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PREFERRING GUARANTORS: A COMPARISON OF AUSTRALIAN AND UNITED STATES PROVISIONS REGULATING VOIDABLE PREFERENCES

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I. INTRODUCTION

Disruption of the orderly and equitable distribution of a bankrupt’s estate by transfers immediately before bankruptcy has long been recognized in common law legal systems. Initially, statutes were formulated allowing recovery to the bankrupt’s estate of pre-bankruptcy transfers to prevent the parties to such transfer from retaining the benefit of any intentional circumvention of bankruptcy. However, preference statutes in both the United States and Australia reflect a de-emphasis of the fraudulent intent of the parties in determining whether a transfer is subject to recovery, relying instead upon objective criteria in their application. While the statutes regulating preferential transfers in Australia and the United States differ significantly, particularly in the defenses (or exceptions) to recovery, they nevertheless indicate that the two countries share common objectives in this matter.

The abandonment of preference regulation on the basis of culpability has not been without difficulty in either country. While Australia is currently undertaking a review of its preference regulation in conjunction with a general insolvency law reform project,¹ a

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¹ The Australian Law Reform Commission was instructed to review the “law
similar process was completed in the United States when its bankruptcy statute was amended in 1984.2 Although similar developments in the separate evolution of both countries from their common English forbear would provide a useful basis for a comparison of the preference statutes of the United States and Australia, this article focuses on United States and Australian preference provisions as they apply to transfers involving guarantors. This aspect of preference regulation is particularly revealing, since, despite many jointly shared policy objectives in the regulation of preferences, the problems encountered in accommodating the interests of all parties to preference transactions involving guarantors have been resolved quite differently in the United States and in Australia.

Regulation of preferential transfers is difficult enough where the transfer in question is the pre-bankruptcy payment from the debtor to one of a number of competing creditors. Where the preferential transfer is one involving a guarantee, however, the regulation of the rights of all the parties, including those with claims against the bankrupt's estate, entails even greater complexity.3 Where the guarantor is an insider or person related to the debtor, he is often in a position not only to assure that the debts to which his guarantee applies are repaid in priority to other debts but also to manipulate events so as to avoid application of the preferential transfer statute. Additionally, the insider is often in a better position than others to use defenses against the recovery of transfers in order to avoid liability upon his guarantee. In the United States, the rights of all parties are balanced by application of the general preference statute to transfers involving guarantors, albeit with certain modifications in its application to insiders. Australia, however, has attempted to control transfers benefiting corporate guarantors by using a specific statute rather than applying its general prefer-


3. The contract of guarantee itself is normally ancillary to a primary obligation from a debtor to a creditor in both Australia and the United States. Under it, the creditor may look to the guarantor for payment of the principal obligation upon default by the primary debtor. By paying this debt, the guarantor is subrogated to the rights of the original creditor against the original debtor. As may be expected, the debtor's declaration of bankruptcy does not relieve the guarantor of his obligations under the guarantee, and the guarantor would normally be required to pay the primary creditor the unpaid portion of the primary debt despite discharge through bankruptcy of the debtor.
Recovery of any transfer benefiting a guarantor may be difficult for a number of reasons, including the applicability of defenses to recovery and problems of proof. In Australia, the payment of the original debt may even affect the contractual liability of the guarantor to the creditor so that, even if recovery from the creditor is achieved, the creditor will have no recourse against the guarantor. On the other hand, recovery of the preferential transfer directly from the guarantor would unfairly prejudice him without the proper safeguarding of his right to assert appropriate defenses and to participate in the bankruptcy estate upon direct surrender of such preference. Adequately balancing the interests of all parties in these circumstances is difficult, and a review of the provisions controlling such transactions reveals that the proper allocation of loss in such cases has not yet been optimally achieved in either the United States or Australia.

Upon bankruptcy of the debtor, the primary creditor would have both a claim against the bankrupt's estate and a right of action against the guarantor. With performance of the guarantor’s obligation to the original creditor, the guarantor becomes a creditor of the bankrupt, replacing the original creditor as a potential recipient of bankruptcy distributions. The bankruptcy regulation of guarantee transactions has certain procedural complexities due to the adjustment of rights, outside of bankruptcy, between the creditor and guarantor. Nevertheless, the ultimate loss on the debt resulting from the discharge of the debtor falls upon the guarantor, such loss being reduced by any distributions from the estate to the guarantor.

Transfers prior to bankruptcy which effect a preference to the primary creditor also reduce the potential liability of the guarantor on the debt. Thus, guarantors in a position of control or influence over the debtor may seek to assure that the debt which they have guaranteed is paid in priority sequence to those of other creditors. This may, of course, be accomplished with the knowledge and consent of the original creditor; however, the creditor may also remain totally unaware of the circumstances of the payment. Punitive notions aside, any such transaction which is avoided as a preference should theoretically result in regulation under bankruptcy

4. Despite the fact that the Australian Law Reform Commission has proposed that the statute concerning guarantors benefited by a preferential transfer be broadened to encompass related party guarantors other than corporate officers (see INSOLVENCY LAW REFORM DISCUSSION PAPER, supra note 1, at para. 435), the formulation of the current Australian corporate guarantor statute necessitates that treatment of company controllers who have given guarantees for their company’s debts be used as the primary basis of comparison of Australian and United States legislation. Nevertheless, observations concerning the regulation of preferential transfers which involve corporate officers who are guarantors of the debt apply equally to any situation where the debtor is closely associated with the guarantor.
equivalent to the position of the parties had the transfer never occurred. Unfortunately, this objective is not always achieved.

Where a transfer prior to bankruptcy benefits a creditor and, consequently, the guarantor of such debt, recovery of the transfer may be accomplished in several ways. Most obvious is the recovery of the transfer from the recipient creditor, which would enable the creditor to claim for such surrendered preference in bankruptcy. This surrender would increase the debtor's estate and restore debtor and creditor to the positions they would have been in had the transfer not been made. With regard to the respective rights of the creditor and guarantor inter se, the trustee's recovery of the preference should also revive the obligations of the guarantor to the principal creditor. In such a case, ultimate liability for the debt and the loss resulting from the debtor's insolvency would fall on the guarantor. However, to ensure equity as between the guarantor and the debtor's other creditors, the guarantor must be entitled to a proportionate share of the debtor's assets along with other creditors of equal priority.

Alternatively, recovery may be effectuated directly from the guarantor. This is a particularly attractive option in circumstances where recovery from the original creditor is not possible because of the inability of the administrator of the bankrupt's estate to prove the elements of a preference with regard to the creditor alone or because of the successful application by the creditor of a defense to recovery. To return the guarantor to the pre-transfer position, recovery of the transfer from the guarantor should also result in the participation of the guarantor in appropriate distributions from the bankrupt's estate.

Finally, the recovery of the preferential transfer might best be accomplished by one single procedure involving both the creditor and guarantor. While this would be beneficial to the bankrupt's estate, both by maximizing the chances of recovering a preferential transfer and by avoiding unnecessary litigation, it would also provide desired judicial supervision to protect the relative rights of the guarantor and creditor. Adjustment of the rights of the creditor and guarantor in this regard may best be accomplished where both are parties to the proceedings. Consequently, allowing both creditor and guarantor the ability to involve the other in the recovery proceedings (even when the administrator of the bankrupt's estate has not desired to do so) may be the best procedure for the proper regulation of such transfers.

The United States and Australia differ in their regulation of voidable preferences in relation to guarantor officers in several respects. The most important of these is that the United States applies its general preference statute to transactions involving guarantors while Australia has found it useful to legislate for prefer-
ences benefiting guarantor officers by a separate, specific statute. Because of these differing approaches, potential complications in achieving the proper supervision of transfers involving insider guarantors are best appreciated through a review of the relevant provisions. This article first considers the preference legislation of section 122 of the Australian Bankruptcy Act\(^5\) (the general preference provision) and section 453(5) of the Companies Code\(^6\) (the specific statute concerning preferences which benefit guarantor officers). The United States preference statute, 11 U.S.C. § 547, is then considered, with the United States and the Australian provisions being contrasted in their application to transactions involving guarantors. The merits and deficiencies in each country’s system in achieving similar objectives are also considered.

II. THE AUSTRALIAN MODEL

In Australia, preference regulation is governed by two statutes. The general preference provision, section 122 of the Bankruptcy Act, will be discussed first, followed by a review of the guarantor preference statute, section 453(5) of the Companies Code.

A. Bankruptcy Act Section 122

In Australia, section 122 of the Bankruptcy Act of 1966 governs the general regulation of pre-bankruptcy preferences.\(^7\) This provision defines\(^8\) which pre-bankruptcy dealings are potentially

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5. The Bankruptcy Act, AUSTL. C. ACTS, No. 33 (1966) is federal legislation covering non-corporate bankruptcy.

6. The Companies Code is cooperative legislation passed in substantially identical form by each state of Australia and by its federal government to avoid constitutional problems concerning the power to regulate companies.

7. Section 451(1) of the Companies Code, which applies § 122 of the Bankruptcy Act to companies in liquidation, provides:
   A settlement, a conveyance or transfer of property, a charge on property, a payment made, or an obligation incurred, by a company that, if it had been made or incurred by a natural person, would, in the event of his becoming a bankrupt, be void as against the trustee in bankruptcy, is in the event of the company being wound up, void as against the liquidator.

8. Section 122 of the Bankruptcy Act, AUSTL. C. ACTS, No. 33 (1966), provides:
   (1) A conveyance or transfer of property, a charge on property, a payment made or an obligation incurred by a person who is unable to pay his debts as they become due from his own money (in this section referred to as “the debtor”), in favour of a creditor, having the effect of giving that creditor a preference, priority or advantage over other creditors, being a conveyance, transfer, charge, payment or obligation executed, made or incurred
   (a) within six months before the presentation of a petition on which, or by virtue of the presentation of which, the debtor becomes a bankrupt; or
   (b) on or after the day on which the petition on which, or by virtue of presentation of which, the debtor becomes a bankrupt is
subject to invalidation.9 Particular defined dealings or transactions by an insolvent debtor in favor of a creditor occurring within six months prior to the commencement of the debtor’s bankruptcy which have the effect of giving the creditor a preference, priority, or advantage over the debtor’s other creditors come within the ambit of section 122(1).10 Unlike the equivalent British provision from which section 122 was derived, the intention of the debtor to prefer the creditor is irrelevant. The section focuses on the effect of the dealing and not on the intent or state of mind of the debtor.11

Section 122(1) requires that a particular dealing between debtor and creditor be capable of classification as one or more of “a conveyance or transfer of property, a charge on property, or a payment made, or an obligation incurred.” These expressions, undefined in the Bankruptcy Act, cover most conceivable dealings between a debtor and a creditor. Nevertheless, section 122 is confined to the enumerated dealings and may not be applied to regulate all legal consequences which flow from a tripartite transaction, such as exist between a debtor, a guarantor and a creditor.

The dealings which apply to the usual transactions between a principal debtor and a creditor are “transfer of property,” “payment,” and “charge on property.” The term “transfer of property” is construed widely. It includes every means by which property may be passed from one person to another.12 The repayment of a past indebtedness, the most common form of preferential dealing, comes within the expression “a payment made.”13 The payment may be in cash but also includes payment by check, payment taking

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9. While § 122(1) of the Bankruptcy Act of 1966 provides that preferential dealings are void as against the trustee in bankruptcy, it is settled that they are not void ab initio but voidable at the option of the trustee in bankruptcy. See N.A. Kratzman Pty. Ltd. v. Tucker (No. 2), 123 C.L.R. 295 (Austl. 1968); N.A. Kratzman Pty. Ltd. v. Tucker (No. 1), 123 C.L.R. 257 (Austl. 1966); Broughton v. Barker [1862] 1 N.S.W.S. Ct. Cas. 78 (Eq.); Re Tucker’s Application, 1969 Q.R. 193; In re Hart, [1912] 3 K.B. 6 (C.A.).

10. The trustee bears the onus of proving each element of § 122(1) of the Bankruptcy Act of 1966.


13. “Transfer of property” overlaps with the term “payment” in that a payment of money is also regarded as a “transfer of property” for purposes of § 122(1). See Ex parte Law v. Austin (Re Bailey), 16 A.B.C. 80 (1952); Richardson v. Commercial Banking Co. of Sydney (Re Price (No. 6)), 15 A.B.C. 26 (1949); Ex parte Official Receiver (Re Docker), 10 A.B.C. 198 (1938); Ex parte Trustee (Re Smith), 6 A.B.C. 49 (1933); Ex parte Young (Re Kelly), 4 A.B.C. 258 (1932); Ex parte Hungerford (Re Sotiros), 4 A.B.C. 125 (1931).
place when the proceeds are credited to the creditor's account. The expression "charge on property" means any type of security interest in property, including, unlike the United States, charges unperfected by registration. While appropriate classification of the dealing is an essential element of the trustee's case, section 122(1) only renders voidable against the trustee changes effected by these dealings. The dealings themselves remain valid. As a result, where a dealing between a debtor and a creditor is of the type prohibited by section 122, the section has potential operation against that creditor but does not normally affect the guarantor.

The existence of a debtor-creditor relationship is an essential prerequisite to the operation of section 122. As noted in Robertson v. Grigg, "[N]othing can amount to a preference unless the person preferred is a creditor." While there is no preference if the creditor acquired such character as a consequence of the dealing, section 122 does not invalidate a dealing with a person merely because he is already a creditor. The dealing must confer a preference in relation to his capacity as a creditor for past indebtedness. In Australia, as in the United States, the existence of a preference requires proof that an impugned dealing made by the debtor in favor of the creditor is on account of an antecedent debt. Finally, section 122 requires proof by the trustee that the questioned transaction was effected while the debtor was insolvent, that it occurred within six months of bankruptcy, and that it had the effect of giving the

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15. Burns v. Stapleton, 102 C.L.R. 97, 104 (Austl. 1959). Section 5(1) of the Companies Code extends the meaning of "charge" to include agreements to grant or execute charges. For authority that "charge" in § 122 of the Bankruptcy Act also includes a floating charge, a common form of corporate security over inventory and receivables, see M. Hoffman Nominees Pty. Ltd. v. Cosmas Fish Processors Pty. Ltd., 1 A.C.L.C. 52 (Vic. 1981) (Marks, J., single justice), aff'd 1983 V.R. 349 (1982).

16. Burns, 102 C.L.R. at 97, 104.

17. 47 C.L.R. at 97, 104.


19. See Burns, 102 C.L.R. 97.

20. Section 451(2) of the Companies Code defines the relevant date for companies which corresponds with the date of presentation of the bankruptcy petition of an individual for purposes of § 122 of the Bankruptcy Act of 1966. In most cases, the relevant
creditor a preference over other creditors. The section, unlike its United States counterpart, provides no assistance for the establishment of insolvency at the time of transfer. It does not distinguish between transactions involving insiders and those involving arm's length creditors. Even the fundamental concept of a preference or advantage is left without further clarification (although it may be said that this has been adequately accomplished through judicial interpretation). These difficulties in applying section 122 have marked the statute as being appropriate for reform. Despite the importance which any proposed changes would have generally, this article is concerned with the specific application of preference statutes to guarantors. Notwithstanding any easing of the trustee's burden which such reforms might provide, section 122 would remain generally inapplicable to guarantors for the reasons discussed below.

