unsurprising that reformed systems of law in other jurisdictions have abandoned debtor intention as a factor in the cause of action.[53] In its extensive report on reform of provincial preferential transfers law the Law Reform

Commission of British Columbia recommended that provincial legislators follow suit.[54] The same view was advanced by Professor Cuming in a report to Industry Canada recommending comprehensive revision of the preferential transfer provisions of the BIA.[55]

b. The Intention of the Creditor

[37] The intention of the creditor who receives a preferential transfer or payment may be a factor in preferential transfer law either as an element of the cause of action or as a consideration in the definition of sheltered transactions or defences. Under the first approach the plaintiff is required to prove that the recipient creditor intended to receive a preference or knew that the debtor was insolvent or verging on insolvency, the latter amounting to knowledge that the payment or transfer would have preferential effect. Under the second the cause of action may be established on the basis of the preferential effect of the transaction or the intention of the debtor, but the transaction is sheltered if the creditor can prove a lack of intention to receive a preference or, more typically, lack of knowledge of the debtor's financial circumstances. Alternatively, an ordinary course payment or transfer might be sheltered *unless* the recipient creditor knew of the debtor's present or looming insolvency. A combined subjective-objective standard of knowledge is typically adopted in all contexts, the question being whether the creditor knew or should have known of the debtor's position.

[38] Rules based on the intention of the creditor are generally viewed as directed towards creditor deterrence.[56] In theory, measures calculated to dissuade creditors from seeking and accepting preferential payments ensure that the debtor's assets are equally available to all and therefore advance the primary policy of equal sharing. However, it is highly doubtful that such measures in fact have deterrent effect.[57] Creditors often act in ignorance of the law or in the hope that their receipt of a preferential payment will not be challenged. Since the only penalty attached to the acceptance of a preference is its forced disgorgement a creditor concerned about the possibility of non-payment has relatively little to lose.[58] On this view, the formulation of rules based on the creditor's knowledge

or intention does not advance the policy of equal sharing and, to the extent that it allows creditors to retain preferential payments on the basis of their blameless state of mind, in fact impinges on that policy.

[39] Whether or not a preferred creditor was at fault in a moral sense bears no direct relationship to the principle of equal creditor sharing in a system designed to restore the preferential transfer to the common pool rather than to punish the participants. Even if one accepts the doubtful proposition that a creditor who accepts a payment knowing the debtor is insolvent is ethically delinquent, it is difficult to argue that an "innocent" creditor should be allowed to keep property received at the expense of others while a "guilty" creditor should not if the distinction does not produce functionally positive outcomes.

[40] That being said, creditor knowledge is a recurring theme in the formulation of defences or exceptions in statutory systems that adopt an effects-based test. Although ethical culpability and deterrence are not convincing rationales for this approach, an argument can be made that recognition of knowledge of the debtor's insolvency as a factor can be justified in terms of risk assessment. A creditor who knows that a debtor is insolvent and therefore implicitly that creditors will not all be paid is in a position to take the risk of losing preferential payments or transfers into account in determining whether to deal with the debtor and in the planning of a debt recovery strategy. In this sense a creditor's state of mind may be a legitimate consideration in the design of preferences law.

c. "Ordinary Course" Transactions and the Finality of Payment

[41] The strict preservation of an equal sharing principle would mean that the routine payments of trade creditors, lenders and others would always be subject to challenge when the debtor is unable to satisfy other creditors. This sort of commercial disruption is clearly unacceptable, and a legal regime that interferes unduly with routine transactions would be strongly resisted by creditors. Further, it would seriously inhibit the ability of a

debtor who is experiencing financial difficulties to procure goods and services or credit of any kind and would discourage creditors from agreeing to debt settlements and work-out arrangements that might facilitate the survival of a debtor's business.[59] In a model under which a transaction may be challenged on the basis of its preferential effect one approach to this concern is to shelter transactions entered into in the ordinary course of business through the provision of an exception or defence.

[42] There is no doubt that creditors want "ordinary" debt recovery practices to be protected. Creditor sentiment has been aptly described as follows:

> The principle of equality only has appeal in the abstract, i.e. the possibility of non-payment. However, once payment is received, creditors no longer have any interest in the equality principle and have an interest in ensuring that the principle will not be used against them. A countervailing norm, being able to preserve the sanctity of carrying on business as usual, becomes much more important than the equality feature of preference rules. An absolute preference rule therefore would never be acceptable to creditors. When the legislation is too successful on the equality front, in other words, when large numbers of transactions are set aside or threatened to be set aside, preference legislation will inevitably come under attack as being disruptive to the expectations of the credit community.[60]

This statement is consistent with concerns expressed by the IIA-CAIRP Joint Task Force about the adoption of an effects-based standard.[61]

[43] Other jurisdictions have qualified an effects-based test with an exception for ordinary course payments. This approach was adopted in the United States Bankruptcy Code of 1978 and modified slightly by amendments introduced in 2005. However a similar system implemented in New Zealand in 1993 to replace law based on the debtor's intention was recently abandoned in favour of an exception focusing on the recipient creditor's knowledge of the debtor's insolvency.[62] The current legislation is modeled after the preferential transfer provisions of Australia's *Companies Act 1993*. [63]

[44] Recommendations for reform of Canadian law recognize the need to accommodate routine payments by insolvent debtors but differ in their strategy for so doing. The LRCBC Report on provincial preferences law would adopt an effects-based cause of action qualified by a general ordinary course of business exception, with specific provisions dealing with security for antecedent debt.[64] In his report on reform of the preferences provisions of the BIA Professor Cuming rejects a general ordinary course of business approach as too uncertain. However, he offers what might be characterized as a particularized version of an ordinary course exception through the exemption of contemporaneous exchanges of value accompanied by a specifically defined list of non-exceptional payments.[65] These approaches are discussed further below.[66]

D. Issues for Determination

1. The Need for Provincial Preferential Transfer Law

[45] This report proceeds on the assumption that provincial legislation governing preferential transfers is to be reformed rather than simply repealed. However, the question of whether there continues to be a place for provincial preferential transfer law is a serious one that should be addressed before that assumption is acted on.

[46] The LRCBC Report addresses this question, outlining various arguments in favour of and against retaining provincial legislation. Although comment on the working paper that preceded the report was divided, the reasons advanced by those who supported retention were accepted by the Commission as grounds for maintaining a provincial system. In summary form, those arguments were:[67]

- Bankruptcy is in many cases not a viable means by which to challenge a preferential transfer due to the prohibitive cost of the proceedings and to the fact that bankruptcy is unavailable in some circumstances; notably, those defined by the BIA in favour of persons engaged in fishing, farming and tillage of the soil.[68]

- The ability of creditors to commence or threaten proceedings under provincial law in many cases prompts settlement among the parties, a result precluded by the initiation of bankruptcy proceedings.

- The availability of provincial preferences law enables a creditor to challenge a transaction on the grounds that it was either a transfer at undervalue (i.e. fraudulent conveyance) or a preferential transfer, thereby ameliorating the difficulty of determining before litigation has commenced which is in fact the case. In the absence of provincial preferences legislation, a plaintiff challenging a transaction as a transfer at undervalue who is confronted with the defence that it was made in payment of a debt must chose between proceeding with the litigation in the hope of establishing the cause of action or seeking a bankruptcy order against the debtor so as to challenge the transaction as a preference.

To these may be added the reasonable speculation that in the absence of provincial preferential transfer law creditors may be motivated to initiate bankruptcy proceedings against the debtor in order to have such transfers set aside, whether they otherwise might not have done so.

[47] The LRCBC Report also notes the relationship between provincial creditors' relief legislation and preferential transfer legislation, discussed earlier. However it perforce did not address the reformed systems of provincial judgment enforcement law, actual and proposed, introduced after the date of its writing. The implications of these reforms warrant comment.

[48] A primary feature of the reformed judgment enforcement law systems is that they enable judgment creditors to protect their claim to a debtor's assets by registering a judgment or writ which thereupon either "binds" the debtor's property or creates a charge.[69] The binding effect or charge follows the property into the hands of a transferee, subject to the statutory priority rules. Thus property transferred by the debtor to a

creditor will remain subject to the judgment creditor's right to have it seized to satisfy the judgment, unless a priority rule operates in favour of the transferee. However, while judgment creditors' rights are enhanced under these systems a creditor who receives property in payment or as security for a debt will often have priority over judgment creditors, notwithstanding that the payment or transfer has preferential effect. For example, the Alberta *Civil Enforcement Act* provides in effect that a creditor who receives money from a judgment debtor has priority over a registered writ binding the money.[70]

[49] There is a second feature of the new and recommended systems of judgment enforcement law that may be pertinent to the reform of provincial preferential transfer law. That is, they limit the operation of the creditor sharing principle to creditors who have obtained a judgment and taken formal steps towards enforcement, either by means of registration of the judgment (or a writ issued on the judgment) or through registration of the judgment and delivery of an enforcement instruction to a sheriff or enforcement official.[71] Creditors who have not obtained a judgment are not entitled to participate in the *pro rata* distribution of the fruits of judgment enforcement measures. In bankruptcy proceedings, by way of contrast, all unsecured creditors who can provide a proof of claim that satisfies the requirements of the BIA are entitled to share in distribution of the bankrupt's estate. This raises the question of whether the creditor sharing principle is of sufficiently pervasive scope to justify a companion system of provincial preferences law addressed to its promotion.

[50] One answer is that preferential transfer legislation protects the potential if not the present right of creditors to seek *pro rata* recovery through the judgment enforcement system. Another is that the existence of creditors' relief legislation is the primary but not the sole rationale for provincial preferences law. As the arguments advanced in the LRCBC Report indicate, the availability of provincial legislation allows creditors to challenge a preferential transfer without initiating bankruptcy proceedings against the debtor. This may be advantageous not only to creditors but also to debtors, whose prospects of surviving a period of insolvency may be enhanced if federal bankruptcy

legislation need not be invoked in order to challenge a preferential payment.[72] Notably, the fact that creditors' relief legislation has historically had a relatively limited scope of operation relative to bankruptcy has not been regarded as reason to abandon provincial preferences legislation in the past.