As with the United States preference statute, the Australian provision not only indicates the broad circumstances which may give rise to avoidance but also contains protective provisions in section 122(2), the most important of which are those in paragraph (a) of that subsection. If a trustee successfully invokes section 122(1), the creditor can protect the dealing from invalidation by establishing that it was made or incurred in good faith, for valuable consideration, and in the ordinary course of business.

The actual application of section 122(2)(a) is, however, more complex than it might first appear. The initial element of the defense requires that the dealing be made in "good faith." This term is not used in its ordinary sense, although it does connote an absence on the creditor's part of any knowledge that a preference has date will be the commencement of winding up (see §§ 365, 393 of the Companies Code). However, where liquidation is preceded by official management, the relevant date is the commencement of the official management, which occurs on the date specified in the resolution placing the company under official management (see § 341(1) of the Companies Code). This earlier commencement date of the preference period is one of the features designed to make official management an attractive proposition. Indeed, § 348 of the Companies Code gives official managers the same rights as liquidators to invalidate preferences conferred on creditors.

21. Section 122 of the Bankruptcy Act of 1966 requires proof of "equitable insolvency," that the debtor was unable to pay his debts as they became due. By contrast, the United States provision requires proof of "balance sheet insolvency."


24. See infra notes 231-46 and accompanying text.

25. Section 122(2)(a) of the Bankruptcy Act of 1966 provides that nothing in the section affects "the rights of a purchaser, payee or encumbrancer in good faith and for valuable consideration and in the ordinary course of business."
been given. Also, the concept concentrates upon the creditor's awareness, determined on objective grounds, of the debtor's financial difficulties at the time the dealing was made and his awareness of the debtor's intention to confer a preference. Section 122(4)(c), while not purporting to list all circumstances in which good faith will be lacking, nevertheless clarifies what is meant by "good faith" in section 122(2)(a) by deeming there to be an absence of good faith if, on an objective examination of the circumstances relating to the impugned dealing, it can be inferred that the creditor had reason to suspect that the debtor was insolvent and that the effect of the impugned dealing would be to provide the creditor with a preference over the debtor's other creditors. Thus, "good faith" under section 122(2)(a) requires not only the absence of actual knowledge on the part of a creditor of the debtor's insolvency and debtor's intention to prefer, but also that, even where the creditor receives payment in complete honesty, circumstances were not such "as to lead to an inference by the court that there was reason to suspect according to the standards of an ordinary reasonable man."

More problematic than the requirement of "good faith" under section 122(2)(a) is the necessity that the transaction be in the "ordinary course of business." Whereas the interpretation of "ordinary course of business" under the United States preference statute has, until recently, placed greater emphasis upon the terms of the dealings than the knowledge or intentions of the parties, the Australian courts have long judged whether a transaction was within the ordinary course of business primarily by reference to the intentions of the parties. The orthodox view of section 122(2)(a) has been that it was intended to protect innocent recipients of preferential transfers, and thus "ordinary course of business" refers to a "transaction into which it would be usual for a creditor and debtor to enter as a matter of business in the circumstances of the particular case unin-

28. Section 122(4)(c) provides:
[A] creditor shall be deemed not to be a purchaser, payee or encumbrancer in good faith if the conveyance, transfer, charge payment or obligation was executed, made or incurred under such circumstances as to lead to the inference that the creditor knew, or had reason to suspect
(i) that the debtor was unable to pay his debts as they became due from his own money; and
(ii) that the effect of the conveyance, transfer, charge, payment or obligation would be to give him a preference priority or advantage over other creditors.
31. See infra notes 142-60 and accompanying text.
fluenced by any belief on the part of the creditor that the debtor might be insolvent."

A recent case from the Supreme Court of Western Australia, *Kyra Nominees Pty. Ltd. v. National Australia Bank Ltd.*, concludes, however, that the intention of both debtor and creditor are relevant to determining whether a transaction is in the ordinary course of business. Drawing support from the Australian High Court case of *Taylor v. White*, in which the court stated in dictum that "payment in the ordinary course of business negatives any design or intent to prefer the creditor," the Western Australia Supreme Court held that "it is not in the ordinary course of business for one of the parties to make a payment, the dominant purpose of which is to give a priority, albeit unbeknown, to the payee rather than carry on their usual business arrangement of using the overdraft facility for trading."

Were the "ordinary course of business" aspect of the defense judged by reference to the knowledge of the recipient alone, it could be regarded as duplicating the requirement of "good faith." Applying the requirement of "ordinary course of business" by reference to the knowledge and intent of both transferor and transferee, however, imposes an unnecessary burden upon innocent recipients who have no knowledge of or control over the transferor. *Kyra Nominees*, which supports an interpretation providing little or no protection to innocent recipients of transactions having a preferential effect, indicates that this aspect of Australian preference regulation warrants reconsideration.

The final requirement of the defense of section 122(2)(a) is that of valuable consideration. In the context of preferential transfers, however, this requirement adds little. The discharge of a prior indebtedness in exchange for a payment, transfer, or charge is valuable consideration for such payment. Nevertheless, any transfer

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32. *Downs Distributing Co.* 76 C.L.R. at 480 (opinion of Williams, J.).
33. 4 A.C.L.C. 400 (W. Aust. 1986).
34. 110 C.L.R. 129 (Austl. 1964).
35. 110 C.L.R. at 153 (opinion of Taylor, J.).
36. 4 A.C.L.C. at 413 (opinion of Rowland, J.).
37. This is the contention of the Australian Law Reform Commission. See *Insolvency Law Reform Discussion Paper*, supra note 1, at para. 427. However, "good faith" may require a more objective standard. See supra notes 26-30.
39. Fortunately, the Australian Law Reform Commission has proposed drastic changes to this aspect of the defense to recovery of a preference. See *Insolvency Law Reform Discussion Paper*, supra note 1, at paras. 427-28.
for which valuable consideration is not given may not be protected by the defense.\footnote{41} In the event the trustee successfully invalidates a dealing, section 122(5) restores the status quo ante. The creditor is put back in the position occupied prior to the preferential dealing by the debtor. Accordingly, if a preferential dealing is the repayment of a debt, the trustee can recover that debt for the benefit of the bankrupt's estate, leaving the creditor with the right to prove for that amount. However, if the preferential dealing involves the grant of a secured interest in the debtor's property, the consequence of a successful invocation of section 122 is simply to remove the creditor's secured status; the underlying debt remains. The creditor then ranks equally in priority with other similar ranking creditors for purposes of dividends from the bankrupt estate. In either case, the creditor is left with a claim from the debtor's estate or with recourse to the guarantor if the guarantor's liability on the guarantee can be revived.

Section 122, however, does not adequately address the position of a guarantor. Indeed, there is merit in the assertion that it was never meant to apply to such persons.\footnote{43} While section 453(5) of the

\footnote{41} This may include forbearance to sue. N.A. Kratzmann Pty. Ltd. v. Tucker, 123 C.L.R. 257, 289 (Austl. 1966).

\footnote{42} For example, provision of additional security will not be protected where there was no direct exchange for valuable consideration. See J. O'DONOVAN, supra note 26, at 323.

\footnote{43} Section 95(1) of the Bankruptcy Act 1924-1960, reprinted in AUSTL. C. ACTS (1955) at 665, the predecessor of the present § 122, avoided a dealing which had "the effect of giving a creditor or any surety or guarantor for the debt due a preference" [emphasis added]. The reference to sureties and guarantors was taken from the United Kingdom provision and was deliberately omitted when the preference provision was redrafted in its present form. See T. CLYNE, THE REPORT OF THE COMMITTEE APPOINTED BY THE ATTORNEY-GENERAL OF THE COMMONWEALTH TO REVIEW THE BANKRUPTCY LAW OF THE COMMONWEALTH para. 180 (1962) [hereinafter Clyne Report], wherein the following justification was provided for the deletion:

[T]he English section differs materially from its Australian counterpart in that it makes the intention of the debtor to give a preference, and not the fact of the preference, the crucial matter. If the reference to a surety or guarantor were not included in the English section, and it were shown that the debtor's intention was to prefer not the creditor but a surety or guarantor for the relevant debt, the payment could not be set aside as a preference. Since, under the Commonwealth section, the intention of the debtor is immaterial, it does not appear to be possible for a payment to give a preference to a surety or guarantor without at the same time giving a preference to the principal creditor.

The difficulties of applying the former United Kingdom statute to transfers intended to benefit only a guarantor are addressed in Ex parte Trustee (In re Warren), [1900] 2 Q.B. 138, and in Ex parte Official Receiver (In re Mills), 58 L.T.R. 871 (C.A. 1883). The general weight of opinion was that, even after the alteration, the United Kingdom statute only allowed recovery against the creditor in such situations. See Ex parte Trustee v. Barclays Bank (In re Conley), [1938] 2 All E.R. 127 (C.A.); Ex parte Barclays Bank v. Trustee (In re Lyons), 1934 All E.R. 124 (C.A.). Contra In re G.
Companies Code, discussed below, provides for direct recovery from guarantors, it is restricted to guarantor company officers and does not extend to guarantors of non-corporate debtors. For guarantors of non-corporate debt, only section 122 is relevant. However, in order for it to have any impact on a guarantor, invalidation of a dealing must restore the guarantor to the position he occupied before the dealing by the debtor was concluded. Section 122 is, unfortunately, inadequate to restore the guarantor to his pre-preference position.

Unlike the United States preference provision, section 122 does not permit, except in unusual circumstances, direct recovery by the trustee in bankruptcy against the guarantor. The advantage a guarantor receives when his obligations under the guarantee are discharged fails to satisfy the threshold issues of section 122(1). "Payment" does not adequately describe the position of a guarantor who is discharged from a liability to the creditor upon repayment by the principal debtor.

Further, a debtor-creditor relationship in respect of an antecedent debt may not exist. However, where the debtor makes a direct payment to the guarantor after the guarantor has fulfilled his obligations under the guarantee, section 122(1) may apply. In such circumstances, the guarantor will no longer be a contingent creditor but will be a creditor either through subrogation or through the debtor's implied obligation of reimbursement.

The case of Re J.F. Aylmer (Manildra) Pty. Ltd. illustrates that section 122 may also be used where the discharge of a guarantor's liability to the principal creditor is an inseparable part of a wider transaction which gives a guarantor a preference over the debtor's other creditors. Unfortunately, the unusual circumstances

Stanley & Co., 1925 Ch. 148. It is doubtful that the Australian statute was intended to provide even broader remedies.

See also Clyne, An Outline of Some Recommendations for the Amendment of the Bankruptcy Act, 1 FED. L. REV. 24, 40 (1964).

44. The primary debtor is contingently liable to the guarantor while the principal debt is wholly or partially unsatisfied. Re J.F. Aylmer (Manildra) Pty. Ltd., 12 F.L.R. 337, 342 (N.S.W. 1968); Re Timbectee Pty. Ltd., [1974] 1 N.S.W.R. 613, 617 (Eq.).


46. Where a person enters into a guarantee at the valid request of another, it is presumed that there is an implied term that the principal debtor will indemnify the guarantor with respect to any liability to the creditor under the guarantee. Israel v. Foreshore Properties Pty. Ltd., 30 A.L.R. 631, 636 (1980); In re A Debtor (No. 627 of 1936), 1937 Ch. 156 (C.A. 1936); Anson v. Anson, [1953] 1 Q.B. 636; Johnson v. Royal Mail Steam Packet Co, 3 L.R.-C.P. 38, 43 (1867); O'DONOVAN & PHILLIPS, supra note 45, at 446.

under which section 122 was applied in that case to avoid the discharge of liability on a guarantee provides little guidance as to the scope of the potential application of section 122 to guarantors on this ground.\textsuperscript{48}

Section 122(1) does not require the trustee to establish that the creditor who is preferred by the dealing made by the debtor is the direct recipient of it. What is required is that the dealing be "in favour of a creditor".\textsuperscript{49} In \textit{Commercial Banking Co. of Sydney Ltd. v. Colonial Financiers of Australia Pty. Ltd.},\textsuperscript{50} for example, the Supreme Court of Victoria held that a payment into court\textsuperscript{51} was a voidable preference so that the creditor's only rights in respect of it were as dividends from the debtor's estate. With respect to the argument that there was no direct payment by the debtor to the creditor by virtue of a payment into court, Justice Smith commented:

\begin{quote}

The words "in favour of a creditor" cannot, in my opinion, be read as relating only to cases in which a disposition or payment is made to the creditor himself or to another person on his behalf .... The making of the payment put the appellant into the situation that if it established its case and recovered judgment it would be entitled \textit{ex debito justitiae} as against the defendant (whatever might be the situation as against other creditors or claimants) to have the money, or so much of it as was necessary, paid out to the appellant to satisfy its judgment.\textsuperscript{52}

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Applying this analysis of section 122(1) so as to give a trustee direct rights against guarantors, it is arguably permissible to assert that the direct recipient of the payment of a guaranteed debt is the primary creditor. However, because the payment extinguishes the liability under the guarantee, it is in favor of the guarantor, a con-
tingent creditor of the debtor. There are no Australian cases which have considered section 122(1) in this way, and even if they did, the court might well be swayed by the practical consequences of permitting such direct recovery from the guarantor. The lack of any entitlement of the guarantor to participate in the debtor's estate was considered significant by the Supreme Court of New South Wales in Re Timbatec Pty. Ltd. when it refused direct application of section 122 against a guarantor:

[T]he principal creditor having been paid in full and no steps having been taken by the liquidator to set aside this particular payment, there would be no amount for which (the guarantor) could prove. He would presumably receive no dividend in respect of the amount which he had been called upon to pay in to the common pool.

In contrast to the United States approach, discussed below, it is apparent that in ordinary circumstances section 122(1) does not permit direct recovery from a guarantor as a consequence of his discharge of liability independently of successful recapture proceedings against the creditor. As the Supreme Court of New South Wales explained in Re Timbatec Pty. Ltd., discharge of the guarantor's liability to the principal creditor is not an independent transaction in itself. Rather, it is an effect or consequence of the debtor's payment. The court's opinion stated,

[I] is not possible under section 122 in circumstances such as the present, simply to invalidate the effect or consequence of the payment to the principal creditor, without avoiding the payment to him, and then make an order that the surety who has been preferred should pay the liquidator the amount which has in fact not been paid to him, but has been paid to the principal creditor.

Where both repayment to the creditor and resultant discharge of the guarantor are challenged under section 122(1), the primary creditor can protect his payment from recapture by raising defenses enumerated in section 122(2)(a). Where this is the case, the require-


54. [1974] 1 N.S.W.R. at 616.


56. Id. at 616.
ment of dual challenge against both creditor and guarantor is not satisfied, and the trustee can obtain nothing from either party despite the fact that the guarantor gains an advantage over the principal debtor's other creditors.

On the other hand, where recovery of the transfer from the initial transferee is accomplished, the obligations of the guarantor to the transferee are not revived by operation of section 122, but are instead left to be determined pursuant to the contract of guarantee and the relevant contract law, which often leaves the creditor with no recourse upon the guarantee. Consequently, recovery of a preferential transfer from the initial recipient would, without specific contractual provision for the revival of the guarantor's obligations, place the entire burden of the recovery upon the initial recipient (without recourse to the guarantor) rather than returning the parties to the position they would have held had the transfer not occurred. This is illustrated in *Commercial Bank of Australia v. Carruthers,* where a payment from a debtor to his bank, resulting in discharge of the guarantor's liability upon the debt, was recaptured as a preference. Although the payment by the debtor to the bank was recovered, this did not, according to the Supreme Court of New South Wales, necessarily revive the obligation of the guarantor upon the debt. Consequently, aside from contractual arrangements reviving the guarantor's liability upon the recovery of a payment from the primary creditor, the guarantor's liability remains discharged, and the creditor's only recourse on surrender of such preference is to prove for dividends from the bankrupt's

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57. 82 W.N. (N.S.W.) Pt. 1, 76 (1964).
58. This very result was anticipated in the Clyne Report, *supra* note 43. The Committee reports, at paras. 177-78:

It has been urged on behalf of certain banks that where a payment by a debtor to a creditor is avoided by section 95 as a preference and a person was a surety or guarantor for the debt, the creditor should, on repayment to the trustee of the amount received by him, have the same remedies against the surety or guarantor, and against any property mortgaged or charged by the surety or guarantor as security, as he would have had if the debtor had nor made the payment to the creditor. The Committee has given careful attention to this suggestion, which at first sight appears to be a reasonable provision aimed at achieving substantial justice for all parties concerned. However, the Committee has come to the conclusion that such a provision should not be included in the legislation.

In coming to this conclusion, the Committee has had regard to the difficulties that would arise in restoring all the parties to their former positions many months after the payment concerned had been made. To take one example, a surety may have entered into such other commitments on the faith of his apparent release from liability as would make it inequitable to restore the creditor's rights against him. The Committee has also taken into account that it is open to a creditor who takes a surety or guarantee to make it a condition of giving credit that the surety or guarantor shall remain liable if payment by the debtor is set aside as a preference.
estate.59

B. Companies Code Section 453(5)

Whilst the general preference provision, section 122, may in appropriate circumstances invalidate a payment by a debtor to a creditor, it does not operate to allow direct recovery against sureties and guarantors.60 Nevertheless, company officers who have been discharged of liability on their guarantees of a company debt may still be liable under company law. Recovery of such transfers, for example, has recently been allowed in Australia under the theory that corporate insiders have misused their positions of trust in order to benefit themselves through the preferential payment.61 Of greater relevance, however, is a specific section in the Companies Code, section 453(5), which provides for the liability of corporate insiders for certain preferential transfers upon liquidation of their company. This section allows the company liquidator (the equivalent for companies of the trustee in bankruptcy) to recover from an officer62 the value of property disposed of by a company where such disposition: “(i) occurs within 6 months before the commencement of the winding up of the company; (ii) confers a preference upon a creditor of the company; and (iii) has the effect of discharging that officer of the company from a liability.” Where the liquidator has already recovered from the creditor part of the value of the relevant property or part of the actual property, the right of recovery against the officer is limited to the unrecovered portion.63

59. The decision in Carruthers is at odds with both United States and United Kingdom authorities on this point. See Swarts v. Fourth Nat. Bank, 117 F. 1 (8th Cir. 1902); Petty v. Cook, 6 L.R.-Q.B. 790 (1871); ROWLATT ON PRINCIPAL AND SURETY 123 (3d ed.).

60. Apparently, § 122 was never intended to allow such recovery. See supra note 43.


62. Under § 5(1) “officer” includes:
   (a) a director, secretary, executive officer or employee of the corporation;
   (b) a receiver and manager of property of the corporation appointed under a power contained in an instrument;
   (c) an official manager or deputy official manager of the corporation;
   (d) a liquidator of the corporation appointed in a voluntary winding up of the corporation; and
   (e) a trustee or other person administering a compromise or arrangement made between the corporation and another person or other persons, but does not include:
      (f) a receiver who is not also a manager;
      (g) a receiver and manager appointed by a court; or
      (h) a liquidator appointed by a court.

63. Section 453(5) provides:
Although the reasons for the enactment of section 453(5) are unarticulated in the legislative history of the Companies Code, the application of direct liability of guarantors only in relation to company officers makes it likely that section 453(5) was intended to prohibit company officers, as fiduciaries, from benefiting themselves by virtue of their positions and to generally prevent circumvention of insolvency regulation. As indicated in the analysis of the requirements of section 453(5) and review of relevant authorities (Re K.D.S. Construction Services Pty. Ltd.64), this subsection is in some respects not as effective as it might be and in other respects treats officers unfairly.

It is apparent that section 453(5) applies only if there is a "disposition of property" made by the debtor company. This is in contrast to section 451(1) of the Companies Code and section 122(1) of the Bankruptcy Act which focus on a wider range of transactions.65 In this respect, section 453(5) adopts similar terminology to section 368(1) of the Companies Code, which invalidates any "disposition of property" made after the commencement of winding up.66 It seems clear that a payment by a debtor company to a creditor is a "disposition of property" in this context.67

It is doubtful, however, whether the expression "disposition of
property" in section 453(5) extends to the granting of a secured interest in the company's property. This means that section 453(5) would not allow recovery from an officer where his company gives a previously unsecured creditor a mortgage or charge over its property in consideration of which the creditor discharges the officer from a liability under a guarantee. Whilst this situation is uncommon in practice, this limitation on the operation of section 453(5) is unwarranted. There is no reason in principle why section 453(5) should be restricted to dealings between the company and its creditor which amount to a "disposition of property" and not be applied to all transactions capable of being classified as preferences.

Clearly, section 453 does not apply to all dispositions which have the stated effect. Dispositions to the creditor are made "within the period of 6 months before the commencement of the winding up of the company." Further, under section 453(5)(b), the disposition of property must confer a "preference" on a creditor of the company; however, that requirement is somewhat ambiguous. A "preference" conferred on the creditor for purposes of that paragraph could be either a transaction which comes within the ambit of section 122(1), but which is protected from recovery by section 122(2), or a transaction in which recovery from the creditor under section 122 may be accomplished because no defense is available.

Which meaning of the term "preference" was intended in section 453(5)—a technical preference satisfying only the requirements of § 368(1)(A), indicating that otherwise such payments would be included as dispositions under § 368(1). 68. According to Re Margart Pty. Ltd., 2 A.C.L.C. 709, 712 (N.S.W. 1984) (Helsham, C.J. in Eq., single justice), a disposition of property normally connotes "a change in the beneficial ownership of an asset by transfer or other type of dealing." See also Re Mal Bower's Macquarie Elec. Centre, [1974] 1 N.S.W.L.R. 254. Note also that, in addition to "disposition of property," § 122 of the Bankruptcy Act and § 451 of the Companies Code specifically refer to "a charge on property," a term absent in § 453(5).

Recovery of preferential transfers under § 451 is allowed for transactions within six months of the commencement of official management where such precedes winding up. See supra note 20. It is not clear why official managers are not also able to recover from officers in circumstances where § 453(5) would otherwise apply. A suggested lengthening of the preference period to two years for "related person" creditors has been proposed by the Australian Law Reform Commission. See INSOLVENCY LAW REFORM DISCUSSION PAPER, supra note 1, at para. 425.

71. See Bankruptcy Act of 1966, § 122(2). Section 453(6) is consistent with the former interpretation. Under that provision, where the liquidator succeeds in recovering from an officer under § 453(5) and subsequently recovers from the creditor under § 122, the liquidator must reimburse the officer. While an officer's right to be reimbursed is dependent on the successful invalidation of the disposition vis-à-vis the creditor, there is nothing in § 453(5) to indicate that the liquidator is required to take any action against the creditor at all.
of section 122(1) or a preference actually recoverable under section 122—was considered in *Matthews v. Geraghty*, a recent decision of a three-judge panel of the Supreme Court of South Australia. In this case, the first in Australia to consider section 453(5), both Chief Justice King and Justice Bollen agreed that a company could confer a preference, as required by section 453(5), even though the recipient of the preferential transfer could have argued defenses to recovery under section 122. Chief Justice King concluded that the term “preference” in section 453(5) was merely a disposition of property which gave its recipient an advantage over other creditors, explaining that:

[T]he word (“preference”) is not used in section 453(5) in any such compendious sense as that contended for is made clear by the fact that certain of the other elements of section 122 of the Bankruptcy Act are reproduced in either identical or analogous terms in [section] 453(5) . . . . If the word “preference” were intended to comprehend all the elements included in [section] 122(1), there would be no need to reproduce those elements or their analogues in [section] 453(5).

Despite the clarification provided in *Matthews v. Geraghty* with regard to the meaning of the term “preference” in section 453(5), it may be contended that the term, though accepted as not incorporating all of the requirements of section 122, continues to be ambiguous. One remaining uncertainty concerning its application in section 453(5) is presented by the difference between section 122 and section 453(5) regarding insolvency.

The general preference provision, section 122 of the Bankruptcy Act, allows the avoidance of a wide range of transactions which effect a preference only if made by a person when he is unable

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72. This dichotomy also existed in the United States preference statute prior to 1903. Under the 1898 statute, technical preferences were defined under § 60(a), while successful recovery necessitated that § 60(b) also be satisfied. In Carson, Pirie, Scott & Co. v. Chicago Title & Trust Co., 182 U.S. 438 (1901), disallowance of claims due to the creditor’s receipt of a preference under § 57 was interpreted as referring to preference in the narrow, technical sense rather than requiring that a fully avoidable transfer be found. See also Campanella v. Liebowitz (In re Peter Cassinelli Macaroni Co.), 103 F.2d 252 (3d Cir. 1939); Pitts, Insider Guarantees and the Law of Preferences, 55 AM. BANKR. L.J. 343, 351 (1981). Interestingly, this interpretation accords with the Australian application of preference in relation to § 453(5).

73. 4 A.C.L.C. 727 (S. Austl. 1986).

74. The company maintained two accounts with the A.N.Z. Bank, a current account and an advance account in overdraft whose payment was guaranteed by the company’s directors. Just prior to the company’s being placed in liquidation, it deposited funds into its current account which were sufficient to cover the overdraft in its advance account. The bank, without the knowledge of the company, transferred these funds from the current account to the advance pursuant to a “Letter of Set-Off” which the company had previously executed. The directors contended that § 453(5) did not apply as there was no “preference.” They asserted that the term, when used in § 453(5), referred to a transaction which could be recovered under § 122.

75. 4 A.C.L.C. at 733.
to pay his debts as they become due. While this requirement of insolvency at the time of the transaction likewise applies to companies by virtue of Companies Code section 451, there is no reference to the insolvency of the company at the time of the disposition of property effecting a discharge of a guarantor's liability in section 453(5). While it is difficult to see how in normal circumstances there could be a preference (a disposition of property which gave its recipient an advantage over other creditors according to Matthews v. Geraghty) in a situation in which the debtor was able to pay his debts when they came due if the preferential effect of the transfer were judged only by reference to circumstances at the time of the transfer. Because the subsequent insolvency of a company may be appropriately considered in determining whether a transfer was preferential, this omission in section 453(5) may relieve the liquidator of the necessity of proving insolvency at the time of the transaction as an element of recovery. He would still have to show that the transaction was a preference (conferring an advantage to the recipient over other creditors), which might necessitate an enquiry into the effect of the transaction given the debtor's insolvency subsequent to the time of the transaction.

The successful operation of section 453(5) is also dependent on the liquidator establishing that the disposition of property conferring the preference had the effect of discharging an officer of the company from a liability. The term "officer" is broadly defined in section 5(1). It is suggested, however, that the section 5(1) definition is inappropriate for the purposes of section 453(5). In some respects it is too narrow. For example, section 453(5) does not apply to former directors of a company nor to the relatives of existing or former directors. If section 453(5) is to provide an effective disincentive to insiders attempting to manipulate their insolvent company's affairs to their advantage, the provision should cover all persons who are not at arm's length with the company.

Perhaps most puzzling of the elements of section 453(5) is that found in subsection (c), which necessitates that, for the section to apply, the disposition must have the effect of discharging that officer of the company from a liability. Dispositions which cause a reduc-

76. See § 453(5)(c).
77. See supra note 62.
78. By way of contrast, §§ 453(1) and (2), which concern the purchase or disposition of any property, business or undertaking by the company within four years of the commencement of winding up, give a liquidator rights of recovery when, in the appropriate circumstances, the company disposes to or purchases from
   (a) promoters of the company, their spouses or their respective relatives;
   (b) directors of the company, their spouses or their respective relatives;
   (c) related corporations or the directors of such related corporations, their spouses or their respective relatives.
tion in an officer's liability have yet to be considered by the Australian courts; however, the decision in *Matthews v. Geraghty* suggests that full discharge is required to call the section into play. This aspect of section 453(5), which substantially undermines its effectiveness, has been recognized, and reform proposals have indicated that any reduction of an officer's potential liability would be a more appropriate basis for imposition of liability upon the officer.

Section 453(5) further requires the liquidator to link paragraphs (b) and (c) of that subsection. In *Matthews v. Geraghty*, this issue was raised by the respondents' denial that there was a causative link between the disposition of property (the deposits by the company to its current account) and the discharge of the company officers required by that section. According to the directors, it was the bank's transfer to the fully drawn advance account, effected without the company's knowledge, rather than the company's deposit into its current account, which operated to discharge the directors of their liability under the guarantee. This submission was not accepted by the Court. Given the directors' knowledge of the bank's rights under the set-off agreement, the two aspects of the transaction; the deposit to the current account and the transfer by the bank to the fully drawn advance account, could not be treated separately. According to Justice Bollen:

> The fact that some other action by someone else is a step in conferring and discharging does not necessarily mean that the disposition did not confer and have the effect of discharging. Here the disposition was made by the company which, through its officers, must have known the terms and effect of the Letter of Set-Off. That disposition played a significant and, indeed, an essential part in the conferring and discharging.

Despite *Matthews v. Geraghty*, section 453(5)(c) is still difficult to apply. For example, the section requires that the disposition of property have the effect of discharging the officer from a liability whether under a guarantee or otherwise and whether contingent or otherwise. If the decision in *Commercial Bank of Australia Ltd v. Carruthers* is correct, payment of a guaranteed debt by the com-

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79. This point was not directly addressed in Matthews v. Geraghty, 4 A.C.L.C. 727 (S. Austl. 1986). Nevertheless, the judgments indicate that full discharge was assumed to be required under § 453(5). See, e.g., id. at 735 (opinion of King, C.J.).

80. INSOLVENCY LAW REFORM DISCUSSION PAPER, supra note 1. In para. 435, the report states: "[T]he existing provision would seem to apply only if the effect of the preference is to discharge the guarantee in full."

81. Under legislation proposed by the Commission, "if the effect of a preference is to reduce the liability of a related person under a guarantee, the liquidator may recover from that person the amount by which the liability under the guarantee is reduced." Id.

82. 4 A.C.L.C. at 732.