[51] The decision to maintain a provincial system of preferences law raises the related question of whether its operation should be limited to circumstances in which insolvency proceedings have not been launched under the *BIA* or the *Companies Creditors' Arrangement Act*.[73] This would change current practice, under which a trustee in bankruptcy may invoke provincial law to challenge transactions that do not fall within the scope of the BIA's preferential transfer provisions.[74] Although such a restriction would not serve to harmonize federal and provincial law it would have the merit of eliminating the overlapping operation of different systems, thereby advancing to some degree the objective of certainty and predictability. However, if imposed without qualification it would mean that litigation commenced under provincial law would be terminated by the initiation of insolvency proceedings under federal legislation. In his recommendations for reform of the BIA preferences provisions Professor Cuming responds to this problem with the proposal that, while the concurrent operation of provincial and federal law should be precluded, the trustee in bankruptcy should be given the authority to continue litigation commenced by a creditor under provincial law.[75] Notably, his recommendations were premised on the adoption of a reformed system of federal law. Given the limited nature of the reforms that have since been enacted it may be that the trustee should be permitted to utilize an updated system of provincial law to challenge preferential transfers without restriction, as is currently the case.

2. Transactions within the Scope of the Act

a. Transfers of Property and Other Transactions

[52] It is clear that a transfer of property or an interest in property in payment of or as security for a debt should fall within the scope of preferential transfer law. While a

payment constitutes direct satisfaction, a transfer by way of security enables the creditor to procure satisfaction immediately or in the future through resort to the collateral. Although all systems capture such transfers they vary in their treatment of other types of transaction that involve the conferral of value on the recipient creditor. Some, such as the United States Bankruptcy Code and the LRCBC Draft Act, are limited to transfers of property.[76] The recent amendments to the BIA add the provision of services to the current list of transactions subject to avoidance, which also includes obligations incurred and judicial proceedings taken in favour of a creditor.[77]

[53] As it does in relation to transfers at undervalue, the United Kingdom *Insolvency Act 1986* takes an even broader approach, allowing an administrator to seek a remedy where "the company does anything or suffers anything to be done" which has the effect of preferring a creditor or surety of the company.[78] The focus is thus on the result rather than the form of the transaction. The Australian *Corporations Act 2001*[79] and the New Zealand *Companies Act 1993* refer, in similarly broad terms, to a "transaction."[80]

[54] There is justification for the view that the statute should not be limited to payments effected or security provided in the form of a transfer of property. The question is whether the transaction satisfied a debt owed to one creditor while diminishing the debtor's capacity to satisfy others. If, for example, professional services provided by way of payment of a debt could have been sold to a non-creditor generating revenue for the satisfaction of creditors generally the transaction creates a preference. Whether the assumption of an obligation in favour of a creditor constitutes a preference will depend on the type of obligation assumed and the manner in which it may be enforced. One can imagine instances, though they are likely to be rare, in which the benefiting creditor may receive more than do others but the transaction does not directly affect the debtor's ability to satisfy them.[81]

[55] The approach taken to the delimitation of transactions subject to the Act may depend upon the manner in which the cause of action is defined. If the legislation offers a formula determining the preferential effect of a transaction the scope of the statute can

be broadly cast to include any type of transaction, since those that do not have preferential effect will not give rise to a remedy. However the adoption of an approach of the kind utilized in the LRCBC Draft Act would require that the transactions subject to the Act be specifically delineated.[82]

b. Contingent and Unmatured Obligations

[56] In Part I of this report, it was suggested that a transaction under which a debtor incurs a contingent obligation to transfer property, pay money or otherwise provide value or an obligation to be performed in the future may properly fall within the scope of legislation directed to transfers at undervalue. While the creation of such an obligation may add the obligee to the list of creditors, it is difficult to conceive of transactions of this kind that would confer a disproportionate benefit on an existing creditor relative to others. That result will not follow unless and until a transfer of value actually occurs. It is therefore unnecessary to bring transactions of this kind within the scope of preferential transfer legislation.

c. Exempt Property

[57] The payment of a creditor through the transfer of exempt property of the debtor may have the effect of giving the recipient a proportionately higher rate of recovery than other creditors but generally does not diminish the amount that the latter can realize through resort to the debtor's property. Although the payment reduces the debtor's total asset base it does not affect the value of the assets available to unsecured creditors generally so is not truly a preference. In fact, the payment of one creditor with exempt property may increase what is available to others by removing the recipient from the group amongst whom the exigible assets must be divided. On that view, only transfers of exigible property should be brought within the scope of the statute. This is the approach adopted in the LRCBC Draft Act.[83]

[58] However, a transfer of exempt property can create a preference relative to creditors against whom exemptions law does not operate. It may therefore be desirable to makes special provision for transactions of that kind.

d. Transfers Pursuant to Court Order or by Operation of Law

[59] Most systems of existing and proposed preferences legislation extend to transfers of property effected by an order of the court or operation of law. This is clearly appropriate. A creditor who procures recovery through the judgment enforcement system or otherwise by operation of law is in the same position relative to other creditors as one who is paid voluntarily by the debtor, except to the extent that provincial creditors' relief legislation mandates sharing of the proceeds of enforcement action. Although qualifying creditors will be entitled to share under that legislation its limited scope of operation means that the claims of many creditors will not be recognized. It therefore cannot be assumed that a creditor who recovers through enforcement of a judgment or order will not be preferred relative to other creditors.[84]

[60] Professor Cuming suggests one exception to the inclusion of transfers through operation of law; namely, the creation of a lien in favour of an artisan or repairer. In such cases there is a contemporaneous exchange of value between the debtor and the lien claimant, since the artisan or repairer has enhanced the value of the subject property.[85] It will also be necessary to make special provision for transfers by court order to those who are creditors by virtue of a debtor's family support obligations, a subject discussed under the next heading.

e. Family Transactions Deserving of Protection

[61] The need to make special provision for transactions involving the satisfaction of family obligations was discussed in Part I.[86] If an intention-based approach is abandoned in reformed preferential transfer legislation transfers made by an insolvent debtor in fulfillment of support obligations or an agreement or order for the division of property

may be subject to challenge as a preference, since they will typically have preferential effect.

[62] The U.S. Bankruptcy Code provides that the trustee may not challenge *bona fide* payments of debts for maintenance or support of a spouse or child, whether made pursuant to an agreement or order of the court.[87] However it does not shelter payments made towards satisfaction of an order or agreement for the division of family property.[88] The Australian *Bankruptcy Act 1966* exempts payments or transfers made or incurred under a maintenance agreement or order without any requirement of *bona fides*.[89] However this is subject to the provisions of the *Family Law Act 1975* discussed in Part I.[90] Those provisions allow an agreement to be challenged if it was entered into for the purpose of defrauding or defeating a creditor or creditors or with reckless disregard of the interests of creditors, and provide for variation of a court order in exceptional circumstances.

[63] As was suggested in relation to transactions at undervalue, the *bona fides* of the parties to a transaction of this kind may be a relevant consideration in a system that is otherwise not based on the intention with which a transfer is made. An approach along the lines of the Australian model might be adopted, such that transfers of this kind would be subject to challenge if an intention to defeat creditors or a reckless disregard of creditors' interests can be established. However the fact that the payor intended to prefer the recipient is not an appropriate consideration, since a payment of this kind may be merit protection notwithstanding that the recipient was intended to benefit relative to other creditors.

3. Standing: Who May Claim a Remedy under the Statute?

[64] The issues arising in connection with the definition of standing are largely the same as those addressed in Part I in relation to transfers at undervalue.[91] Three points are considered below with specific reference to preferential transfers legislation.

[65] First, should standing be limited, as it is under current provincial legislation, to a person who was a creditor at the date of the transaction in question? The right of creditors to share under both the BIA and provincial creditors' relief legislation is based on their status as at the date of a bankruptcy or a distribution, respectively. If the trustee in bankruptcy succeeds in challenging a transfer under the BIA anyone who is a creditor as at the date of bankruptcy will share in the property recovered, regardless of whether they were a creditor at the date of the challenged transaction. Similarly under provincial creditors' relief legislation the persons entitled to share in the distribution of proceeds generated by enforcement of a judgment against a debtor's property are those who have standing under the terms prescribed by the statute at the date the fund is generated or within a stipulated time thereafter. Extrapolating from these statutory approaches, one might conclude that a person who is a creditor at the date of initiating proceedings to challenge a preferential transfer should have standing, regardless of whether that person was a creditor at the date of the transaction. The fruits of successful litigation would, of course, be shared with other qualified claimants.

[66] On the other hand, the very nature of the cause of action entails an assessment of the position of the recipient creditor relative to others to whom the transferor is indebted at the date of the transaction, not relative to creditors whose claims might arise in future. This suggests that only persons who are creditors at the date of the transaction should have standing to challenge it, since only they directly suffer the harm supporting a remedy. While this view is conceptually cogent it entails the somewhat arbitrary denial of a remedy to a creditor whose claim arose immediately or shortly after a preferential payment was made. That result would be avoided by differentiating the cause of action from standing to launch proceedings. A subsequent creditor could be allowed to challenge a transfer on the grounds that it had preferential effect as against creditors existing at the time it was made, thereby supporting a remedy the benefit of which would be shared by all creditors with qualifying claims at the date of the litigation or the award.

[67] The second question to be addressed is whether standing should be limited to creditors who have a judgment at the pertinent time, whether that be the date of the

challenged transfer or the time when proceedings to challenge the transfer are commenced. If the rationale for provincial preferences law flows from the rights of creditors to share under creditors' relief legislation, it is not unreasonable to suggest that only those who qualify under that legislation should have standing to challenge a preferential transfer. An approach based on the integration of creditors' relief legislation and provincial preferential transfer legislation would therefore grant standing only to those who meet the requirements of the former. However, such an approach would very substantially restrict the operation of provincial preferences law, particularly if standing were limited to those who qualified to share under creditors' relief legislation at the date of a preferential transfer. Further, such a definition of standing may have perverse incentive effects. Some creditors may be induced to pursue judgment rather than participating in settlement or workout efforts. Some may seek preferential payments in the face of impending litigation by others. As was suggested earlier, a broader approach can be justified in theoretical terms if preferences law is viewed as means to guard against the loss of creditors' potential right to share under creditors' relief legislation rather than as a device to protect an established right to do so. Further, the requirement that judgment be obtained before preference litigation is commenced would entail the happenstance qualification of those who were able to do so expeditiously and the exclusion of those who were not.