83. 82 W.N. (N.S.W.) Pt. 1, 76 (1964).
pany discharges the guarantor from liability to the creditor. Where, however, the guarantee is drafted so as to ensure that the guarantor is not discharged in the event of invalidation of the disposition to the creditor, section 453(5) by definition cannot apply. This gives rise to a curious anomaly. The creditor, being obliged to return the payment to the liquidator, can then turn to the guarantor. When the guarantor satisfies his obligations under the guarantee he is subrogated to the creditor’s rights against the debtor company and may prove for the debt on its liquidation.

Under section 453(5), however, the liquidator is under no obligation to challenge the disposition to the creditor before proceeding against the officer. In such a case, section 453(5)(d) specifies that the liquidator may recover from the officer an amount equal to the value of the property disposed of by the company. In other words, the liquidator may recover from the officer the payment made by his company to the creditor. No provision is made for the officer to prove for this amount in the company’s liquidation. The loss is borne by the guarantor to the advantage of the other unsecured creditors. This is unfair to the guarantor officer in that he is treated more harshly in this type of preferential transaction than he would be under preferences invalidated under section 122, which merely restores the parties to their pre-preference positions.

Likewise, where the liquidator takes section 122 proceedings against the creditor but succeeds only in recovering part of the payment, section 453(5)(e) permits him to recover the balance from the officer. Again, the officer cannot prove for this amount in the company’s liquidation. The anomaly which section 453(5) presents in this regard was acknowledged in *Matthews v. Geraghty*. In that case Chief Justice King remarked:

> If the bank had not been paid and the respondents had discharged their obligations under the guarantee, they would have been subrogated to the right of the bank to prove in liquidation. The liquidator has chosen to sue the respondents rather than to proceed against the bank to recover the amount of the preferential payment. There may be sound reasons for that course but its consequence is that the respondents are placed in a less favourable position than if they were called upon to discharge their obligations under the guarantee.

The ultimate allocation of loss between guarantor officer and creditor is governed by section 453(6). If the liquidator recovers payment from the officer and subsequently invalidates disposition to the creditor, section 453(6) entitles the officer to recover the amount

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84. The liquidator may, for instance, perceive that disposition to the creditor is protected by § 122(2).
85. See § 122(5).
86. 4 A.C.L.C. at 735.
he previously paid to the liquidator. The loss is borne by the creditor to the advantage of the guarantor officer. This legislative allocation of losses is curious given the fact that by entering into the guarantee it was contemplated by the parties that the ultimate responsibility for the payment of the company's debt would lie with the guarantor, not the creditor.

Where section 453(5) applies, a strict liability is imposed on the officer. Where the liquidator can establish the facts required by subsections 453(5)(a), (b) and (c), he can recover from the officer. On the other hand, where the company confers a preference on an officer to which section 122 applies, the officer has the ability to protect the preference if he can claim section 122(2) defenses. There appears to be no reason in principle why one type of preference should be treated differently than another. An indirect preference which discharges an officer of a liability is not inherently worse than a direct preference conferred on an officer. Perhaps, in recognition of this point, the Australian Law Reform Commission has tentatively proposed that any provision which would allow direct recovery by the insolvency administrator against "related person" guarantors be part of the general preference provision, thereby incorporating certain time limits, presumptions, and protective provisions applicable to other creditors.87

III. UNITED STATES MODEL: 11 U.S.C. § 547

The regulation of pre-bankruptcy transfers by insolvent debtors is controlled in the United States both by state laws, often derived from the English statutes,88 and, since 1841, by federal bankruptcy legislation.89 While the regulation of voidable prefer-

87. INSOLVENCY LAW REFORM DISCUSSION PAPER, supra note 1, paras. 422-35.
88. The state laws generally cover transfers which could be characterized as fraudulent transfers or bulk transfers (cf. 11 U.S.C. § 548 (1982)). The provisions of the Uniform Fraudulent Conveyance Act deal with this problem, and the interrelationship of this uniform state law to the federal bankruptcy statute and other remedies, such as equitable subordination, is examined in Baird & Jackson, Fraudulent Conveyance Law and Its Proper Domain, 38 VAND. L. REV. 829 (1985); Clark, The Duties of the Corporate Debtor to its Creditors, 90 HARV. L. REV. 505 (1977); Jackson, Avoiding Powers in Bankruptcy, 36 STAN. L. REV. 725, 777-86 (1984); Rosenberg, Interim Corporate Guarantees and the Law of Fraudulent Conveyances: Lender Beware, 125 U. PA. L. REV. 235 (1976); and Note, Good Faith and Fraudulent Conveyances, 97 HARV. L. REV. 495 (1977).
89. Although the first federal bankruptcy legislation, the Bankruptcy Act of 1800 (2 Stat. 19), did not deal directly with voidable preferences, the Bankruptcy Acts of 1841 (5 Stat. 440) and 1867 (14 Stat. 517) regulated certain pre-bankruptcy transactions where the purpose of such transactions was to prefer a creditor. The Bankruptcy Act of 1898 (30 Stat. 544) declared, in § 60(a), that a debtor shall be deemed to have given a preference if, being insolvent, he has procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer [would] be to enable any one of
ences in the United States originally followed the English pattern, current federal bankruptcy provisions, the Bankruptcy Reform Act of 1978 as amended in 1984, provides a legislative framework for the regulation of preferences distinct from that found in either the United Kingdom or in Australia. The United States statute, like that of Australia, differs significantly from the British counterpart, most noticeably in the absence of any requirement for culpable knowledge or intent by either debtor or transferee. The current provision represents the culmination of the numerous legislative amendments which have gradually altered the primary purpose of the preference provision from the prevention of wrongful conduct (as it arguably remains in Britain) to the appropriate ordering of the debtor's estate upon bankruptcy.90

A. Avoidance of Transfer Generally

In contrast to voidable preference legislation found in Australia, United States provisions regulating voidable preferences allow them to be applied to tripartite arrangements involving guarantors. However, separation of preference regulation in the United States into distinct provisions for avoidance of transfer and for recovery thereof adds complexity to the proper adjustment of rights upon recovery of a preferential transfer involving a guarantor. Similar complexity is not found in Australia.

The United States statute which renders preferential transfers voidable, codified as section 547 of Title 11 of the United States

his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class.

The Bankruptcy Reform Act of 1978 (92 Stat. 2549), as amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984 (98 Stat. 333), provides a substantially altered preference regime to that of the 1898 legislation; nevertheless, many of the cases which applied the 1898 Act, particularly in the context of preferences to insiders, continue to provide the basis for effective regulation of these transactions under the current statute (codified as 11 U.S.C. § 547).

For a comparison of the different statutes mentioned above and the cases applying them, see Weisberg, Commercial Morality, the Merchant Character, and the History of the Voidable Preference, 39 STAN. L. REV. 3 (1986); and McCoid, Bankruptcy, Preferences, and Efficiency: An Expression of Doubt, 67 VA. L. REV. 249 (1981).

90. The 1841 Act made transfers voidable if the debtor intended to prefer a particular creditor. The 1867 Act changed the appropriate enquiry to whether the creditor had knowledge of the debtor's intent to prefer. The 1898 Act originally indicated in § 60(b) that a preference was recoverable if the person receiving it or the person to be benefited thereby had reasonable cause to believe that it was intended to give a preference. This provision was amended in 1910 to require that the recipient or person to be benefited thereby need only have reasonable cause to believe that enforcement of the judgment or transfer would effect a preference. This was changed by amendment in 1938 to reasonable cause to believe that the debtor was insolvent. In 1978, the requirement of reasonable cause to believe that the debtor was insolvent was deleted.
Code,\textsuperscript{91} may be applicable to transfers involving guarantors for two separate reasons. First, the transaction may be a voidable preference in relation to the primary creditor or transferee. Second, the transaction may also be considered a voidable preference by reference to the position of the guarantor, a potential creditor. In such circumstances, the trustee in bankruptcy may have several options in assuring the surrender of the preference. The most obvious method of recovery, as with the use of section 122 of the Australian Bankruptcy Act, is to concentrate upon the preferential nature of the transfer with regard to the initial recipient. The avoidance of such transfer, uncomplicated by regard to the guarantor until the remedies available to the trustee are implemented, requires proof of the same elements, discussed below, as for avoidance of transfers not involving guarantors.

The threshold concept of a "transfer" from the debtor, upon which the application of the section is premised, is defined to encompass most conceivable types of dispositions of property or interests in property. Unlike the Australian equivalent, which effects dealings only if they fall within a listed class, the United States statute attempts a comprehensive definition consistent with a statute of broad application. While the concept of "transfer" is defined in relation to the disposition of property or property interests, this definition, found in 11 U.S.C. § 101(48), is expansive in its potential application to various methods by which such dispositions may be effected: "['T]ransfer' means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption."

\textsuperscript{91} The requirements for avoiding a transfer under the United States preference statute, 11 U.S.C. § 547, are specified in its operative portion, subsection (b), as follows:

Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest in property of the debtor—

(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made—
(A) on or within 90 days before the date of the filing of the petition; or
(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) that enables such creditor to receive more than such creditor would receive if—
(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.
Though the current definition of transfer differs slightly from that found in the 1896 legislation considered by the United States Supreme Court in *Carson, Pirie, Scott & Co. v. Chicago Title & Trust Co.*,\(^92\) that case nevertheless indicates that this initial requirement has, even from that early date, been broadly applied:

"Transfer" is defined to be not only the sale of property, but "every other and different mode of disposing of or parting with property." All technicality and narrowness of meaning is precluded. The word is used in its most comprehensive sense, and is intended to include every means and manner by which property can pass from the ownership and possession of another, and by which the result forbidden by the statute may be accomplished . . . \(^93\)

A second element for the application of section 547 is that the transfer be either to a creditor or for the benefit of a creditor. The definition of a creditor, found in 11 U.S.C. § 101(9), indicates that "creditor" means an entity\(^94\) that has a claim against the debtor that arose at the time of or prior to the order for relief concerning the debtor.\(^95\) It is clear from the statutory language of section 547(b)(1) that a transaction cannot be characterized as preferential unless there is a debtor-creditor relationship.\(^96\) Despite the requirement that the preference be directed to a creditor, the phrase "to or for the benefit of" has been applied to prevent circumvention of the preference statute by use of indirect transfers. In *National Bank of Newport v. National Herkimer County Bank*,\(^97\) the United States

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92. 182 U.S. 438 (1901).
94. The term "entity" is defined to include person, estate, trust, and governmental unit, 11 U.S.C. § 101(14) (1982).
95. The section further provides that creditor means:
   (B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; or
   (C) entity that has a community claim;
97. 225 U.S. 178 (1912).
Supreme Court unequivocally indicated that the substance of a transaction would be considered as paramount to its form:

To constitute a preference, it is not necessary that the transfer be made directly to the creditor. It may be made to another for his benefit. If the bankrupt has made a transfer of his property, the effect of which is to enable one of his creditors to obtain a greater percentage of his debt than another creditor of the same class, circuitry of arrangement will not avail to save it. It is not the mere form or method of the transaction that the act condemns, but the appropriation by the insolvent debtor of a portion of his property to the payment of a creditor's claim, so that thereby the estate is depleted and the creditor obtains an advantage over other creditors.

A further requirement for the avoidance of a preferential transfer in the United States is that the transfer is "for or on account of an antecedent debt owed by the debtor before the transfer was made." This statutory requirement confirms that "preference implies the paying or securing of a pre-existing debt of the person preferred." While ascertaining that the subject transfer related to an antecedent debt would appear to provide no difficulty in many circumstances, even the simplest sales transaction may nevertheless be construed as being the payment of an antecedent debt where payment given or security provided is not contemporaneous with the delivery of goods, the provision of services, or the advance of money. In assessing whether a transfer is on account of an antecedent debt, both the time when the debt was "incurred" and time when the transfer occurred must be determined. While Congress has indicated when a transfer is deemed to have occurred under 11 U.S.C. § 547(e), discussed in the context of section 547(b)(4) below, establishing when a debt is incurred as a rule of general application is obscured by the absence of legislative direction. Whilst the application of state laws complicates the process, there is general acceptance of the view that debts are incurred when the debtor

98. See 11 U.S.C. § 547(b)(5) (1982), which no longer refers to a comparison to the recovery by other members of the same class. Preferential effect is now determined by comparing the position of the recipient to the result which would have occurred under bankruptcy had the transfer not been made.
99. 225 U.S. at 184.
102. See National City Bank of New York v. Hotchkiss, 231 U.S. 50 (1913) (delay in securing a day loan of between four and five hours resulted in characterization of the provision of security as being for an antecedent debt).
103. The difficulty of ascertaining the exact date of the incurring of the debt and the date of the payment thereon is avoided in Australia, where transactions are ascertained as being preferential by placing the parties' dealings in a much broader context. See supra note 22.
104. Production Steel, Inc. v. Sumitomo Corp. of Am. (In re Production Steel), 54 Bankr. 417 (M.D. Tenn. 1985).
receives the benefit of goods or services provided and thus becomes legally bound to pay.105 Consequently, under this view most payments in a commercial context would technically be on account of an antecedent debt.106

Rather than attempting to clarify the concept of an antecedent debt,107 Congress enumerated several specific exceptions to avoidance which could apply where a transaction, though technically on account of an antecedent debt, was in reality an exchange transaction. Of particular relevance is 11 U.S.C. § 547(c)(1), which allows a recipient of a transfer to rely upon an exchange of new value for the transfer to avoid recovery where such exchange was intended to be contemporaneous and was, in fact, substantially contemporaneous. While the exception in section 547(c)(1) does not directly relate to the determination of whether a transfer is on account of an antecedent debt, it nevertheless prevents the harsh results which would follow from strict application of the antecedent debt component of section 547(b). Determining what is “substantially contemporaneous” under section 547(c)(1), however, has proved to be a difficult task in itself. Inconsistencies in the application of this exception which the cases exhibit108 indicate that both “antecedent debt” and “contemporaneous exchange” are better determined by reference to the facts of each case than through universal application of a precise statutory definition.109

105. Iowa Premium Serv. Co. v. First Nat'l Bank (In re Iowa Premium Serv. Co.) 695 F.2d 1109 (8th Cir. 1982); Barash v. Public Fin. Corp., 658 F.2d 504 (7th Cir. 1981). Several other points in the transaction at which a debt could be said to have been incurred (e.g., upon shipment or invoicing) are considered in Herbert, The Trustee Versus the Trade Creditor: A Critique of Section 547(c)(1), (2) & (4) of the Bankruptcy Code, 17 U. RICH. L. REV. 667 (1983).

106. For example, acceptance of the proposition that a debt is incurred when a service is provided rather than when an account is rendered would result in most payments on service contracts being technically on account of an antecedent debt. See, Barash v. Public Fin. Corp., 658 F.2d 504 (7th Cir. 1981).

107. Both attempts to define “antecedent debt” as a debt incurred more than five days before the transfer paying or securing it and the grounds for abandoning such a definition are fully discussed in Countryman, The Concept of a Voidable Preference in Bankruptcy, 38 VAND. L. REV. 713, 760 (1985).


109. Section 547(e) is pertinent to determining whether a transfer was “for or on account of an antecedent debt” or was “a substantially contemporaneous exchange for new value.” This section governs when a transfer is deemed to have occurred, and, though usually considered in ascertaining whether a transfer occurred within the statutory period under § 547(b)(4), may also bear upon whether a transfer was either a substantially contemporaneous exchange for new value or a transfer made on account of an antecedent debt. Transfers which would not normally be viewed as being on account of an antecedent debt may nevertheless be so regarded where, by virtue of § 547(e), they are considered to have taken place at a later time because they were not perfected within
Section 547(b)(3) requires that for any transfer to be recoverable it must have been made "while the debtor was insolvent." Insolvent is defined in 11 U.S.C. § 101(29), for entities other than partnerships,\textsuperscript{110} to be a financial condition "such that the sum of such entity's debts is greater than all of such entity's property, at fair valuation" excluding exempt property and property transferred, concealed, or removed to hinder, delay, or defraud such entity's creditors. Thus, the United States accepts the "balance sheet insolvency" test\textsuperscript{111} rather than the "equitable insolvency" test\textsuperscript{112} (the inability of a debtor to pay his debts as they come due in the ordinary course of business) preferred in Australia and other common law countries.\textsuperscript{113}

The administrative burden upon the trustee in the United States is eased significantly by the statutory presumption that the debtor was insolvent on and during the ninety days immediately preceding the date of the filing of the bankruptcy petition.\textsuperscript{114} Due to this presumption, a trustee may normally avoid a transfer, assuming the presence of the other elements of a preference, without the need to reconstruct the financial state of the debtor at the time of the transfer. Nevertheless, the ultimate burden of proof on the issue of a debtor's insolvency still remains with the trustee in bankruptcy if evidence is presented to counter the presumption.\textsuperscript{115}

\footnotesize{ten days. In such circumstances, the transfer, usually deemed to have occurred on the date of perfection, would be on account of an antecedent debt. See Weill v. Tennessee Cent. Credit Union (In re Kelley), 3 Bankr. 651 (E.D. Tenn. 1980). See also Morris, Bankruptcy Law Reform: Preferences, Secret Liens and Floating Liens, 54 MINN. L. REV. 737 (1970); Note, Avoidance of Preferential Transfers Under the Bankruptcy Reform Act of 1978, 65 IOWA L. REV. 209, 226 (1979). In such circumstances, the contemporaneous exchange exception to preference recovery becomes the primary issue of dispute. The transaction may nevertheless be protected by characterizing it as a "substantially" contemporaneous exchange for new value or by applying another of the exceptions under § 547(c).

\textsuperscript{110} Partnership insolvency includes provision for the excess of each general partner's non-partnership property over non-partnership debt.
\textsuperscript{112} See Sample v. Jackson, 223 N.C. 335, 26 S.E.2d 876 (1943) (proof of equitable insolvency considered inappropriate).
\textsuperscript{113} See Note, Preferential Transfers and the Value of the Insolvent Firm, 87 YALE L. REV. 1449, 1456-59 (1978) (questioning the appropriateness of the balance sheet test of insolvency for preferences in bankruptcy). Cf. Insolvency Act, 1986, ch. 45 (U.K.) (allowing alternative tests). Some creditors may be unaware of the financial difficulties of an insolvent firm where that insolvency is determined under the balance sheet test, whereas all creditors will be in an equal position to determine that a firm is insolvent where such insolvency is determined by equitable insolvency. Use of the equitable insolvency test would thus maintain creditor equality and further prevent creditors from taking preferences in the hope that the debtor will last the statutory period before declaration of bankruptcy.
\textsuperscript{114} 11 U.S.C. § 547(f) (1982).
\textsuperscript{115} See Clay v. Traders Bank of Kansas City, 708 F.2d 1347 (8th Cir. 1983); FED. R. EVID. 301.
In order for a transfer to be subject to recovery, it must have been made within ninety days before the date of the filing of the bankruptcy petition or, where the creditor was an insider, between ninety days and one year of filing of the bankruptcy petition. Section 547(e) provides that a transfer is made at the time such transfer takes effect between the transferor and the transferee, where such transfer is perfected at the time of the transfer or within ten days thereafter. Otherwise, the transfer is usually considered to have been made at the time such transfer was perfected.

The final requirement of a preferential transfer within section 547(b) is that the transfer enable the creditor to receive more from the debtor than that creditor would receive under straight bankruptcy assuming that the transfer had not occurred. This test of preferential effect is an advance upon that formerly provided by section 60(a) of the 1898 Act, which applied to transfers enabling a creditor to obtain "a greater percentage of his debt than any other such creditor of the same class." Under the current provision, the preferential effect of transfer benefiting a creditor who is the sole member of a class of creditors to the detriment of those in a class of

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118. Section 547(e)(1)(A) indicates that a transfer of real property (other than fixtures) is perfected when a bona fide purchaser from the debtor cannot acquire an interest that is superior to that of the transferee. Similarly, under § 547(e)(1)(B) a transfer of a fixture or property other than real property is considered perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee.
   For purposes of this section, except as provided in paragraph (3) of this subsection, a transfer is made—
   (A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time;
   (B) at the time such transfer is perfected, if such transfer is perfected after such 10 days; or
   (C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of—
   (i) the commencement of the case; or
   (ii) 10 days after such transfer takes effect between the transferor and transferee.
120. 11 U.S.C. § 547(b)(5) (1982) refers to any transfer to a creditor which enables such creditor to receive more than such creditor would receive if "(A) the case were a case under Chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title."
121. Palmer Clay Prod. Co. v. Brown, 297 U.S. 227 (1936) indicated that the preferential effect test under the former section required a consideration of the distribution of the debtor's liquidated assets to the creditor's fellow class members at the date of bankruptcy rather than at the time the alleged preferential payment was made. Where the distribution so calculated was less than full payment (as was likely for unsecured creditors), the preferential effect of the transfer was proven. Id. at 229.
senior position will now be recognized. Preferential effect will thus be found wherever the transferee would not be entitled to full payment of his claim under straight bankruptcy assuming that the preference is surrendered.\textsuperscript{122} The new test’s reference to a hypothetical distribution in bankruptcy has the further advantage of including within the test many of the variables of bankruptcy law, including the proof of the debt, the security for the debt, and the priority of the debt for payment under straight bankruptcy.

The trustee in bankruptcy’s proof of all of the elements of a preference contained in section 547(b) will not necessarily result in recovery of such transfer, for seven exceptions to recovery are provided for in section 547(c). The exceptions allowed under section 547(c) protect transfers which can be characterized as being within one of the following types:

1. Contemporaneous exchanges for new value;
2. Payments on debts in the ordinary course of business;
3. Security interests in newly acquired property for which new value is provided to enable the debtor to acquire such property;
4. Transfers for which new value was subsequently given;
5. Perfected security interests in inventory, receivables, or their proceeds except to the extent of the creditor’s improvement in position in relation to such security interest within the statutory period before bankruptcy;
6. Certain statutory liens; and
7. Payments by individuals of small consumer debts.

Of the exceptions provided in section 547(c), those relating to small consumer payments and statutory liens are of minimal relevance to guarantee transactions. Four of the remaining exceptions concern the preferential effect of the transfer and prevent avoidance where the transfer, though preferential when considered in isolation, cannot properly be seen as preferential when viewed in the context of the broader dealings of the parties.

The first exception allowed under section 547(c)(1), contemporaneous exchange for new value, reflects existing case law, including \textit{National City Bank of New York v. Hotchkiss}\textsuperscript{123} and \textit{Dean v. Da-}

\textsuperscript{122} 11 U.S.C. § 547(b)(5) (1982). \textit{See}, \textit{e.g.}, \textit{Grogan v. Southwest Textiles, Inc. (In re Advance Glove Mfg. Co.)}, 42 Bankr. 489 (E.D. Mich. 1984); \textit{Tonyan Constr. Co. v. McHenry State Bank (In re Tonyan Constr. Co.)}, 28 Bankr. 714 (N.D. Ill. 1983); \textit{Groppper v. Matador Fabrics, Inc. (In re Fabric Buys of Jericho, Inc.)}, 22 Bankr. 1010 (S.D.N.Y. 1982). \textit{See also Countryman, supra} note 107, at 733-37. Preferential effect would not be found where a creditor is fully secured or where a partially secured creditor receives payment from assets which represent the security. However, where a creditor is unsecured or partially secured, payment from unsecured assets will normally result in preferential effect. \textit{See}, \textit{e.g.}, \textit{Barash v. Public Fin. Corp.}, 658 F.2d 504 (7th Cir. 1981).

\textsuperscript{123} 231 U.S. 50 (1913).
In Hotchkiss the Supreme Court indicated that a transfer, even if made within a few hours of the provision of credit, would be considered preferential where it was not intended by the parties as being contemporaneous. On the other hand, the court in Dean v. Davis concluded that a transfer was not preferential where it was intended to be contemporaneous with the provision of value even though there was a delay of seven days in effecting the transfer. Section 547(c)(1) reflects the views presented in those cases by providing that the trustee may not avoid a transfer under section 547 to the extent that such transfer was: (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given; and (B) in fact a substantially contemporaneous exchange.

New value is defined in section 547(a)(2) to mean money or money’s worth in goods, services, or new credit, or release by a transferee of previously incumbered property, including proceeds of such property, but it does not include substitution of obligations. Contemporaneous exchange, however, is not defined by statute and thus has been applied with great flexibility (and perhaps some inconsistency).

It has been suggested that the exception in section 547(c)(1) was intended to provide protection only for payments by check (the transfer actually occurs upon honoring of the check by the drawee bank and would thus be on account of an antecedent debt). While it appears that the legislative history, though less than comprehensive, does support the view that such transactions were intended to be covered by this exception, the cases which have applied section 547(c)(1) indicate that its application to non-check-
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The application of this exception to secured transactions is less certain, however, and depends upon whether section 547(c)(3) is viewed as having a circumscribing effect upon the application of the contemporaneous exchange exception.

Section 547(c)(3) protects a creditor who receives a security interest in property acquired by a debtor when the acquisition of such property is made possible through the provision of new value by the creditor to the debtor. This “enabling loan” exception requires that the new value be given at or after the signing of the security agreement, that it be given by or on behalf of the secured party under the agreement to enable the debtor to acquire such property, and that the property in fact be acquired by the debtor. Finally, for this exception to apply, the security interest must be perfected on or before ten days after the debtor receives possession of such property.

The exception provided in section 547(c)(3) and the deeming provision under section 547(e)(2) would appear to protect adequately the provision of security by a debtor in exchange for new value where the perfection of security is delayed by no more than ten days. Delays of greater than ten days in perfecting security provided results in such transfer being deemed to have occurred at the time of perfection, and thus the transfer would be on account of an antecedent debt. Likewise, such delay prevents section 547(c)(3) from applying, even though the transaction could otherwise be classified as an enabling loan. The transfer may nevertheless be protected if the contemporaneous exchange exception applies. It is in this context that the interrelationship between section 547(c)(1) and section 547(c)(3) must be addressed. The Court of Appeals for the

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131. 731 F.2d 358 (6th Cir. 1984).


Sixth Circuit in *In re Arnett* \(^{134}\) summarized the issue as follows:

One line of cases holds that section 547(c)(1) is merely cumulative with section 547(c)(3), so that a transfer which occurs more than 10 days after the cash advance, thus not qualifying under section 547(c)(3), may nonetheless be deemed substantially contemporaneous under 547(c)(1). . . . The practical effect of an expansive reading in the "enabling loan" context is to give creditors "two bites at the apple."

Most courts, however, have concluded that an expansive reading of section 547(c)(1) renders section 547(c)(3) redundant and superfluous in the enabling loan context, and thus, is an unwarranted and erroneous construction. These courts have been persuaded that Congress intended section 547(c)(3) to be the exclusive provision applicable in the enabling loan context. "Expressio unius est exclusio alterius." \(^{135}\)

Where a transfer is preferential when made but does not result in the depletion of the debtor's estate because of a subsequent advance by the recipient of the transfer to the debtor, such transfer is protected by provisions of section 547(c)(4). This exception is often justified on the basis that a creditor who has received a preference has replenished the estate by his subsequent advance to the debtor. In order for this exception to apply, the creditor must give new value after the preferential transfer takes place. The preferential transfer will not be subject to recovery to the extent that new value has subsequently been given but will apply only if the new value is not secured by an unavoidable security interest and the debtor has made no unavoidable transfers on account of the new value given.\(^{136}\)

The exception in section 547(c)(5) covers security interests over inventory,\(^{137}\) receivables,\(^{138}\) or their proceeds. Where a creditor has a perfected security interest, a security interest arises in each

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\(^{134}\) 731 F.2d 358 (6th Cir. 1984).

\(^{135}\) *Id.* at 362-63 (citations omitted). Unfortunately, there is no consensus on whether the contemporaneous exchange exception can apply to secured transactions of the enabling loan variety. In addition to the Court of Appeals for the Sixth Circuit, the Courts of Appeals of the Ninth and Eleventh Circuits have indicated that the contemporaneous exchange exception does not apply in such circumstances. *Gower v. Ford Motor Credit Co. (In re Davis)*, 734 F.2d 604 (11th Cir. 1984); *Valley Bank v. Vance (In re Vance)*, 721 F.2d 259 (9th Cir. 1983). Despite the strength of this authority and the merit in the arguments accepted in those cases, the relationship of §§ 547(c)(1) and 547(c)(3) will regretfully continue to provide uncertainty in the remaining circuits for some time. *See also* Contemporaneous Exchange Annotation, *supra* note 108.

\(^{136}\) In Australia, similar consequences occur where the account is considered a "running account." See, e.g., *M. & R. Jones Shopfitting Co. v. NBA Ltd., 1 A.C.L.C. 946 (N.S.W. 1983)*, for a discussion of a running account under the Australian statute. *See also* Baxt, *Ballad of the Running Account*, 7 MELB. U.L. REV. 178 (1969).

\(^{137}\) Inventory means personal property that is leased or furnished, held for sale or lease, or to be furnished under a contract for service, raw material, work in progress, or materials used or consumed in a business, including farm products such as crops or livestock, held for sale or lease. 11 U.S.C. § 547(a)(1) (1982).
newly acquired item of inventory or in each new receivable if acquired in the ordinary course of business. Prior to the 1978 Bankruptcy Reform Act, there was some doubt whether the security interest in such new additions to inventory and receivables occurred at the time of the original perfection of the security interest or later, at the time of the acquisition of the specific item. Under the current statute, a transfer is not made until the debtor has acquired rights in the property transferred. Thus, where the acquisition by the debtor occurs within three months prior to bankruptcy, the security interest which arises in favor of the creditor by virtue of the acquisition of the new item might be considered a preference, especially where the acquisitions, in aggregate, exceed items disposed of in the ordinary course of business.

Under section 547(c)(5), transfers which create a perfected security interest in inventory or receivables are not considered in isolation. The creditor's position at the beginning of the statutory period or when new value was first given for the security (if this date was within the statutory period) is compared to his position at the date of bankruptcy. Where the creditor's position with regard to the unsecured portion of his debt has not improved by virtue of the aggregate transfers during that period, section 547(c)(5) will protect each transfer from recovery.