[68] The Draft Act advanced in the LRCBC Report responds to these concerns by granting standing to those who have procured a judgment at the date proceedings to challenge a transfer are launched or who are entitled to commence proceedings to enforce an obligation owed by the debtor. [92] In the latter case the plaintiff would, presumably, be obliged to establish the validity of his or her claim as creditor in the preference action itself.

4. Grounds for a Remedy (Bases for Challenging Transaction) and the Designation of Sheltered Transactions (Exceptions or Defences)

[69] Current and proposed systems of law base the cause of action under which a transfer or payment may be challenged on some version of one of the following two basic models:

a. The transaction had preferential effect (herein referred to as an "effects-based" test or system); or

b. The transaction was intended to and did have preferential effect (herein referred to as a "debtor intention" test or system).

Both types of system may include provisions sheltering certain transactions through the definition of exceptions or defences.

[70] In addition, some systems make separate provision for special types of transaction; for example, a transfer of property pursuant to an agreement creating a security interest in after-acquired property. Although the limits of space preclude a full examination of such specialized provisions they are addressed briefly under heading "d" below.

[71] The following discussion will consider in turn the two general approaches to definition of the cause of action, along with the potential exceptions or defences.

a. Transactions having Preferential Effect (the Effects-Based Test)

[72] Modern systems of preferential transfer law strongly favour an effects-based cause of action.[93] Such a system requires (i) the formulation of a test of preferential effect and (ii) the definition of sheltered transactions. These will be considered in turn.

i. Formulation of the Test

[73] The fundamental premise of effects-based systems is that any payment or transfer of value that has the effect of enabling the recipient creditor to recover proportionately

more than other creditors is subject to challenge. This approach is based on the equal sharing policy discussed earlier.

[74] Since tests of this kind typically appear in bankruptcy or insolvency legislation they are often defined in terms of the right of unsecured creditors to recover in liquidation proceedings. That is, a transfer can be challenged if:

(a) it is made at a time when the debtor is insolvent and

(b) it enables a creditor to recover more than the creditor would have recovered in a distribution by the trustee or liquidator if the payment had not been made.[94]

It is not possible to adopt a formulation of this kind under provincial legislation, since a general liquidation of the debtor's assets is not involved. It would therefore be necessary to articulate an effects-based test differently.

[75] Any payment towards antecedent unsecured debt made by an insolvent creditor will have preferential effect, since it diminishes the pool of assets available to other creditors and thereby disproportionately benefits the recipient.[95] This is reflected in the effects-based approach adopted in the LRCBC Draft Act, which would provide a remedy where a disposition of exigible property is made for past value by a transferor who is insolvent, on the eve of insolvency or rendered insolvent by the disposition.[96] In effect this formulation captures all payments towards antecedent debt by an insolvent debtor, except those made through the transfer of exempt property.[97]

[76] One difficulty with the LRCBC approach is that it obscures the distinction between payments toward unsecured debt and payments towards secured debt. In the latter case the payment is not a preference to the extent that it frees the debtor's property from the creditor's security interest, making it available to unsecured creditors or a subordinate secured party. If the payment simply reduces the unsecured portion of an under-secured debt it will create a preference in the same way as any other payment of unsecured debt.

[77] The need to differentiate between payments towards secured and unsecured debt may be addressed in the design of an effects-based test or in the formulation of a defence or exception. A payment that results in release of a security interest would in principle be sheltered by a general defence for transactions involving a contemporaneous exchange of value, discussed under heading "ii" below. However it may be advisable to explicitly provide for such payments, depending on the manner in which an effects-based test creating the cause of action is designed.[98]

[78] An alternative approach to the design of an effects-based test is the provision of a formula structured in terms of the operation of provincial creditors' relief or judgment enforcement legislation. For example, a transaction might be subject to challenge where it enables the recipient creditor to recover more than that creditor would have recovered in a distribution to unsecured creditors pursuant to the relevant provincial statute if (i) the payment had not been made, (ii) the value of all the debtor's exigible property available to unsecured creditors comprised a distributable fund and (ii) all unsecured creditors of the debtor existing at the date of the transfer were entitled to share in the distribution.

[79] A comparable approach appears in provisions of current provincial legislation defining transactions that are subject to avoidance on the basis of their preferential effect alone.[99] The following section of the Alberta *Fraudulent Preferences Act* is representative:

> 4(1) A transaction is deemed to be one that has the effect of giving a creditor a preference over other creditors, within the meaning of section 3, if by the transaction a creditor is given or realizes or is placed in a position to realize payment, satisfaction or security for the debtor's indebtedness to that creditor or a portion of it greater proportionately than could be realized by or for the unsecured creditors generally of the debtor or for the unsecured portion of that creditor's liabilities out of the assets of the debtor left available and subject to judgment, writ proceedings, attachment or other process.

[80] A third alternative would be to simply provide for a remedy where a transfer has preferential effect, leaving it to the courts to articulate the meaning of the phrase. This

approach is adopted in the BIA, the amended provisions of which avoid a transfer in favour of a non-arm's length creditor "that has the effect of giving that creditor a preference over another creditor."[100] No definition of preferential effect is provided. However this strategy entails an unattractive degree of uncertainty in determination of the circumstances in which a remedy is available.

ii. Sheltered Transactions

[81] The most problematic dimension of devising a statutory regime that provides a remedy on the basis of the preferential effect of a transaction is the definition of circumstances that ought to fall outside the general rule for the policy reasons discussed under heading "C.2." above. The overall goal is to promote the equal treatment of creditors without interfering unduly with the debtor's ability to carry on his or her business or financial affairs in routine fashion by penalizing those who deal with the debtor in that context. Professor Telfer puts the point in these terms:

> The success or failure of any preference regime will depend largely upon how the defences or exceptions are perceived by the credit community. The question is not whether the preference regime upholds the equality principle. Rather, the more significant question is whether the regime makes appropriate exceptions to the equality principle.[101]

[82] Whatever approach is adopted, the sheltered transactions would be cast as a defence or exception to the operation of the primary effects-based test. A plaintiff would therefore be required to establish the cause of action by proving the preferential effect of the transaction while the defending creditor would carry the burden of proving the exception or defence.

[83] In principle, the defences discussed below might also be incorporated in a debtor intention system. However they are considered in relation to an effects-based test because they appear in current and recommended systems of that kind. If a debtor intention test were to be adopted as the basis for reformed legislation, the potential role of these defences should be considered in that context.

a) Substantially Contemporaneous Exchange of Value

[84] Most effects-based systems explicitly recognize in some fashion that a payment or transfer made in exchange for a substantially contemporaneous transfer of property or payment of money does not create a preference in the relevant sense, because the transaction does not result in a net diminution of the value of the debtor's estate available to creditors.[102] For example, if Debtor pays Seller $10,000 for inventory purchased from Seller, the $10,000 debit is compensated for by the value of the inventory acquired. In effect, other creditors have the same ability to recover through resort to the inventory as they had through resort to the source of funds used to pay for it. Their position is therefore not affected by the transaction.

[85] Strictly speaking this theory supports only the exemption of transactions under which the debtor receives property of some sort rather than services, since other creditors cannot recover through realization against services provided to the debtor. However it is inherently unfair to insulate suppliers of goods and other types of property from having to disgorge payments made by an insolent debtor while obliging service providers to do so. Further, it can be argued that preference law "should encourage people to do business on normal terms with financially distressed debtors."[103]

[86] The U.S. Bankruptcy Code applies only to transfers on account of "antecedent debt,"[104] and explicitly precludes a trustee from avoiding a transfer to the extent that it was intended to be and in fact was a substantially contemporaneous exchange of new value, defined as including services or new credit.[105] The recommendations advanced in the LRCBC Report and by Professor Cuming are to similar effect, except that Professor Cuming's system would protect payments towards recently incurred debt only when the recipient does not know and could not reasonably be expected to know of the debtor's current or imminent insolvency.[106]

b) The Conferral of a Security Interest

[87] One of the concerns associated with preferential transfer legislation is that it may stifle the willingness of creditors to extend credit to a financially troubled debtor, thereby

inducing the debtor's collapse. A general provision sheltering substantially contemporaneous exchanges of value should facilitate the provision of credit and extension of loans secured by a security interest in presently owned property of the debtor, since the property interest is transferred in return for the credit or funds advanced. However some systems also specifically address transactions in which a debtor grants a purchase money security interest to a creditor.[107] A purchase money security interest is, generically, an interest that secures repayment of a loan or an advance of credit that enabled the debtor to acquire the property subject to the security interest. Special provisions sheltering such interests are apparently included to ensure that a delay between execution of the agreement to extend credit or lend funds and the creation of the security interest upon the debtor's subsequent acquisition of the property does not bring the transaction within the general avoidance provisions.[108]

[88] The system proposed in the LRCBC Draft Act would go farther than others by including a provision that would enable a debtor to give security for antecedent debt in an attempt to sustain the debtor's business and recover from insolvency. Such a transaction would be protected if, by reason of giving the security, the transferee gives new value or agrees not to take enforcement action in relation to an obligation owed, in the *bona fide* belief that the new value or forbearance will achieve the indicated objective.[109]

c) Ordinary Course Transactions and Creditor Knowledge of Insolvency

[89] With the exception of the last mentioned, the transactions described under the previous two headings are not truly preferences because they do not diminish the value of the asset pool available for other creditors. They are specifically protected in order to guarantee that they do not fall afoul of the general avoidance provisions, assuring persons who deal with the debtor on such terms that they will not be deprived of the benefit of the transaction. However some transactions may merit protection even if they do entail the conferral of a preference. Current and proposed effects-based systems generally recognized this by sheltering either transfers made in the ordinary course of business or

transfers made to creditors who did not know of and had no reasonable grounds to suspect the transferor's present or imminent insolvency. The difficulty of choosing between these strategies is demonstrated by the fact that New Zealand has, within the space of less than two decades, adopted first one approach and then the other.[110] The United States has, over a longer period of time, followed the converse route.

[90] The U.S. Bankruptcy Code currently shelters a transfer or payment made in the ordinary course of business or financial affairs of the debtor and the transferee if the transfer was made either in the ordinary course of business of the parties *or* according to ordinary business terms. Before the 2005 Code amendments a transaction was sheltered only if it was made both in the ordinary course of business of the parties *and* according to ordinary business terms. The meaning of the pre-amendment provision was regarded as uncertain and the requirement that a defending creditor prove relevant industry standards was onerous, making it very difficult for creditors to rely on the ordinary course of business defence.[111] The LRCBC Draft Act would shelter "a disposition of property made in the ordinary course of the transferor's business or affairs,"[112] thereby focusing on the ordinary practices of the debtor rather than commercial or financial practices generally.

[91] A general ordinary course of business exception or defence has been criticized as indeterminate. Indeed New Zealand moved away from such a defence on the ostensible ground that its uncertain meaning and application generated a significant volume of cumulatively inconclusive litigation. However, it has been suggested that the flood of litigation was caused in large part by the procedural advantage given by the statute to the liquidator, who need only serve a notice of intention to avoid a transaction which must be defended by the recipient creditor in order to avert automatic avoidance.[113] Although the criticism of uncertainty has also been leveled at the U.S. provisions the 2005 amendments were designed to alleviate the problem by clarifying the test. Notably, the redefined the U.S. test resolves at least in part the interpretational uncertainties associated with New Zealand's ordinary course of business defence, which related largely to the question of whether the ordinary course character of a transaction was to be determined by reference

to general industry standards or by reference to the particular relationship between the parties.[114]

[92] Professor Cuming's recommendations for reform of the BIA preferences regime respond to concerns about certainty of outcomes by eschewing a general ordinary course of business test, instead defining transactions that qualify as "non-exceptional" with some particularity.[115] The transactions specified are limited to payments, thus excluding transfers of property by way of security. However, the latter are sheltered to some extent by provisions of the kind described under the previous headings. The non-exceptional payments are:

- A payment of a business debt made within 35 days from the date the property or service for which the payment was made was received by the debtor or given for the benefit of the debtor;

- A payment of a loan where the period between the date the obligation was incurred and the date of payment is not greater than 35 days; and

- A payment under a running account in substantial conformity with the ordinary pattern of payment.

[93] Professors Duggan and Telfer point out that a rules-based approach of the kind proposed in the Cuming model avoids the case-by-case inquiry required by a standards-based approach and is therefore more predictable. On the other hand, they suggest that the use of temporally defined limitations may not give full effect to the policies the legislation is designed to achieve. To the extent that ordinary course payments do not fall within the stipulated time period the provisions impinge on the finality of routine transactions. To the extent that non-ordinary course transactions falling within the stipulated time period are sheltered they threaten the equal sharing objective.[116] Although this is a legitimate observation a defence based on clear rules is likely to balance these competing policies at least as effectively as a standards-based defence. Finality of

transactions is advanced by relieving creditors of the need to demonstrate the ordinary course quality of routine transactions in the majority of cases while the equal sharing principle is protected by limiting the scope of the defence.

[94] Professor Cuming's approach differs from the broader ordinary course of business standard adopted in the U.S. and recommended in the LRCBC Report in another important respect. Those approaches would exempt an ordinary course transaction regardless of whether the transferee creditor knew of or had reason to suspect the debtor's insolvency. Professor Cuming's regime would shelter the listed non-exceptional payments only if the creditor did not know and could not reasonably be expected to know that the debtor did not have assets sufficient to pay other creditors at the time of payment (i.e., was insolvent) or could not reasonably be expected to have in the near future sufficient assets to do so (i.e. was on the verge of insolvency).

[95] In Australia and New Zealand, the sphere of protected transactions is defined by the recipient creditor's knowledge of the debtor's insolvency rather than by characterization of the transaction as inherently routine or non-exceptional in nature. The relevant provision of both statutes provides in essence that a court may not order recovery against a creditor who is able to prove that:

a) The creditor acted in good faith,
b) A reasonable person in the creditor's position would not have suspected and the creditor did not have reasonable grounds for suspecting that the debtor was or would become insolvent, and
c) The creditor gave value for the property received or altered position in the reasonably held belief that the transfer was valid.

[96] The adoption of a lack of knowledge defence or exception in an effects-based system means that a remedy is available where (a) a transfer has preferential effect and (b) the creditor knows or should have known of the debtor's insolvency (an inference

flowing from the creditor's inability to prove that he or she did not know and did not have reason to know of the debtor's insolvency).

[97] The choice as between an ordinary course of business approach (whether cast in terms of a general standard or particularized rules) and a creditor knowledge approach should take into account the extent to which each advances selected policies, as well as their practicability and the likely predictability of the outcomes they would produce. While most systems adopt one or another of these approaches, Professor Cuming's proposals demonstrate that recognition of the ordinary course quality of a payment or transfer and regard for a recipient creditor's knowledge of the debtor's circumstances are not necessary mutually exclusive approaches. The third possibility presented by his recommendations is therefore taken into account in the following discussion.

Consistency with Selected Policy

[98] The extent to which the alternative approaches to the definition of sheltered transactions advances policy goals is difficult to determine. Relevant considerations in that regard are suggested here but the conclusion to be drawn is left to the working group tasked with design of the legislation.

[99] A defence based on the ordinary course character of a transaction may in practice be available in more cases than one based on the recipient creditor's lack of knowledge of the debtor's insolvency, since a payment may conform with regular business practices even if the creditor knows of the debtor's financial circumstances. Further, the imposition of an objective standard of knowledge will prevent a creditor from relying on a lack-of-knowledge defence if the debtor's insolvency should have been apparent, regardless of whether the creditor actually knew of it. A creditor knowledge approach to the definition of defences may therefore impinge less on the policy of equal creditor sharing than would an ordinary course of business approach, which would shelter a broad range of transactions.

[100] Conversely, however, a lack-of-knowledge defence is in principle less likely than an ordinary course of business defence to protect transactions that are inherently routine in nature, since a payment may be properly characterized as consistent with ordinary business practices even if the recipient creditor knows of or has reason to suspect the debtor's financially precarious circumstances. An ordinary course of business defence formulated in terms of the ordinary practices of the debtor, or the debtor and creditor jointly, would further emphasize the protection of transactions at the expense of equal creditor sharing, since creditors could defend on the basis of the parties' own particular practices regardless of whether they are consistent with business practices generally.

[101] If the concern is the ability of a creditor to protect himself or herself from losing the benefit of a transaction creditor knowledge is clearly a relevant consideration. As was suggested earlier, a creditor's knowledge of the debtor's financial circumstances plays a role in risk assessment and corresponding credit management practices. It may therefore be legitimate to protect a creditor who is not in a position to assess the risk of dealing with a debtor but not one who is.

[102] Risk assessment considerations may be recognized through an Australia-New Zealand type approach to the definition of defences or through the sort of hybrid approach recommended by Professor Cuming. The latter would shelter transactions on the basis of their inherently routine quality through an ordinary course of business type defence, but only to the extent that a recipient creditor does not know and is not in a position to know of the debtor's insolvency at the time a payment or transfer is received.[117] Such a qualification advances the policy of equal sharing by narrowing the scope of the defence. An approach of this kind could instead shelter an ordinary course of business payment or transfer unless the creditor knew or should have known of the debtor's insolvency at the time of entering into the transaction giving rise to the debt. Either way, it may be appropriate to take the recipient creditor's knowledge into account in the definition of some sheltered transactions but not others. For example, substantially contemporaneous exchanges of value might be protected regardless of whether the creditor knew or should have known of the debtor's financial condition while payments

towards a long term loan or debt on a running account might be treated as a preference if the creditor had that knowledge.

Practicability and Predictability of Outcomes

[103] Assessment of the practicability and predictability of alternative approaches to the definition of sheltered transactions requires consideration of (i) the degree to which the meaning of the test adopted is clear and (ii) the difficulty of proving the relevant facts. If a lack of knowledge approach is adopted a defending creditor would be required to prove that he or she did not know of and a reasonable person in his or her position would not have recognized the debtor's current or imminent insolvency at the date of accepting a preferential payment or transfer. If an ordinary course of business defence is adopted the defending creditor must prove that the transaction was in the ordinary course or that it fell within the parameters of a more specifically articulated series of transactions, depending on the manner in which the defence is formulated. The hybrid approach proposed by Professor Cuming would evidently require the creditor to prove the nature of the transaction, whereupon the onus would shift to the plaintiff to prove that the creditor knew or should have known of the debtor's insolvency.

[104] The meaning of the requirement that a creditor did not know and a reasonable person in his or her position would not have recognized the debtor's insolvency may be clarified by the provision of a definition of knowledge along the lines of that included in the provincial *Personal Property Security Acts.* Section 1(2) of the Alberta Act is representative:

> 1(2) For the purposes of this Act,
>
> (a) an individual knows of has knowledge when information is acquired by the individual under circumstances in which a reasonable person would take cognizance of it.[118]

Further clauses address knowledge on the part of corporations and other artificial legal persons.

[105] As noted earlier, it has been argued that it is difficult to ascribe a clear meaning to a general ordinary course of business formulation. The difficulty is considerably lessened if the test is defined in terms of the ordinary practices of the debtor, the creditor, or the debtor and the creditor jointly, rather than the ordinary practices of a broader commercial community. Problems of indeterminacy are further minimized by a system that defines non-exceptional transactions by way of specific rules rather than through a general ordinary course of business standard.

[106] There are problems of proof associated with both the subjective and objective branches of a creditor knowledge test. The proof of a negative, that is, lack of knowledge, is inherently problematic. The determination of whether a reasonable creditor in the circumstances under consideration would have known the debtor was insolvent or verging on insolvency depends on identifying not only how such a person would have interpreted the available information but also what active steps he or she would have taken to investigate the situation on the basis of that information. The latter, in particular, may be highly context specific and correspondingly difficult to establish. Thus proof that the creditor was not in a position to know that the debtor was insolvent, determined objectively, may be relatively easy in some cases but quite difficult in others.

[107] The relative ease or difficulty of proving an ordinary course of business defence will depend upon the way in which it is formulated. The parties' own practices can be readily demonstrated. The difficulties associated with proving broader industry or commercial practices prompted the previously described amendment of the U.S. Bankruptcy Code to remove the requirement to do so. Problems of proof would also be minimized by a rules-based defence.