Perhaps the most important exception under section 547(c) is that for payments of debts in the "ordinary course of business." Under section 547(c)(2), the trustee in bankruptcy may not recover a transfer to the extent it was (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and transferee; (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and (C) made according to ordinary business terms.

Due to the comprehensive nature of this exception, the exact effect of the preferential transfer statute cannot be properly appreciated without full consideration of this exception's consequences. A review of the evolution of section 547(c)(2) assists in understanding the reasons for which the exception was enacted and provides insight into its proper construction.

As previously noted, the abandonment of culpability as an essential element of United States preference regulation culminated in 1978 with the elimination of the requirement that the transferee had "reasonable cause to believe" that a debtor was insolvent from the

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138. Receivable means any right to payment, whether or not such right has been earned by performance. 11 U.S.C. § 547(a)(3) (1982).
140. There is no equivalent in Australia.
141. This is normally ninety days prior to bankruptcy; however, the statutory period is one year prior to bankruptcy for insider creditors.
operative portion of the preference statute.\textsuperscript{142} With this change, transfers to a person unaware of the debtor’s financial plight became subject to recovery under the newly formulated statute, despite the transferee’s innocence.\textsuperscript{143} Unlike some exceptions under section 547(c) which were necessary to establish an appropriate burden of proof in preference recovery proceedings, section 547(c)(2) was undoubtedly enacted on more substantive grounds, to prevent the application of the new preference statute to transactions where recovery would actually be counter to bankruptcy objectives.\textsuperscript{144} Provision of short term credit to the financially troubled (through ordinary trade credit terms), for example, was preferable to the withdrawal of such credit upon the first signs of difficulty.\textsuperscript{145} Whereas such providers of credit had been protected adequately prior to 1978 when recovery necessitated that the transferee have “reasonable cause to believe” that the debtor was insolvent,\textsuperscript{146} the elimination of the subjective element left innocent providers of short term credit exposed. The ordinary course of business exception under section 547(c)(2) limited this exposure by enabling innocent providers of short term credit to avoid recovery. Indicative of an intention to protect only short term creditors, the 1978 version of section 547(c)(2) was limited to payments made “not later than 45 days after such debt was incurred.”

Unfortunately, the limitation of the ordinary course of business exception to payments made within forty-five days after such debt was incurred created uncertainty, mostly due to difficulty in determining the time the debt was incurred and the date of payment.\textsuperscript{147} Timely payments of the principal on long term debts were not cov-


\textsuperscript{143} This change of emphasis in the United States preference statute is discussed in Countryman, supra note 107, at 726-27; DeSimone, Section 547(c)(2) of the Bankruptcy Code: The Ordinary Course of Business Exception Without the 45 Day Rule, 20 AKRON L. REV. 95, 105 (1986); McCoid, supra note 89, at 253-59; Nutovic, The Bankruptcy Preference Laws: Interpreting Sections 547(c)(2), 550(a)(1), and 546(a)(1), 41 BUS. LAW. 175, 178 (1985).


\textsuperscript{145} See Jackson, supra note 88, at 763; Note, Preferential Transfers and the Value of the Insolvent Firm, 87 YALE L.J. 1449, 1449-50 (1978) (discussing this function of preference legislation). See also H.R. REP. No. 595, 95th Cong., 1st Sess. 373, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6329; S. REP. No. 989, 95th Cong., 2d Sess. 88, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5874 (discussing a desire to discourage unusual action by either the debtor or his creditors “during the debtor’s slide into bankruptcy”).

\textsuperscript{146} See Countryman, supra note 107, at 767-68 (discussing protection for payments relating to “current expenses” under prior legislation).

\textsuperscript{147} See DeSimone, supra note 143, at 96; Nutovic, supra note 143, at 177.
tered by this exception as these debts were considered to be incurred at the date of the original advance, rather than at the due date of any installment. Interest payments, however, were considered by some courts to be protected because interest was incurred only as it accrued.\textsuperscript{148} Likewise, the 45-day limit did not adequately protect the provision of short term debt in industries where the billing cycle was longer than forty-five days.\textsuperscript{149} In 1984, Congress deleted the 45-day limitation, thereby eliminating the most litigated and troubling aspect of the section.\textsuperscript{150} This change, however, enabled section 547(c)(2) to apply outside the context of short term credit and focused enquiry under the exception to the concept of the "ordinary course of business," an undefined term new to United States bankruptcy jurisprudence. The exact scope of the exception still remains uncertain.

One aspect of section 547(c)(2) which does seem clear is that it does not apply to the provision of security. The section is limited in its application to "transfers in payment of a debt" rather than to the broader concept of transfers generally. Further supporting this view is the presence of other exceptions within section 547(c), particularly subsection (c)(3) and, to a lesser extent, subsection (c)(5), which specifically relate to transactions for the provision of security, thereby making the application of section 547(c)(2) in those circumstances unlikely.

With regard to the operative requirements of section 547(c)(2), there are three aspects of a transaction which must be considered to determine whether the "ordinary course of business" exception will apply. Both the debt incurred and the transfer made must be in the ordinary course of business, and this must be considered in relation to the businesses of both debtor and transferee.\textsuperscript{151} Additionally, the transfer must be made according to ordinary business terms.\textsuperscript{152} Since imminent bankruptcy most often leads to extraordinary transactions upon payment rather than upon incurrence of a debt,\textsuperscript{153} the most obvious aspect for consideration under section 547(c)(2) is

\begin{itemize}
\item \textsuperscript{149} See DeSimone, supra note 143, at 111.
\item \textsuperscript{150} Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 462(c), 98 Stat. 333, 378. See Nutovic, supra note 143, at 177 n.11 (noting the frequent appearance of the 45-day issue in litigation under section 547(c)(2)).
\item \textsuperscript{151} § 547(c)(2)(A), (B).
\item \textsuperscript{152} § 547(c)(2)(C).
\item \textsuperscript{153} Nevertheless, it is possible that a debt itself may be incurred outside the ordinary course of business. For example, the debt may arise from a previous breach of contract, Cohen v. Kern (In re Kennesaw Mint, Inc.), 32 Bankr. 799 (N.D. Ga. 1983); it may be incurred subsequent to the termination of business, In re Peninsula Roofing & Sheet Metal, Inc., 9 Bankr. 257 (W.D. Mich. 1981); or it may arise in circumstances completely outside normal business practice, Merrill v. Abbott (In re Independent Clearing House Co.), 41 Bankr. 985 (D. Utah 1984) (pyramiding investment schemes),
\end{itemize}
whether the transfer in payment of the debt was in the ordinary course of business.

In determining whether a transfer was made in the ordinary course of business of debtor and transferee, reference has been made to the "normal business practice" of both the industry\textsuperscript{154} and the particular debtor's and transferee's prior similar transactions.\textsuperscript{155} In this regard, timeliness of payment has often proved important.\textsuperscript{156} Likewise, imposition of additional terms or the requirement of different methods of payment from the ordinary have resulted in transfers being considered outside the ordinary course of business and not according to ordinary business terms.\textsuperscript{157}

Of even greater difficulty is the subjective element in the transfer from debtor to transferee. Initially, one might be inclined to accept, as have the Australian courts, that the concept of the ordinary course of business incorporates within it the requirement that the transfer be made in good faith. That Congress would have considered that a "reasonable cause to believe that the debtor was insolvent" would prevent application of the ordinary course of business exception is highly unlikely considering its explicit removal of such a concept from the elements of a preference in 1978. The presence of creditor pressure or the intent of a debtor to prefer a particular creditor (both of which are somewhat more indicative of bad faith than mere "reasonable cause to believe" that the debtor was insolvent) should prevent the ordinary course of business exception from applying. Although this proposal has received academic consideration,\textsuperscript{158} there has been no clearly articulated incorporation of such subjective elements as contra-indicators of the ordinary course of business.\textsuperscript{159} The presence of such elements may have been considered as contributing to findings in several cases already decided that the subject transactions were not within the ordinary course of business.\textsuperscript{160}

\begin{thebibliography}{9}
\bibitem{Production} Production Steel, Inc. v. Sumitomo Corp. of Am. (\textit{In re Production Steel, Inc.}), 54 Bankr. 417 (M.D. Tenn. 1985); Ewald Bros. v. Kraft, Inc. (\textit{In re Ewald Bros.}), 45 Bankr. 52 (D. Minn. 1984); \textit{Campbell}, 37 Bankr. 914.
\bibitem{Gold} Gold Coast Seed Co. v. Beachner Seed Co. (\textit{In re Gold Coast Seed Co.}), 24 Bankr. 595 (9th Cir. 1982); \textit{In re Brenton's Cove Dev. Co.}, 52 Bankr. 287 (D.R.I. 1985); \textit{Ewald Bros.}, 45 Bankr. 52.
\bibitem{Marathon} Marathon Oil Co. v. Flatau (\textit{In re Craig Oil Co.}), 785 F.2d 1563 (11th Cir. 1986).
\bibitem{Desimone} DeSimone, supra note 143, at 131.
\bibitem{See} See, e.g., Marathon Oil Co. v. Flatau (\textit{In re Craig Oil Co.}), 31 Bankr. 402 (M.D. Ga. 1983), aff'd 785 F.2d 1563 (11th Cir. 1986); Production Steel, Inc. v.
of preferential transfers may, through the ordinary course of business exception, be returned indirectly to recovery actions. In many cases this would necessitate an inquiry into the motives of the transfer, a development already underway in Australia.

B. Avoidance Vis-à-vis Guarantor

In contrast to the provisions of the Australian general preference provision, section 547 not only provides for avoidance of a transfer where the transfer prefers its direct recipient but also facilitates avoidance of a transfer in circumstances where it could not be applied by reference to the initial transferee alone. Prior to 1978, for example, the United States preference provisions required that the creditor benefited have "cause to believe" that the transferee was insolvent. Without application of the avoidance provision by reference to the guarantor, any transfer to an innocent creditor would have remained unassailable even if a guarantor relieved of potential liability by the preference was aware of the debtor's position. Similarly, the current statutory period differential between insiders and arm's length creditors reinforces the importance of being able to apply the avoidance provision to transfers by virtue of their effect upon an insider guarantor where a transfer occurs outside the ninety-day period but within one year of bankruptcy. Perhaps, because of the inequitable results which would result from the inability to utilize the preference statute against guarantors in such circumstances, application of the preference statutes to guarantors became firmly established in the United States.

The 1978 inclusion of benefited creditors among those potentially liable for avoided preferences under the remedial provision, 11 U.S.C. § 550,\(^1\) confirmed that guarantors in the United States, unlike those in Australia, may be subject to direct liability for preferential transfers which benefit them. The interpretation of the elements of the various preference statutes in a manner consistent with their direct application to guarantors, however, was well settled in the United States even prior to the 1978 Act. In contrast to Australia, the expansive definition of "transfer" used in both current and past legislation, the acceptance that contingent creditors are normally\(^2\) to be considered as creditors for purposes of the

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\(^1\) See infra note 207.

\(^2\) For example, where an indorser, avoids recourse on the instrument through proper indorsement or through contract, payment by the bankrupt of the primary debt would not result in a preference to the indorser. Likewise, the voidable preference for a guarantor, surety, indorser, or accommodation maker could only be found where the basic requirements of the voidable preference could be established. For this reason, reductions on primary obligations which were not considered as "transfers" to the pri-
preference statute, and characterization of payments made by a
debtor to his primary creditor as being "to or for the benefit of a
creditor,"164 as a result of its effect upon the guarantor of the
debt165 have all promoted the application of the United States stat-
ute to guarantors.

In the 1874 case of Bartholow v. Bean,166 the United States
Supreme Court took the opportunity to indicate its views on the
application of the 1867 preference statute to payments in a tripar-
tite arrangement: "The statute in express terms forbids such prefer-
ence, not only to an ordinary creditor of the bankrupt, but to any
person who is under any liability for him; and it not only forbids
payment, but it forbids any transfer or pledge of property as secur-
ity to indemnify such persons."167

That guarantors and other contingent creditors were subject to
the 1898 preference statute despite significant changes from the
1867 Act was accepted by the Court of Appeals for the Eighth Cir-
cuit Court in Swarts v. Siegal168 and Kobusch v. Hand169: "Con-

mary debtor (e.g., reduction of a loan through bank setoff) may not be a voidable prefer-
ence and would therefore not be recoverable from the contingent creditor. See, e.g.,
Joseph F. Hughes & Co. v. Machen, 164 F.2d 983 (4th Cir. 1947); Drugan v. Crabtree,
299 F. 115 (4th Cir. 1924).

states:

"creditor" means—
(A) entity that has a claim against the debtor that arose at the
time of or before the order for relief concerning the debtor;
(B) entity that has a claim against the estate of a kind specified
in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; or
(C) entity that has a community claim.

The term "entity" is defined to include person, estate, trust and governmental unit. 11


165. The Bankruptcy Act of 1978 does not as clearly apply its preference avoidance
provision to guarantors, sureties, indorsers, and others as earlier statutes did. For ex-
ample, the 1867 Bankruptcy Act, 14 Stat. 517, provided for avoidance, in the appro-
ciate circumstances, of any preference made to any creditor or person having a claim
against the bankrupt, or to one who was under liability for him. Section 39 of the Act
further provided for recovery of preferences given to persons under liability for the
bankrupt as "indorsers, bail, sureties, or otherwise." See Kobusch v. Hand, 156 F. 660,
661 (8th Cir. 1907).

The operative portion of the 1898 statute, § 60(b), provided,
If a bankrupt shall have given a preference, and the person receiving it, or
to be benefited thereby, or his agent acting therein, shall have had reason-
able cause to believe that it was intended thereby to give a preference, it
shall be voidable by the trustee, and he may recover the property or its
value from such person.

Id.

166. 85 U.S.(18 Wall.) 635 (1874).
168. 117 F. 13 (8th Cir. 1902).
169. 156 F. 660 (8th Cir. 1907). In Kobusch v. Hand, the court relied upon the fact
gress intended to adopt the substance of the prior provisions upon this subject, and in doing so to employ terms more concise, but equally as comprehensive.\textsuperscript{\text{170}}

The application of the preference statute to guarantors and other contingent creditors was further supported by observations in \textit{National Bank of Newport v. National Herkimer County Bank}, in which the United States Supreme Court accepted that a preference could occur where transfer by the bankrupt was not made directly to the creditor.\textsuperscript{\text{171}} Changes to the statute in 1910, under which the person receiving or benefiting from a preferential transfer need only have reasonable grounds to believe the transfer would have a preferential effect (rather than the prior reasonable grounds to believe the debtor intended such preference), did not alter the status of guarantors, sureties, or indorsers, but effectively increased the potential application of the provision.\textsuperscript{\text{172}} Similarly, the effect of the 1938, amendment which required that the recipient of the transfer or person benefiting thereby have reasonable cause to believe that the debtor was insolvent at the time of the transfer, merely extended the possible application of the statute without altering the treatment afforded guarantors, sureties, or indorsers.\textsuperscript{\text{173}} Continued and frequent application of the current preference statute to guarantors indicates that the following observations in \textit{Paper v. Stern} apply with equal force to the current preference statute as to the section then in force:

The rule, however, is too well settled, and the reasons for it have been too clearly stated, to warrant further discussion, that a guarantor, an indorser, an accommodation maker, or a surety on the obligation of a bankrupt is a creditor within the meaning of that the contingent creditor had induced the payment. \textit{Id.} at 662. \textit{But see Paper v. Stern}, 198 F. 642, 644 (8th Cir. 1912):

\begin{quote}
[T]his case should be excepted from this rule because the guarantors did not pay, or induce the payment of the debt, and the bankrupt himself paid it, has been deliberately and thoughtfully considered; but it presents to our minds no sound reason for an exception to the rule . . . .
\end{quote}

\textsuperscript{170} 156 F. at 661. In both \textit{Kobusch v. Hand} and \textit{Swarts v. Siegal}, the Court of Appeals for the Eighth Circuit addressed the contention that only a creditor could receive a preference under the statute. In \textit{Swarts}, the court reviewed the customary and statutory definitions of "creditor" to determine whether contingent creditors were included. The statutory definition at the time, "one who owns a demand or claim provable in bankruptcy," was complemented by the inclusion within the statute of certain claims deemed provable but which were only contingent. 117 F. at 17. The right of an indorser, accommodation maker, or surety to make a claim in bankruptcy where the primary creditor failed to prove such claim (see §§ 57(i), 63(a) of the 1898 Act, then in force) supported the conclusion that these were creditors within the statutory scheme. 117 F. at 18.