Other Considerations

[108] A final point that may be noted is the provision of value or alteration of position requirement of the Australia - New Zealand defence, outlined above. Such a requirement further narrows the scope of a lack of knowledge defence, thereby promoting the equal sharing principle embodied in an effects-based test. However the provision raises questions of policy and precision. It is not clear what the requirement of value entails. Most transactions that constitute a person a creditor will entail the giving of value by that person (the provision does not require *new* value), though judgment debts arising from causes of action other than contract generally do not. In any event, there is no obvious reason for differentiating between the two categories of creditor. As for change of position, it is very difficult without further statutory elaboration to determine what sort and degree of change is relevant. It may be noted that alteration of position may be recognized in reformed legislation as a factor in the provision of a remedy rather than in the determination of liability.

d) Transactions Part of a Series

[109] Virtually all effects-based systems respond in some way to the special problems associated with an ongoing business relationship between a debtor and creditor. The existence of such a relationship may be taken into account in the determination of whether a payment has preferential effect or addressed in the definition of sheltered transactions.

[110] The first approach is illustrated by the Australia and New Zealand statutes. The cumulative effect of the payments made pursuant to an ongoing business relationship and the reciprocal value received by the debtor is assessed in the determination of whether a transaction has preferential effect.[119] Although the pertinent provision makes no reference to the purpose of the payments in question the courts, following earlier case authority, have considered whether the payments were made at least in part in order to secure continued supply. Applied in this manner the provision is evidently designed to

induce creditors to refrain from terminating the supply of goods and services to a financially unstable debtor. While this may be a worthy goal the operation of the provision in conjunction with the defence of lack of knowledge of insolvency is problematic.[120] If an approach of this kind is adopted in reformed legislation any such problems of interface should be addressed.

[111] The U.S. Bankruptcy Code is representative of the second approach. It includes a provision designed to encourage creditors to continue supplying a financially unstable debtor by sheltering payments made to a creditor who subsequently provides further value.[121] However the structure of the provision is highly complex and the difficulties associated with its interpretation and applications are considerable.[122] The LRCBC Draft Act offers a more limited defence for security given to induce the provision of additional value by the recipient creditor.[123]

[112] Professor Cuming's system would also address payments made in an ongoing business relationship through the provisions creating defences. Such payments would be sheltered if made towards a recently incurred debt or towards a running account in conformity with the usual payment pattern.[124] Although "running account" is not defined the differentiation of such payments from those made pursuant to a recently incurred debt suggests that the term contemplates sequential payments of long term debt rather than payments under a revolving line of credit. Payments of either kind would not be sheltered if the creditor knew or should have known of the debtor's insolvency.

b. Transactions Intended to have Preferential Effect (the Debtor Intention Test)

[113] The essential question in the reform of provincial preferential transfer law is whether the cause of action should retain the historic requirement that the debtor intended in making a payment or transfer to prefer the recipient creditor relative to others. This remains a feature of the current and amended preference provisions of the BIA and is the basis for challenge under the U.K. *Insolvency Act 1986*.[125] In light of what appears to be

the reasonable likelihood of their enactment, the following discussion will reference the amended provisions of the BIA, currently enacted but not yet declared in force.[126]

[114] The BIA and the U.K. statute both differentiate between transactions involving arm's-length and non-arm's length parties. Where the parties are dealing at arm's length, the essential conditions giving rise to a remedy under both systems are that:

- The debtor was insolvent at the time of the transaction,
- The debtor intended to give the recipient a preference over other creditors,
- The transaction had preferential effect (though this is not an explicit requirement under the BIA) and
- The transaction occurred within the prescribed period prior to bankruptcy or formal insolvency proceedings, being 3 months under the BIA and 6 months under the U.K. statute.

[115] Under the BIA, a rebuttable presumption that the debtor intended to confer a preference arises from the preferential effect of a transaction, but evidence of pressure is not admissible to support the transaction. In spite of its surface reliance on intention as a requirement, this means that the BIA system implements an effects-based test but shelters transactions on the basis that they were not intended to have preferential effect rather than on the basis that they occurred in the ordinary course of business or that the recipient creditor did not know of the debtor's insolvent circumstances. Nevertheless, the courts have indirectly introduced both considerations in their assessment of the debtor's intention.[127] Therefore while there are important structural and evidentiary differences between the effects-based test described above and the BIA debtor intention test, the operation of the two systems is not as divergent as a superficial comparison might suggest.

[116] The effects-based systems and the BIA converge even more closely under the amended BIA provisions addressed to transactions involving a non-arm's length creditor which, if they occur within the 12 months prior to bankruptcy can be set aside on the basis of the debtor's insolvency and their preferential effect alone. In fact the BIA system is markedly more rigid in this context than the other systems discussed, since non-arm's length creditors cannot rely on either an ordinary course of business or lack of knowledge defence. The U.K. *Insolvency Act 1986* imposes a presumption of intention to prefer where a preference is given to a non-arms' length ("connected") person within 2 years prior to insolvency proceedings, but the presumption is rebuttable.

[117] Although explicit ordinary course of business defences typically appear in effects-based systems a defence of that kind could potentially be used in a system based on intention to prefer, since the fact that a debtor intended to give a preference does not necessarily mean that the payment was other than routine. Alternatively, a debtor-intention system could offer a defence to creditors who can prove that they did not know of the debtor's insolvency at the time of accepting the transfer or payment.

[118] Commentators and law reformers are critical of a debtor intention test as the foundation of preferential transfer legislation, both because it does not relate in a meaningful way to the fundamental policy goal of equal sharing among creditors and because it entails significant problems of interpretation and proof. As was suggested in the previous discussion of policy considerations, it may be the case that intention to prefer represents a device to shelter ordinary course transactions rather than a legislative commitment to an essentially ethical standard, particularly in light of the judicial gloss cast on the test of intention. If that is the goal, it is likely to be achieved more effectively by directly defining the types of transaction meriting protection under an effects-based system.

[119] The discussion of debtor intention as a factor in the cause of action relating to transfers at undervalue in Part I of this report recognizes that intention may be a relevant consideration where the debtor takes measures deliberately designed to defeat creditors.[128]

Truly fraudulent conduct is less likely to occur in relation to the apportionment of payment among creditors than in relation to efforts to put assets beyond the reach of creditors entirely. More to the point, an effects based test will in any event capture most if not all such fraudulent schemes because the recipient creditor will likely not be able to demonstrate that such payments or transfers fall within a sheltered category, whether the defences are cast in term of the ordinary course of business or in terms of creditor knowledge of insolvency. If in fact a transfer does not diminish the ability of creditors to recover relative to the recipient, they have no cause for complaint.

c. The Relevance of the Parties' Relationship

[120] The question of whether the relationship between parties to a preferential transfer is a relevant consideration in the definition of the cause of action or the availability of defences was discussed in Part I in connection with transfers at undervalue. As was suggested in that context, the nature of the transaction is not inherently qualified by the proximity of the parities. The preferential effect of a transfer is determined by the relative advantage conferred on the transferee rather than his or her identity. Similarly, if a transfer is made under the conditions that would support a defence in relation to an arm's length party there is no evident reason for denying the defence to one who is not at arm's length. Nevertheless, legislation governing preferential transfers often includes provisions that make transactions involving non-arms' length parties particularly vulnerable. Such provisions may take the form of an extension of the period of time during which a transaction is subject to challenge or a presumption establishing the cause of action. Often both approaches are used together. They will be discussed in turn.

[121] Since preferential transfer law is ordinarily invoked in relation to bankruptcy or other formal insolvency proceedings against the debtor it is possible to limit the scope of the cause of action by defining a period of time prior to the commencement of the bankruptcy or other proceedings during which transfers are subject to challenge by the trustee or insolvency administrator. Under the BIA the standard "reach-back" period is 3 months. Under the U.S. Bankruptcy Code it is, similarly, 90 days.[129] Other jurisdictions

offer longer reach-back periods of varying lengths. In Australia and the U.K. the standard period is 6 months while in New Zealand it is 2 years.[130] Where the relationship between the parties is recognized by the legislation as a factor it is usually through extension of the reach-back period.

[122] Under the BIA and the U.S. Bankruptcy Code, the reach-back period is extended to 1 year where the transaction in question involves a non-arm's length party.[131] The likely objective of this approach is to minimize a debtor's ability to plan a bankruptcy in concert with creditors who are aware of the debtor's financial circumstances by timing payments so as to insulate them from challenge. Professor Cuming recognizes this problem but suggests that since the concern is with creditors who are in a position to reap special benefits by virtue of their knowledge of the debtor's position the extended reach-back should be defined in those terms rather than in terms of the proximity of the parties' relationship. Thus he recommends a one year reach-back period where;

> (i) the preference involved a voluntary act on the part of the debtor; (ii) the preference occurred when the debtor was insolvent; and (iii) the creditor knew or could reasonably be expected to know that the debtor did not have at that time or could not reasonably be expected to have in the near future sufficient assets to pay the claims of other creditors.[132]

This approach more accurately addresses the underlying policy concern. Although it requires the person challenging the transaction to prove the creditor's knowledge of insolvency the evidentiary burden is lessened by the use of an objective standard. Alternatively, a presumption of knowledge could be imposed on the basis of the proximity of the parties' relationship, subject to rebuttal by the recipient creditor.

[123] The second means by which the relationship of the parties to a transaction is taken into account under current systems is through a presumption establishing the cause of action. The amendments to the BIA introduced by statute c. 36 go further than other systems of law by conclusively deeming transactions between non-arm's length parties to

be unfair preferences. Given that the cause of action is otherwise based on the debtor's intention to prefer this amounts to the adoption of an irrebuttable presumption that a payment to a non-arms' length party within a year prior to formal insolvency proceedings is an intentional preference. A creditor who meets the statutory definition of related person is deemed not to deal with recipient creditor at arm's length, so can escape the presumption only by showing that it was dealing with the debtor at arms' length in relation to the transaction in question.[133] This amendment reflects the recommendations of the IIC-CAIRP Joint Task Force, which otherwise advocated retention of a debtor intention test.[134] Professors Duggan and Telfer suggest that if the concern of the Task Force was that a debtor is more likely to have intended a preference in relation to a non-arm's length party, that consideration "at most supports a rebuttable presumption of intention."[135] This is the approach adopted in the U.K. *Insolvency Act 1986*, under which a company that has given a preference to a connected person is presumed, unless the contrary is shown, to have intended to give a preference.[136]

[124] The use of a reach-back as such is not possible in provincial preferential transfer legislation, since it does not address a situation in which the initiation of formal insolvency proceedings allows for the identification of a specified date that may be used to demarcate the end of the period. Instead, the period during which a transaction is subject to challenge is circumscribed by the imposition of a limitation period beginning at the date of the transaction, which could be extended on the basis of the proximity of the parties' relationship. The need to guard against planned bankruptcy is not of direct concern under provincial preferential transfer law, since it does not operate in the context of formal insolvency proceedings. However, essentially the issue may arise in relation to an insolvent debtor who simply goes out of business. Whether extension of the limitation period is warranted by the relationship between the parties or by the recipient creditor's knowledge of the debtor's insolvency at the time of the transaction is therefore a relevant question. Notably, the LRCBC Draft Act does not extend the limitation period on these grounds, but does so "where the transferee conceals, or assists or acquiesces in the concealment of, a material fact relation to the disposition of property."[137] Such a

provision offers some protection against complicit strategic behaviour on the part of debtors and creditors.

[125] The potential utilization of a presumption establishing grounds for a remedy depends upon the manner in which the cause of action is defined. A presumption of intention may be used in a system based on intention to prefer. In an effects-based system no presumption is required to establish the cause of action. The onus on the recipient creditor to prove an ordinary course of business or lack of knowledge defence in all cases amounts to a rebuttable presumption that a preferential transfer was not in the ordinary course or was accepted by a creditor who knew of the debtor's insolvency. Therefore a presumption based on the relationship of the parties would affect outcomes only if it were in effect irrebuttable, as is the case under the revised BIA provisions. In an effects-based system this would be accomplished by precluding a non-arm's length transferee from relying on an ordinary course of business or lack of knowledge defence. However, while such a provision would advance the policy of equal sharing it would invalidate many completely routine, *bona fide* transfers.

d. Miscellaneous Special Provisions

[126] The legislation and literature addressing preferential transfers identify a number of specialized issues that do not fit neatly within the discussion of broader issues of policy and approach. They are listed below, accompanied by only brief commentary along with references to pertinent sources.

i. Small Value Transfers

[127] Litigation costs are such that creditors who have received small payments from an insolvent debtor may feel compelled to settle a preferences action against them, even if they believe the payment to be defensible. The U.S. Bankruptcy Code responds to this by providing defences for small value transfers to consumer ($600) and business ($5,000) debtors respectively. The defence for business debtors was added in the 2005

amendments to the code. [138] Any provision to this effect should: (a) specify whether aggregate transfers amounting cumulatively to less than the stipulated amount qualify and (b) make it clear that the provision does not shelter any portion of a single transfer the value of which exceeds the stipulated amount. These Code provisions are discussed in greater detail by Professor Tabb.[139]

ii. Set-off

[128] Where a debtor owes money to a bank or other depositary institution the bank can recover satisfaction through the exercise of a right of set-off against funds of the debtor held on deposit. Some systems of bankruptcy law make special provision for set-off. This is illustrated by the U.S. Bankruptcy Code §553 and the commentary offered by Professor Tabb.[140] In a non-bankruptcy statute the issue may be sufficiently addressed by ensuring that payments effected by means of set-off are captured in the general definition of transactions subject to the Act.

iii. After-Acquired Property Clauses in Security Agreements

[129] Security agreements routinely provide for attachment of a security interest in property acquired by the debtor in the future. The interest attaches automatically at the date of acquisition of the property. Where the agreement secures antecedent debt the attachment of the security interest amounts to a preferential transfer of property to the creditor that would be captured by an effects-based test. This may not be appropriate where the property acquired replaces original collateral that has been dealt with by the debtor in a manner such that the security interest in that collateral is lost, whether the new property is proceeds of or acquired in substitution for the original collateral. The transaction will not be sheltered by a contemporaneous exchange of value defence, since the newly acquired property interest secures old debt. Whether it is sheltered by an ordinary course of business defence would depend on the way in which such a defense is articulated and interpreted.

[130] Although the U.S. Bankruptcy Code includes special provisions to deal with security interests in after-acquired property those provisions offer limited guidance because they are structured around the pre-bankruptcy period of time during which a transfer is subject to challenge. It may be possible to deal with the issue through a formula based on the net change in the creditor's position in the period following execution of the security agreement, taking into account payments made by the debtor and the value of the collateral subject to the agreement. Part (b) of Professor Cuming's Recommendation 9 may be helpful in this regard. The intended operation of that part of the recommendation is explained in his report.[141]

[131] The LRCBC Draft Act would shelter an interest arising under an after-acquired property clause more broadly under a provision exempting "security for past value given or made in fulfillment of a commitment undertaken by the transferor when the value was received."[142] Whether such a widely cast exception is desirable is open to debate.

iv. Letters of Credit

[132] Professor Cuming points out that a creditor who receives a letter of credit covering the obligation of an insolvent debtor will be paid while other creditors are not. If the issuer is compensated or given security by the debtor the creditor has in effect received a preference. Whether or not the compensation or security given to the issuer is itself subject to challenge would depend upon whether the issuer can rely on a defence offered by the statute. If it can, the other creditors will have lost the value of the property transferred to the issuer but indirectly received by the beneficiary creditor in payment of a debt. It may, therefore, be appropriate to adopt a provision analogous to that recommended by Professor Cuming, to the effect that a transfer by an insolvent debtor to the issuer of a letter of credit under which a creditor is the beneficiary should be deemed to be a transfer by the debtor to the creditor.

v. Payments Made to Release a Guarantor

[133] Professors Tabb and Cuming discuss the unique problems associated with payments made to a creditor in order to release a guarantor from liability to the creditor.[143] Such problems are likely to arise in a statutory system that differentiates between arm's-length and non-arm's length creditors in the determination of the validity of a transfer. Where the creditor is at arm's length from the debtor but the guarantor is not a payment that would be invalid if made directly to the guarantor may be beyond challenge, notwithstanding that it was procured in order to forestall liability that would otherwise have been imposed on the guarantor and therefore in effect constitutes a preferential transfer to the guarantor. The recommendation advanced by Professor Cuming to avoid this result is that a transfer to a creditor to discharge the obligation of a guarantor or indemnitor of an obligation of a debtor should be deemed to be a transfer to the guarantor or indemnitor. Under this recommendation the transaction would be subject to the standard applied to a transfer to a non-arm's length party and the remedy would be award against the guarantor rather than the creditor.

5. Issues Addressed in Part I

[134] Part I of this report addresses a number of issues that arise in relation to both transfers at undervalue and preferential transfers. Although the analysis of those issues was referable to the former it may generally be transposed to the latter. For the sake of space and the avoidance of redundancy those issues will not be revisited here. Instead, readers should consult those portions of Part I listed below, making suitable accommodation for the contextual differences:

4. Defences and the Protection of Third Parties

   c. Change of Position by the Transferee
   d. Protection of Third Parties dealing with a Transferee

5. Remedies (all subheadings)

E. Conclusion

[135] The Conclusion to Part I sums up the steps to be taken towards formulation of draft legislation dealing with transfers at undervalue and preferential transfers. The suggested format of the legislation is equally relevant in relation to the latter, with the exception of the reference to declaration of dividends by corporate debtors as one of the "special cases" to be addressed in structuring the cause of action.

[1] The jurisdictions canvassed are the United Kingdom, United States, Australia and New Zealand.

[2] R.S.C. 1985, c. B-3 as am. (hereafter the BIA).

[3] The right of unsecured creditors to take proceedings to enforce their claims is stayed by bankruptcy or the initiation of a proposal, on the premise that the trustee in bankruptcy acts on behalf of creditors collectively; BIA ss. 69.1 – 69.3.

[4] This is subject to certain legislated priorities protecting favoured creditors such as unpaid employees and public revenue authorities, often through the creation of a deemed trust or security interest.

[5] See C.R.B. Dunlop, Creditor-Debtor Law in Canada, 2nd ed. (Carswell, 1995) at 595-98.

[6] *Ibid.*

[7] Generally speaking, this system is only imposed on creditors acting under writs of execution. However the proceeds of garnishment may in some instances be brought within the sharing scheme. For a discussion of the operation of the legislation in place in common law jurisdictions other than Alberta and Newfoundland, see Dunlop, *ibid.* Ch. 16. Under the reformed judgment enforcement statutes of Alberta and Newfoundland the obligation to share the proceeds of enforcement action extends to any type of process, including garnishment. See *Civil Enforcement Act*, R.S.A. 2001, c. C-15, Part 11, *Judgment Enforcement Act*, S.N.L. 1996, c. J-1.1, Part XI.

[8] Exigible property of a debtor is available to unsecured creditors only to the extent that it is not subject to a security interest that has priority over the enforcement rights that may be asserted directly by judgment creditors pursuant to a writ of execution or equivalent judgment enforcement device or indirectly through the trustee in bankruptcy. Property subject to a security interest that is subordinate to the rights of unsecured creditors asserted by either means is available for the satisfaction of their claims and is therefore "unencumbered" in the relevant sense.

[9] The statutes are typically titled the "*Fraudulent Preference(s) Act*" or "*Assignments and Preferences Act*," but see the *Frauds on Creditors Act*, R.S.P.E.I. 1988, c. F-15.

[10] For a thorough examination of the features of provincial legislation see M. A. Springman, George R. Stewart, Michael J. MacNaughton, *Fraudulent Conveyances and Preferences*, looseleaf (Carswel,l 1994). See also Dunlop, *supra* note 5 at 623 *et seq.*

[11] *Fraudulent Preferences Act*, R.S.A. 2000, c. F-24, s. 2. And see *Assignments and Preferences Act*, R.S.O. 1990, c. A.33, s. 4.

[12] e.g. Alberta *Fraudulent Preferences Act*, *supra* note 11 s. 5.

[13] Dunlop, *supra* note 5 at 628.

[14] e.g. Alberta *Fraudulent Preferences Act*, s. 2, Ontario *Assignments and Preferences Act*, s. 4(2) providing that the debtor must have intended an "unjust" preference," both *supra* note 11.