\textsuperscript{171} 225 U.S. 178 (1912).

\textsuperscript{172} \textit{See}, e.g., \textit{Cohen v. Goldman}, 250 F. 599 (1st Cir. 1918).

\textsuperscript{173} \textit{See}, e.g., \textit{Cooper Petroleum Co. v. Hart}, 379 F.2d 777 (5th Cir. 1967).
While alterations to the preference statute between 1898 and 1978 did not prevent its application to guarantor and other contingent creditors, certain of the changes made in 1978 to the general scheme of the preference provision had implications for its application to guarantors. Most of the 1978 changes, as exemplified by the elimination of the "reasonable cause to believe" requirement, greatly facilitated the recovery of transfers made by debtors which had the effect of favoring a particular creditor. Counter to this general trend, however, was the shortening of the statutory period prior to bankruptcy during which a transfer would be subject to recovery from four months to ninety days. This shortening of the statutory period accentuated the importance of closer scrutiny of any transfer which benefited a creditor in a close relationship with the debtor. In such cases, the creditor was likely to have better knowledge of the debtor's financial position than other creditors and would also be in a better position to conceal the transaction for the statutory period due to the influence which that relationship would afford. Due to the potential for circumventing the preferential transfer statute which such position might afford, transfers from "insiders" were regulated differently from transfers to general creditors for the first time in the 1978 preference provision.

The major statutory difference between the treatment of insiders and other creditors in the United States is the extension of the period prior to the filing of the bankruptcy petition during which any transfers may be subject to avoidance. Whereas normal creditors may consider transfers made earlier than ninety days before the debtor's bankruptcy as being beyond question, insiders must consider all transactions within the year before bankruptcy as potentially voidable. The statutory presumption of insolvency in section 547(f) only applies for the ninety-day period prior to bankruptcy; therefore, the extension of the period for insiders is balanced by the requirement that the insolvency of the debtor at the time of the transfer must be shown in order to avoid transfers which occurred between ninety days and one year before bankruptcy. Nevertheless, the task of the trustee in bankruptcy has been greatly eased by the deletion of the requirement that transfers made to insiders during the extended period require the insiders' having "rea-

174. 198 F. 642, 644 (8th Cir. 1918).
sonable cause to believe the debtor insolvent.”

Thus, characterizing the creditor as an insider has the effect of extending to one year the period during which transfers may be avoided provided that insolvency of the debtor at the time of the transfer can be shown.

The term “insider” is defined in the Bankruptcy Code at 11 U.S.C. § 101(25) in a liberal manner. While the definitions of insider in relation to a debtor individual, a debtor partnership, or a municipality are quite broad, it is the definition in relation to corporate debtors which particularly relates to the subject of this article, corporate guarantors. In relation to corporate debtors, the Code defines an insider as including a director, officer, or person in control of the debtor as well as any general partner of the debtor or any partnership in which the corporate debtor was a general partner. Additionally, the managing agent of the debtor and any affiliate, or insider of an affiliate, of the debtor are defined as insiders in relation to any type of debtor.

As might be expected from such expansive definitions, courts have been required to provide guidance on the precise limits of the term. While not uniform in approach, the decisions have tended toward a flexible interpretation so as to cover a number of situations where the relationship between debtor and creditor could not be described as “arm’s length.” Whether the courts will continue to expand the application of this concept remains to be seen. However, despite any uncertainty which may remain concerning the exact limits of the term “insider” under the current statute, it would seem clear that the lengthened statutory period for insiders would

179. See Countryman, supra note 107, at 732.
184. See Carlson v. Farmers Home Admin. (In re Newcombe), 744 F.2d 621, 625 n.4 (8th Cir. 1984) (citations omitted) (discussing the concept of a person “in control”): It is conceivable that a creditor could become so involved in the day to day business of the debtor as to become an insider. However, the mere fact that a large creditor has “control” over the debtor, in the sense that the creditor can compel payment of a debt, does not make the creditor an insider.
187. See Note, supra note 176, at 731 n.36.
normally apply to individuals providing guarantees for corporate debt. Those individuals requested to provide such guarantees are usually chosen because of their close connection to the corporation as either corporate officers or substantial shareholders. As discussed below, this lengthened statutory period for insiders has implications both in the avoidance of the transfer and its recovery.

One uncertainty in the United States scheme for preference regulation is the relevance of the exceptions provided under section 547(c). In circumstances where section 547 is applied in relation to a guarantor, it would seem appropriate that certain of the exceptions of section 547(c) should apply even though the primary creditor was responsible for the actions giving rise to the exception. Thus, the provision of value, either contemporaneously or subsequently by the initial transferee, should not only protect the original transferee who provided such value but should also avail any guarantor of the transferee of the appropriate exceptions under section 547(c)(1) and section 547(c)(4). Similarly, protection would also appear to be appropriately applied to the guarantor of a debt secured by newly acquired property in compliance with section 547(c)(3).

While it may be accepted that a guarantor should be able to rely upon exceptions arising from the primary creditor's provision of value to the debtor, the application of the ordinary course of business exception to guarantors is significantly more problematic. This is due in part to the uncertain nature of the exception itself, particularly whether it is inapplicable if certain subjective elements, such as creditor pressure, are present. Where there is pressure by either the primary creditor or the guarantor upon the debtor, the exception may not apply if the transfer were thus considered as not in the ordinary course of business of the debtor. This result would be particularly unfortunate for an innocent creditor who for whatever reason had no effective recourse against his guarantor.

C. Disallowance of Claims as a Consequence of Avoidance

Upon discovery of a voidable preference, the appropriate method to assure its recovery under the current United States statute largely depends upon the position of the creditor so preferred.

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189. This point is addressed with regard to §§ 547(c)(1) and 547(c)(4) in Nutovic, supra note 143, at 175 n.62. See also Lansdowne v. Harbor Sec. Bank (In re Bagwell) 29 Bankr. 461 (D. Or. 1983).


191. The alternatives are even less satisfactory. It would be inappropriate for a guarantor to rely upon such an exception where payment was caused by the guarantor's own pressure. Likewise, applying the exception in relation to the creditor and guarantor separately could lead to anomalous results, particularly in view of the remedies available against either the guarantor or the transferee under 11 U.S.C. § 550.
Section 502(d) necessitates that the claims of any creditor who retains a voidable preference be disallowed.\textsuperscript{192} Where such a creditor has significant claims against the estate of the bankrupt, either related or unrelated to the preferential transfer,\textsuperscript{193} the disallowance of those claims until surrender of the preference might accomplish recovery. However, if the expected distribution to the creditor upon surrender of the preference does not exceed the value of the preference itself, disallowance of the creditor's claims may not induce the surrender of the preference retained by a creditor (thus the need for the recovery provision, 11 U.S.C. § 550).

The disallowance of a creditor's claims because of his retention of a preference, uncomplicated in application to a simple creditor, is more troublesome when the preferential transfer is one involving guarantees. The surrender of a preferential payment on a guaranteed debt would require at least a tripartite adjustment of rights. Additionally, the guarantor's rights against the bankrupt debtor are usually derivative of the rights of the original creditor.\textsuperscript{194} As a result, the establishment of the guarantor's claims in bankruptcy may depend upon the position adopted by the original creditor toward the debtor's bankruptcy. The creditor may decide, without regard to the position of his guarantor, whether to proceed with any claims in bankruptcy, whether to acknowledge the receipt of a preference, or whether to surrender such preference or to await recovery proceedings. Each of these decisions by the primary creditor may be beyond the control of the guarantor, but each decision may change the guarantor's position as a bankruptcy creditor.

Although the recipient of a voidable preference is prevented from establishing a claim in bankruptcy while retaining that preferential transfer, the creditor's claim may be allowed upon the surrender of the preference.\textsuperscript{195} Where a voidable preference to a creditor is on account of a debt for which a guarantee has been provided, the surrender of the preference by the creditor would normally increase the claim of that creditor against the bankruptcy estate\textsuperscript{196} and would likewise increase the exposure of the guarantor to such

\begin{footnotes}
\footnote{192. 11 U.S.C. § 502(d) (1982) provides:
Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim if any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over such property, for which such entity is liable under section 522(i), 542, 543, 550, or 553 of this title.}
\footnote{195. 11 U.S.C. § 502(d) (1982); supra notes 192-93.}
\footnote{196. Surrender of the preference would increase the claim on the underlying debt in}
\end{footnotes}
A guarantor's claims in bankruptcy will also be affected by the original creditor's position in several ways, even if the original creditor decides not to surrender his preference. The original creditor may make no claim in bankruptcy, either because he has elected to rely solely upon his rights under the guarantee or because the retention of a voidable preference requires the disallowance of his claims. Whatever the original creditor's reason for failing to file a claim in bankruptcy, the guarantor may file a claim in bankruptcy based upon his performance under the guarantee and his resultant subrogation to the rights of the original creditor, based upon his anticipated subrogation to the rights of the original creditor upon future performance on the guarantee, or based upon rights of contribution under contract.

It is important to note that the rights of the original creditor to share in the bankruptcy estate, to which the guarantor is subrogated, remain subject to the obligation of the original creditor to surrender any preference received, whether or not the preference related to the transaction from which the guarantee arose. As a consequence, the guarantor's ability to participate in the bankrupt's estate may be jeopardized by the original creditor's retention of any preferential payment. Where a guarantor has paid a reduced amount on a guarantee because the original creditor has retained a preferential transfer, the disallowance of the guarantor's claim may be justified. The guarantor's rights to participate would, with less justification, also be defeated if the claim arises from the guarantor's payment of, and consequent subrogation to, the creditor's claim, and thus the creditor retains a preference totally unrelated to the guaranteed debt.

Just as with other creditors, any guarantor who has a claim in bankruptcy will be prevented from pursuing that claim if he retains recoverable property or is the transferee of a transfer avoidable under section 547. In addition to the disallowance of the guaran-

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197. See supra note 3. See also infra text accompanying notes 209-15.
tor's claims caused by the original creditor's retention of a preference, a guarantor's direct liability for a preferential transfer would also prevent his participation in the bankruptcy estate so long as he retained property subject to recovery. Such direct liability of a guarantor for a preference is provided for in 11 U.S.C. § 550, discussed below, which allows recovery of a transfer avoidable under section 547 from either "the initial transferee of such transfer or the entity for whose benefit such transfer was made; or any immediate or mediate transfer of such initial transfer."

As recovery proceedings are normally instituted by the trustee in bankruptcy in order to maximize the bankrupt's estate, the guarantor cannot be assured that recovery of a preference will necessarily be sought from the original creditor. The threat of recovery of a voidable preference from the guarantor under 11 U.S.C. § 550 or disallowance of his claims in bankruptcy may induce the guarantor to surrender the preference. If the guarantor elects to surrender a § 550 preference voluntarily, rather than await proceedings, the guarantor should be able to participate in the estate. Although provision is made for participation in the bankrupt's estate of one required to surrender a preference, legislation does not address the rights of one who voluntarily surrenders a preference before being compelled.


Where the surrender of the voidable preference is not accomplished through the disallowance of claims in bankruptcy or the threat of proceedings, recovery of the preference may be accomplished by the trustee in bankruptcy pursuant to the provisions of

203. See supra notes 200-201.
205. Recovery of a preferential payment on a guaranteed debt from the original creditor would increase that creditor's claim against the bankrupt's estate on the underlying debt, and the guarantor would then be subrogated to the original creditor's increased claim upon satisfaction of his obligations under the guarantee. That the guarantor should be in a similar position where recovery of a preference is accomplished directly from him is clear, though the basis of such a claim against the bankrupt's estate has not been clearly articulated. See infra note 230 and accompanying text. Likewise, the guarantor should be in the same position vis-à-vis the bankrupt whether surrendering the preference pursuant to an order under § 550 or prior to recovery proceedings; however, the provisions of 11 U.S.C. §§ 502(h) and 501(d) both refer to "recovery under section 550." A guarantor's surrender of a preferential payment on a guaranteed debt prior to § 550 proceedings would most likely occur where the guarantor has already been subrogated to the creditor's rights, and the basis of an increased claim in bankruptcy upon surrender of the preference in such circumstances is clear.

If a guarantor elects, for tactical reasons, to surrender a preference totally unrelated to the debt guaranteed in order to proceed with the rights to which he has been subrogated, the consequences of such surrender are less certain.
11 U.S.C. § 550. This section enables the trustee to recover "for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from 1) the initial transferee of such transfer or the entity for whose benefit such transfer was made,\(^{206}\) or 2) any immediate or mediate transferee of such initial transfer."\(^{207}\)

Where a transfer to a creditor reduces the potential liability of a person who has guaranteed the loan of the debtor to that primary creditor, the trustee has at least two potential defendants for recovery of the preferential transfer, the creditor who has received the transfer and the guarantor who has benefited by reduction of his potential liability by virtue of the reduction of exposure on the guarantee.\(^{208}\) This broad remedy presents some complexity because a transaction may be avoidable under section 547 either in relation to the recipient of the transfer or in relation to some other benefited creditor (such as a guarantor). Section 550 enables the trustee to recover from either a primary creditor or a guarantor notwithstanding that the requisites of avoidance under section 547 may not be present in relation to the chosen defendant. For this reason, the implications of recovery from both a primary creditor and his guarantor must be addressed with consideration of the appropriate adjustment of rights in both instances.

As previously mentioned, in the United States the recovery of a transfer from the initial transferee who has been protected by a guarantee would normally result in the primary creditor's proceeding against the guarantor for any deficiency of payment. In contrast to Australia's position illustrated in *Commercial Bank of Australia v. Carruthers*\(^{209}\) and *Re Timbatec*,\(^{210}\) the United States accepts the view that payment of a debt which is afterward avoided as a prefer-

\(^{206}\) In *Paper v. Stem*, 198 F. 642 (8th Cir. 1912), the characterization of a guarantor, surety, indorser, or accommodation maker as a person to benefit from a transfer was first proposed, as an alternative to their characterization as a creditor, as a basis for finding liability on a voidable preference:

> "It is evident that the appellants, who were guarantors of the payment of his note to the bank and who must have paid it if he did not, were the parties to be benefited by this transaction whether they were creditors or not, so that the objection here urged would not be fatal to the decree if the appellants were not creditors."