[15] e.g. Alberta *Fraudulent Preferences Act*, s. 3, Ontario *Assignments and Preferences Act*, s. 4(3), *ibid.*.

[16] For cases addressing the requirement of intention, see Springman et al, *supra* note 10 at S. 18(e)(iv), and see Dunlop, *supra* note 5 at 629-31.

[17] Compare the presumption of intent drawn from the fact of insolvency in the context of fraudulent preferences law. See Part I, paras. 21 – 22.

[18] The so-called doctrine of pressure has been part of Canadian law for well over a hundred years. See *Stephens v. McArthur* (1891), 19 S.C.R. 446.

[19] Several of the statutes contain a provision defining what constitutes a transaction that has the effect of giving a preference for purposes of the presumption. See e.g. Alberta *Fraudulent Preferences Act*, *supra* note 11, s. 4(1).

[20] Dunlop, *supra* note 5 at 632-33, Springman et al., *supra* note 10 at S. 18(g)(i).

[21] See e.g. Alberta *Fraudulent Preferences Act*, *supra* note 10, s. 4(2).

[22] See e.g. New Brunswick *Assignments and Preferences Act*, R.S.N.B. 1973, c. 13, s. 2(3).

[23] *Frauds on Creditors Act*, R.S.P.E.I. 1988, c. F-15, s. 2(5).

[24] Springman et al., *supra* note 10 at S. 18(e)(ii).

[25] e.g. Alberta *Fraudulent Preferences Act*, s. 2, Ontario *Assignments and Preferences Act*, s. 4(2), both *supra* note 11.

[26] See Dunlop, *supra* note 5 at 626-7, Springman et al, *supra* note 10 at S. 17(a), Law Reform Commission of British Columbia, *Report on Fraudulent Conveyances and Preferences* (LRC 94, 1988) online at http://www.bcli.org, heading IV.B.4. The report is hereafter called the LRCBC Report and the proposed draft statute contained in it the LRCBC Draft Act.

[27] See further Springman et al., *ibid.* at S. 17(c).

[28] See e.g. Alberta *Fraudulent Preferences Act*, ss. 6 and 9, Ontario *Assignments and Preferences Act*, s. 5, both *supra* note 11.

[29] See BIA s. 101.1, *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 as am., s. 36.1.

[30] See Part I, paras. 38 and 43 – 46. Since the writing of Part I the proposed amendments were replaced by further amendments introduced in *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*, S.C. 2007, c. 36, s. 43. However the substance of the reforms discussed in Part I is not materially affected by these amendments.

[31] *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*, *ibid*., s. 42.

[32] This part of the section was changed marginally by an unproclaimed amendment introduced in S.C. 2005, c. 47, s. 73 that would have extended the one year time period to transactions involving a person who is not at arm's length, rather than a person related to the debtor. However the Statute c. 47 amendment is supplanted by Statute c. 36, *ibid.*

[33] The presumption of intention to prefer is specifically not applicable to a narrow range of transactions relating to securities trading and defined investment contracts. BIA s. 95(2.1).

[34] The effect of the current BIA provisions as interpreted and amplified by the courts is conveniently summarized by Anthony Duggan and Thomas G.W. Telfer in Stephanie Ben-Ishai and Tony Duggan, eds. *Canadian Bankruptcy and Insolvency Law: Bill C-55, Statute C.47 and Beyond* (Toronto: LexisNexis Canada Inc., 2007), Ch. 6 at 157-60. The following synopsis of the judicial interpretation of these provisions is drawn primarily from their discussion.

[35] Duggan and Telfer, *ibid.* at 163.

[36] For a discussion of the uneasy distinction between pressure and diligence, see Duggan and Telfer, *ibid.* at 160-63.

[37] *Ibid* at 159.

[38] BIA s. 4 (amended by Statute c. 47, *supra* note 32 and Statute c. 36, *supra* note 30) establishes the circumstances in which persons are "related" for purpose of the Act.

[39] Statute c. 36, *ibid.*, s. 2 amends the provisions of s. 4 dealing with related persons as follows:

> (5) Persons who are related to each other are deemed not to deal with each other at arm's length while so related. For the purpose of paragraph 95(1)(b) or 96(1)(b), the person are, *in the absence of evidence to the contrary*, deemed not to deal with each other at arm's length (emphasis added).

[40] The Insolvency Institute of Canada Canadian Association of Insolvency Restructuring Professionals Joint Task Force (hereafter the "IIC – CAIRP Task Force") on Business Insolvency Law Reform Report, March 2002 and Supplemental Report, June 2005, online: http://www.insolvency.ca/dhtml/en/page/papers.q/indexType$Topic/indexID$10/a$index.html.

[41] *Ibid.*, heading F. Preferences.

[42] *Ibid.*, recommendations 520 and 522. The recommendations of the Task Force are discussed more fully and criticized by Duggan and Telfer, *supra* note 34.

[43] See in particular **Canada:** Duggan and Telfer, *supra* note 34 and *Canadian Preference Law Reform* (2007), Tex. Int'l L.J. 661), Ronald C.C. Cuming, "Unfair Preferences: Reformulation of section 95 of the Bankruptcy and Insolvency Act," paper prepared for the Corporate Law Policy Directorate, Industry Canada, December 1997, online: http://www.ic.gc.ca/epic/site/cilp-pdci.nsf/en/h_cl00207e.html, subsequently published in abridged form; *Transfers at Undervalue and Preferences under the Bankruptcy and Insolvency Act: Rethinking Outdated Approaches* (2002), 37 Can. Bus. L.J. 5; **United States:** Charles Jordan Tabb, *The Law of Bankruptcy* (Foundation Press, Westbury, N.Y. 1997) Ch. 6, *Rethinking Preferences* (1992), 43 S.C.L. Rev. 981 and *PanglossianPreference Paradigm?* (1997) 5 Am. Bankr. Inst. L. Rev. 407; **Australia:** Andrew Keay, *In Persuit of the Rationale Behind the Avoidance of Pre-Liquidation Transactions* (1996), 18 Sydney L. Rev. 55; **New Zealand:** David Brown and Thomas G.W. Telfer, *The New "Australasian"Voidable Preference Law* (2007), 13 N.Z.B.L.Q. 160, **United Kingdom:** Gerald MacCormack, *Swelling Corporate Assets: Changing What is on the Menu* (2006), Journal of Corporate Law Studies 39.

[44] The most commonly favoured classes of unsecured creditors are unpaid employees, family maintenance and support claimants and unpaid public revenue authorities.

[45] See generally *supra*, note 7. As to the use of certificates, see e.g. *Creditors' Relief Act*, R.S.S. 1978, c. C-46, ss. 17 – 21.

[46] Keay, *supra,* note 43 at 68.

[47] The preservation of a financially distressed debtor's enterprise is sometimes identified as a distinct policy objective. See e.g. .MacCormack, supra note 43 at 42. However it can also be viewed as a function of the policy of equal sharing. Tabb implicitly recognizes this correlation in his conclusion that the abandonment of preferences law would both subvert the bankruptcy distributional scheme and "foster a debilitating 'race to the courthouse' when a debtor is in financial distress." *Panglossian Preference Paradigm?*, *supra* note 43 at 420.

[48] For an overview of the history of preferences law, see Springman et al., *supra* note 10 at S.16.

[49] See the *Insolvency Act 1986* (U.K.), 1986, c. 45, s. 239(5).

[50] *Supra* note 40, 2002 report, recommendation 66.

[51] Duggan and Telfer express a similar view of the Task Force's concerns. See *supra* note 34 at 168-69.

[52] In the context of bankruptcy, the opprobrious element of a transaction subject to avoidance has been characterized as intentional interference with a statutorily designated scheme of recovery. Lord Mansfield described a voluntary preference made in contemplation of bankruptcy as a fraud upon the bankruptcy law itself. See Springman et al, *supra* note 10 at S. 16. Professor Cuming suggests in a similar vein that the "fraudulent" conduct proscribed by preferences law is frustration of the policy of bankruptcy legislation that "any preference given to one or more creditors should be given by the law and not the debtor," *supra* note 43 at 2. This characterization of the fraudulent quality of the debtor's intention is more difficult to maintain in relation to provincial law, under which the sharing principle is not part of a comprehensive system of debt recovery encompassing all creditors.

[53] This is true of the United States Bankruptcy Code and the corporate insolvency legislation of Australia and New Zealand. For discussions of these systems of law respectively see Tabb, as to U.S. law, and Brown and Telfer, as to Australia and New Zealand, both *supra* note 43. However an intention-based system remains in effect in the United Kingdom. See the *Insolvency Act 1986*, *supra* note 49, s. 239.

[54] LRCBC Report, *supra* note 26.

[55] Cuming, *supra* note 43.

[56] See e.g. Duggan and Telfer, *supra* note 43.

[57] See e.g. Keay, *supra* note 43 at 77 – 78, John C. McCoid II, *Bankruptcy Preferences and Efficiency: An Expression of* Doubt (1981), 67 Va. L. Rev. 249 at 263-65, Tabb, *Panglossian Preference Paradigm*, *supra* note 43 at 407.

[58] However it has been suggested that the prospect of incurring potentially wasted costs in obtaining a preference and potentially litigating to defend it may have some deterrent effect. See Duggan and Telfer, *supra* note 43 at 669.

[59] See Tabb, *Panglossian Preference Paradigm, supra* note 43 at 413, reporting on concerns expressed by creditors in a comprehensive survey conducted in 1997 by the Unsecured Trade Creditor Committee of the American Bankruptcy Institute.

[60] Thomas G.W. Telfer, *Voidable Preference Reform: A New Zealand Perspective on Shifting Standards and Goalposts* (2003), 12 Int. Insolv. Rev. 55 at 57.

[61] While the concerns of the Task Force are legitimate their proposals may not represent the best solution. For a critique of the proposals of the Task Force Working Group on Preferences, see Duggan and Telfer, *supra* note 34.

[62] *Companies Act 1993*, s. 292 *et seq.* For a discussion of these reforms see Brown and Telfer, *supra* note 43.

[63] *Corporations Act 2001* (Cth.), s. 588FA *et seq.*

[64] LRCBC report, *supra* note 26.

[65] Cuming, *supra* note 43.

[66] *Infra*, heading 4.a.ii.

[67] LRCBC Report, *supra* note 26, Ch. 7, heading B.5.

[68] BIA s. 48.

[69] For a discussion of this feature of current and proposed law, see Ronald C.C. Cuming, *When an Unsecured Creditor is a Secured Creditor* (2003), 66 Sask. L. Rev. 255.

[70] *Civil Enforcement Act*, R.S.A. 2000, c. C-15, s. 38.

[71] Under the Alberta *Civil Enforcement Act*, creditors entitled to share in the proceeds of judgment enforcement measures are those who hold eligible claims, defined as the amounts outstanding on "related writs" in force against the enforcement debtor. See *ibid*, ss. 99(1), 1(1)(mm) "related writ." Under the Uniform Law Conference of Canada *Uniform Civil Enforcement of Money Judgments Act* (Proceedings of the Annual Meeting, 2004), creditors who have registered a judgment and delivered an enforcement instruction to the sheriff or enforcement official are so entitled. Online: http://www.ulcc.ca/en/us/Uniform_Civil_Enf_Money_Judgments_Act_En.pdf, s. 179.

[72] While inducements to put a debtor into bankruptcy are generally not regarded as desirable the invocation of federal law would not necessarily result in termination of a debtor's business since, as was noted earlier, the preference provisions of the BIA operate in reorganization proceedings under the BIA and the *Companies' Creditors Arrangement Act*, *supra* note 29.

[73] *Ibid.*

[74] See *Robinson v. Countrywide Factors Ltd.*, [1978] 1 S.C.R. 753.

[75] Cuming, *supra* note 43 at 34-5.

[76] United States Bankruptcy Code §547; LRCBC Report, *supra* note 26, Draft Legislation, ss. 1 "disposition" and 3. And see Cuming, *supra* note 43, Recommendation 2 "transfer".

[77] A similar approach is adopted in the list of transactions enumerated in the New Zealand *Companies Act 1993*, s. 292(3).

[78] *Supra* note 49, s. 239.

[79] *Supra* note 63.

[80] *Supra* note 62.

[81] Assume, for example, that Debtor owes money to Creditor A. Rather than paying the debt in money or property, Debtor assumes a debt owed by Creditor A to 3rd party. If 3rd party grants a release to Creditor A, Creditor A will have been effectively paid by Debtor. However insofar as Debtor's other creditors are concerned the obligation originally owed to Creditor A has simply been replaced by an obligation owed to 3rd party. Until 3rd party is actually paid, the ability of other creditors to recover from Debtor is therefore unaffected.

[82] The manner in which an effects-based cause of action may be formulated is discussed *infra* under heading 4.a.i.

[83] *Supra* note 26, Draft Act s. 1 "disposition" and "property" and s. 3.

[84] In the context of bankruptcy, Professor Cuming argues that it is arbitrary to allow a judgment creditor who is lucky enough to have completed judgment enforcement measures to enjoy a preference relative to those who have not reached a similar point in their enforcement efforts. See *supra* note 43 at 14.

[85] *Ibid.*

[86] Part I, para. 117 *et seq.*

[87] U.S. Bankruptcy Code §547(c)(7).

[88] Charles Jordan Tabb, *The Law of Bankruptcy* (Westbury, N.Y., Foundation Press 1997) at 402.

[89] *Bankruptcy Act 1966*, s. 122(2).

[90] See Part I at paras. 120-21.

[91] *Ibid.* at para. 127 *et seq.*

[92] LRCBC Report, *supra* note 26, Draft Act ss. 1 "claimant" and s. 5.

[93] Systems adhering to this model include the preferences provisions of the U.S Bankruptcy Code, the New Zealand *Companies Act 1993* as amended, the Australian *Corporations Act 2001* and the systems proposed by Professor Cuming, *supra* note 43 and the Law Reform Commission of British Columbia, *supra* note 26.

[94] See e.g. U.S. Bankruptcy Code §547(3) and (5), New Zealand *Companies Act 1993*, s. 292(2).

[95] This is subject to the qualifications noted earlier in relation to transfers of exempt property. See heading D.2.c., *supra*.

[96] See LRCBC Report, *supra* note 26, Draft Act s. 3(1).

[97] Professor Cuming's proposed definition of an "unfair preference" under the BIA adopts a similar approach. The definition captures a transfer during the stipulated reach-back period by an insolvent or imminently insolvent debtor of property that would otherwise have vested in the trustee made in satisfaction of an obligation that would have been a claim provable in bankruptcy. There is no comparison between the amount recovered through the payment and the amount the recipient would have recovered in bankruptcy proceedings. See Cuming, *supra* note 43, Recommendation 2 "unfair preference."

[98] A test based on the creditor's right to recover in a bankruptcy distribution inherently protects payments towards secured debt. For an explanation of this dimension of the test employed in the U.S. Bankruptcy Code see Tabb, *supra* note 88 at 376-77.

[99] See the discussion under heading B.1.b.ii., *supra*.

[100] BIA s. 95(1)(a) as am. by statute c. 36.

[101] Telfer, *supra* note 60 at 63.

[102] Professor Cuming's recommendations are designed to ensure that a brief delay between the provision of value by the opposite party and the payment or transfer by the debtor is protected by providing that a contemporaneous exchange is not an unfair preference if the transfer occurred "within a period of time after the debtor received the value that is reasonable in the context of the kind of arrangement." *Supra* note 43, Recommendation 5.

[103] Tabb, *supra* note 88 at 370.

[104] U.S. Bankruptcy Code §547(b)(2). The stipulation that transfers subject to challenge are those directed to antecedent debt appears to be redundant in a system that explicitly shelters contemporaneous exchanges.

[105] *Ibid.* §547(c)(1). The requirement of intention is designed to capture those cases, however rare, in which a creditor who initially intended to grant credit on an unsecured basis demands security immediately thereafter upon learning of the debtor's precarious financial condition. See Tabb, *supra* note 88 at 380.

[106] The LRCBC Draft Act excludes dispositions of property "for fair new value." See *supra* note 26, Draft Act ss. 1 "fair value" and 3(2)(a); Cuming, *supra* note 43, Recommendations 5 and 6. Recommendation 5, which is addressed to substantially contemporaneous exchanges of value generally, is limited to transfers other than payments of money. Recommendation 6 defines rules under which payments of money towards recently incurred debts relating to the provision of property or services or a loan of money are sheltered as non-exceptional payments.

[107] U.S. Bankruptcy Code §547(c)(3), Cuming, *supra* note 43, Recommendation 8. The New Zealand *Companies Act 1993* s. 293 clearly exempts security interests granted in existing property for new value and makes specific provision for delays arising in relation to transactions in which a security interest is given to secure the purchase price of property, whether or not the security interest is in the property purchased.

[108] Special provision for purchase money security interests may also be required in order to protect the security interest attaching to proceeds of the original collateral.

[109] LRCBC Report, *supra* note 26, Draft Act s. 3(2)(c).

[110] Amendments to the *Companies Act 1993* were introduced by the *Companies Amendment Act 2006*. For a discussion of the amendments see Brown and Telfer, *supra* note 43.

[111] The process preceding and the rationale for this amendment are discussed by Tabb, *Panglossian Preference Paradigm*, *supra* note 43.

[112] LRCBC Report, *supra* note 26, Draft Act s. 3(2)(b).

[113] Telfer, *supra* note 60 at 77 - 80.

[114] *Ibid.* at 66 – 75.

[115] Cuming, *supra* note 43, Recommendation 6.

[116] Duggan and Telfer, *supra* note 43 at 683-84 .

[117] Professor Cuming recommends that "A payment [that would otherwise qualify as non-exceptional] should be treated as exceptional if the creditor knew or could reasonably be expected to know that the debtor did not have at the time of the payment or could not reasonably be expected to have in the near future sufficient assets to pay the claims of other

creditors." See *supra* 43, Recommendation 6.

[118] *Personal Property Security Act*, R.S.A. 2000, c. P-7.

[119] See New Zealand *Companies Act 1993* as am., s. 292(4B).

[120] For a discussion of the provision and the problems associated with it, see Brown and Telfer, *supra* note 43 at 175-181.

[121] U.S. Bankruptcy Code §547(c)(4).

[122] See Tabb, *supra* note 88 at 391-95.

[123] LRCBC Report, *supra* note 26, Draft Act s. 3(2)(c).

[124] Cuming, *supra* note 43, Recommendation 6.

[125] The relevant provisions of the U.K. *Insolvency Act 1986*, *supra* note 49, are ss. 239-41.

[126] *Supra* note 30.

[127] See the discussion under heading "B.2." above.

[128] See Part I paras. 166-87.

[129] Bankruptcy Code §547(b)(4).

[130] Australia: *Bankruptcy Act 1966*, s. 122, *Corporations Act 2001*, s. 588FE(2); U.K.: *Insolvency Act 1986* s. 240(b); New Zealand: *Companies Act 1993*, s. 292(5).

[131] BIA s. 96. The provision is addressed to "a person related to the insolvent person." The statute c. 36 amendments broaden the category to persons who are not dealing at arm's length with the debtor. See s. 95(1)(a) as am. See also U.S. Bankruptcy Code §247(b)(4).

[132] Cuming, *supra* note 43 at 16.

[133] BIA s. 4(5) as am. by statute c. 36.

[134] *Supra* note 40, Supplemental Report 2005.

[135] *Supra* note 34 at 169.

[136] A company that has given a preference to a connected person is presumed, unless the contrary is shown, to have intended to give a preference. See *Insolvency Act 1986*, s. 239(6). In an effects-based system where the extended time period is based on the creditor's knowledge of the debtor's circumstances the presumption would be that the creditor knows that the debtor is insolvent or verging on insolvency.

[137] LRCBC Report, *supra* note 26, Draft Act s. 5(3).

[138] U.S. Bankruptcy Code §547(c)(8) and (9).

[139] Tabb, *The Law of Bankruptcy*, *supra* note 88 at 403-4.

[140] *Ibid.* at 404-12

[141] *Supra* note 43 at 22 - 3, discussing the "second rule."

[142] LRCBC Report, *supra* note 26, Draft Act s. 3(2)(d).

[143] Cuming, *supra* note 43 at 16-17 and Recommendation 3, Tabb, *The Law of Bankruptcy*, *supra* note 88 at 364 – 369.

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