*Id.* at 644.

The current wording of § 547 makes such reasoning inappropriate to the avoidance provision; however, it would still appear to be relevant to the recovery provision, § 550.

\(^{207}\) The trustee's right to recover an avoided transfer is limited with regard to good faith transferees. 11 U.S.C. § 550(b) (1982).

\(^{208}\) The availability of alternative defendants has necessitated a specific provision limiting the trustee to only a single satisfaction for the recovery of an avoided transfer. 11 U.S.C. § 550(c) (1982). *See In re Acadania Elec. Serv.*, 66 Bankr. 164, 166 (W.D. La. 1986).

\(^{209}\) 82 W.N. (N.S.W.) Pt. 1, 76 (1964).

entail transfer does not effect a valid discharge of the obligations of a guarantor, surety, or indorser on the obligation. Although authority for the view accepted by the Australian courts can be found in the United States, such as in the 1867 Act,211 Swarts v. Fourth National Bank212 effectively distinguished the earlier authority as resting upon the proposition that "the acceptance of the preference discharged the sureties because it was a prohibited act—a fraud upon the bankrupt law of 1867."213 Recovery of preferences after the 1898 Act, however, was not based upon fraud of the recipient, and, consequently, payment and subsequent recovery would not effect a release of the guarantor or surety on the basis of the fraud of the recipient. Judge Sanborn, delivering the opinion of the court in Swarts v. Fourth National Bank, relied not only on the American authority of Watson v. Poague214 to come to this conclusion but also on English authority in Petty v. Cooke and Pritchard v. Hitchcock, authorities which were considered inapplicable to Australia in Carruthers:

The only just and equitable conclusion is that the accommodation makers, indorsers, or sureties upon the obligations of an insolvent debtor are not discharged from liability to pay them by the innocent acceptance, by their creditor, of payments thereon from the insolvent debtor which the creditor is subsequently required to, and does surrender to the latter's trustee in bankruptcy as a condition of the allowance of its claim under . . . the bankruptcy act.215

As a result of this decision and more recent authority,216 the rights of a primary creditor in the United States who must surrender a preference are not prejudiced by the discharge of his guarantors or sureties. In this regard the Australian position is clearly inferior.

In the United States, recovery of an avoided transfer from a creditor who is secured by a guarantee may thus be expected to result in further action by the initial creditor against his guarantor. A court exercising its equitable jurisdiction in bankruptcy may formulate an order to reflect these rights if it has all of the relevant parties before it.217 When the guarantor performs on the guarantee,

211. Bartholow v. Bean, 85 U.S. (18 Wall.) 635, 641-42 (1874); In re George M. Hill Co., 130 F. 315 (7th Cir. 1904); Doyle v. Milwaukee Nat'l Bank, 116 F. 295 (7th Cir. 1902); Northern Bank of Ky. v. Cook, 76 Ky. 340 (1878).
212. 117 F. 1 (8th Cir. 1902).
213. 117 F. 1, 10.
214. 42 Iowa 582 (1877).
215. 117 F. 1, 12.
whether pursuant to judicial supervision or not, the guarantor is
subrogated to the rights of the initial creditor against the debtor,
including the right to participate in the bankrupt's estate.218 The
rights of the guarantor against the bankrupt's estate are safeguarded
by allowing the guarantor to file a claim in bankruptcy based upon
his anticipated subrogation to the rights of the original creditor
where the original creditor has refrained from filing his own claim
in bankruptcy.219 Likewise, flexibility with regard to time limita-
tions in the filing of bankruptcy claims allows adjustment of rights
even where recovery of a preferential transfer from the creditor and
consequential performance by the guarantor upon his guarantee is
delayed through recovery litigation.220

One interesting consequence of the alternative defendants for
recovery of an avoided transfer under 11 U.S.C. § 550 is that, if
literally applied, it would allow recovery of an avoided transfer
from an arm's length creditor who was the initial recipient of the
transfer even though the transfer occurred outside the ninety-day
statutory period. The transfer, if benefiting a guarantor to whom
the lengthened statutory period for insiders applied, could be
avoided by reference to the guarantor. Once the transfer was
avoided (whether by reference to the recipient or the guarantor),
recovery from either party would be permitted under section 550.
While this potential avenue for recovery would be particularly use-
ful where the insider guarantor had insufficient assets to meet the
trustee's claim, the efficacy of recovery from the initial recipient by
such an indirect method has been questioned as being inequitable
and thus contrary to bankruptcy policy.221 With one exception,222

Ozark Restaurant Equip. Co.), 41 Bankr. 476 (W.D. Ark. 1984); 28 U.S.C. § 1471(b)
(Supp. IV 1986).


219. 11 U.S.C. § 501(b) (1982). Under § 509, however, the guarantor's claim is
subordinated to that of the creditor until such creditor's claim is paid in full. 11 U.S.C.
§ 509(c) (Supp. IV 1986). Seeking distribution from the bankruptcy does not prevent
the creditor from enforcing his rights against those who have assumed secondary liabil-
ity upon the debt. See Gorman v. Wright, 136 F. 164 (4th Cir. 1905); In re Realty
turers Trust Co., 162 F.2d 350, modified on other grounds, 163 F.2d 387, cert. denied,
332 U.S. 836 (1947); In re Myer, 14 N.M. 45, 89 P. 246 (1907).

claim which arises or becomes allowable as a result of a judgment for the recovery of
property or money may be filed within 30 days after the judgment becomes final unless a
liability or duty under such judgment is not performed within the permitted time.

221. The first suggestion that a bankruptcy court should decline to allow recovery in
such an instance appeared in Collier on Bankruptcy:

In some circumstances, a literal application of section 550(a) would per-
mit the Trustee to recover from a party who is innocent of wrongdoing
and deserves protection. In such circumstances the bankruptcy court
should exercise its discretion to use its equitable powers under section
105(a) and 28 U.S.C. [section] 1481 to prevent an inequitable result.
the cases in which section 550 have been applied in such circumstances have accepted that recovery against the initial recipient should not be permitted, despite the literal wording of section 550, as to do so would be to penalize the creditor for prudence in seeking a guarantor of the debt.223

Despite limitations imposed by the judiciary upon the use of section 550, this recovery provision provides great flexibility. It enables a trustee in bankruptcy to seek, in most circumstances, recovery of an avoided transfer from either the initial recipient of the transfer or the creditor for whose benefit the transfer was made. While this would prove significant where the initial recipient is unavailable or insolvent, it imposes liability perhaps too widely by exposing innocent parties, those other than guarantors, to recovery actions in circumstances which may not be justifiable.224

In addition to the liability of a direct recipient of a preference, section 550 also expressly indicates that a guarantor or other creditor benefited may be directly responsible for the preference. Such direct recovery of a preference from guarantors, sureties, indorsers, or other benefited creditors has been possible under United States preference legislation prior to the Bankruptcy Reform Act of 1978 due to the requirements of those statutes that the creditor or person benefited be shown to have been culpable.225 Where the primary creditor was entirely innocent, proof of the requisite knowledge of the surety, guarantor, indorser, or accommodation maker would result in such transfer being recoverable against them alone.226 Under the current statutory scheme, avoidance of a preferential transfer

See 4 COLLIER ON BANKRUPTCY § 550.02 (15th ed. 1983).

This point is also discussed in great detail in Pitts, supra note 72, at 343. See Nutovic, supra note 143, for a different perspective.


224. For example, payments to an oversecured first lienor which benefit an undersecured second lienor or its unsecured guarantor may be recoverable from the first lienor. See Pitts, supra note 72, at 356-60.

225. This occurs through either knowledge or reasonable grounds of belief in the bankrupt's intent to prefer (1898), the preferential effect of the transfer (1910), or the insolvency of the debtor (1938).

may in certain circumstances also result in recovery against a guarantor alone. As mentioned above, such recovery of a preference against the guarantor, surety, indorser, or accommodation maker alone might result where a transfer occurred prior to ninety days before bankruptcy and the primary creditor was not an insider but the guarantor, indorser, surety, or accommodation maker was.

A guarantor may be the only appropriate defendant for recovery of a preference, or he may be chosen by the trustee to return the preference for reasons such as ease of execution. In either event, the recovery by the trustee in bankruptcy against the creditor whose potential liability has been relieved would normally result in that party's being placed in a similar position to the one he would have occupied had the preferential transfer not been made. The trustee in bankruptcy's claim for an amount equivalent to the guarantor's pre-preferential transfer liability to the primary debtor approximates recovery by the trustee in bankruptcy of the transfer and simultaneous enforcement of the primary creditor's claims against the guarantor, surety, and so on. This would appear to appropriately deal with all parties so long as the guarantor is able to participate in the bankrupt's estate in the event of direct liability to the trustee in bankruptcy. Subrogation of the guarantor to the creditor's claim in bankruptcy may not have occurred, however, as the guarantor would not yet have performed on the guarantee. While this has caused difficulties in Australia, the United States procedures appear to make sufficient allowance for guarantors in such a position.227

Where the recovery of a preferential transfer is successfully accomplished by the trustee in bankruptcy, the creditor required to return the transfer may establish a claim in bankruptcy despite the expiration of the ordinary claim period.228 The creditor would thus participate in the estate to the extent of the recovery notwithstanding the delay caused by the recovery proceedings. In circumstances where the preferential transfer is recoverable only from the guarantor, recovery of the preference from the guarantor has been recognized as establishing a claim against the bankrupt's estate.229 As

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227. See infra note 229.

228. 11 U.S.C. § 502(h) (Supp. IV 1986). A claim which arises or becomes allowable as a result of a judgment for the recovery of property or money may be filed within 30 days after the judgment becomes final, unless a liability or duty under such judgment is not performed within permitted time. See supra note 220.

229. 11 U.S.C. § 502(h) (Supp. IV 1986). For prior law, see Platt v. Ives, 86 Conn. 690, 86 A. 579 (1913). In reference to the scope of section 502(h), Collier on Bankruptcy suggests:

The import, however, of section 502(h) is that regardless of the circumstances by which the trustee or debtor recovers property under section 522, 550 or 553, the claim which arises from such recovery will be allowed under sections 502(a), (b), or (c) to the extent allowable unless
the courts involved are exercising equitable jurisdiction, orders requiring turnovers have often been structured to account for the rights of the party surrendering the preference to participate in the bankrupt's estate.\textsuperscript{230}

IV. CONCLUSION

As this comparison of the preference provisions of the United States and Australia reveals, the statutes of both countries have certain deficiencies in accomplishing appropriate regulation of preferences involving guarantors. Although the shortcomings of the current Australian scheme are more numerous and more substantial than those of the United States, the recent review of the insolvency laws by the Australian Law Reform Commission has resulted in proposals which, when instituted, will significantly improve Australian insolvency law. Included in the Australian Law Reform Commission's suggestions are several submissions directly related to preferential transactions immediately prior to insolvency. The Law Reform Commission's planned incorporation of an expanded guarantor provision into the general preference statute\textsuperscript{231} would mean that most of the suggested alterations to the preference statute would apply to transactions involving guarantors. While a number of the proposals rely heavily upon concepts already tested by foreign experience, several are quite innovative and, perhaps, point to potential areas for improvement in the United States statute.

While several specific deficiencies in the Australian preference provision of general application made alteration of that provision inevitable, the Law Reform Commission opted for a more funda-

\textsuperscript{disallowed under sections 502(d) or (e) but with status as a pre-petition claim existing at the time of the filing of the debtor's petition.}

4 \textit{COLLIER ON BANKRUPTCY} § 502.08 (15th ed. 1983).

The basis of a guarantor's claim in the event of direct recovery under § 550 is imprecise, though it probably derives from the equitable right of indemnification. Though such a claim would be that of the guarantor directly, that claim by the guarantor might, nevertheless, be prejudiced by the actions of the original creditor in the same manner as a claim by subrogation. See \textit{11 U.S.C.} § 509 (1982 & Supp. IV 1986), which is intended to assure similar treatment for guarantors and others whether their claim is by way of subrogation or not.

\textsuperscript{230. See South Falls Corp. v. Rochelle, 329 F.2d 611 (5th Cir. 1964). The preferential transfer benefiting guarantor officers represented the major asset of the estate, but such officers' claim upon return of the transfer represented the major part of the claims against the estate. The turnover order required return of only that which was necessary to protect the remaining creditors on condition that the officers did not make a claim in bankruptcy.}

\textsuperscript{231. \textit{INSOLVENCY LAW REFORM DISCUSSION PAPER}, \textit{supra} note 1, at paras. 422-35. The guarantor statute would be incorporated in the proposed Antecedent Transactions statute as section 4 of the ten proposed sections. The proposed statute, which relates only to the insolvency of companies, is intended only as a model which, with appropriate modifications, would apply to non-corporate insolencies as well. \textit{Id.} at para. 420.}
mental reconsideration of preference law by introducing in its draft legislation an entirely new definition of preference. Interestingly, the new preference definition (as well as many of the other alterations suggested in the draft Australian legislation) has a great similarity to the United States model. For example, the Law Reform Commission's draft legislation defines a preferential transaction as one made within a prescribed period of insolvency proceedings by an insolvent company "to or for the benefit of a person for or on account of an antecedent debt or liability"232 which would, if not avoided, "enable the person to receive more toward satisfaction of the debt or liability than the person would otherwise receive or be likely to receive in winding up."233

The term "transfer" in the draft legislation is given "an extensive definition with the aim of embracing a wide range of means by which property may be disposed of,"234 thus increasing the types of transactions to which the definition would apply. Unlike the current Australian provision, which determines a transaction as preferential based on a broad view of the dealings of the parties, the new section, similar to 11 U.S.C. § 547, would consider the effect of the questioned transaction alone. This change is particularly important given the absence under the proposed statute of specific defenses for substantially contemporaneous exchanges or subsequent advances found in the United States.

In addition to the new preference definition, the Law Reform Commission has made several other suggestions which should improve the regulation of preferences in Australia. These include a rebuttable presumption of insolvency similar to that used in the United States, for a period of ninety days prior to bankruptcy,235 and introduction of the concept of the "related person" into Australian insolvency law.236 In order to discourage manipulation of the

232. Antecedent Transactions Draft Bill, supra note 1, at AT3(1)(a)(ii). A similar provision in the United States necessitated a specific exception for "substantially contemporaneous exchanges" due to the difficulty in applying the concept of the antecedent debt strictly.

233. Antecedent Transactions Draft Bill, supra note 1, at AT3(1)(b).

234. INSOLVENCY LAW REFORM DISCUSSION PAPER, supra note 1, at para. 421. Under the new definition found in Antecedent Transactions Draft Bill, supra note 1, at AT3, a transaction would be

(a) a conveyance or transfer executed, charge created, payment made, obligation incurred, interest created or assignment effected by the company;

(b) a release or waiver of a right effected by the company; or

(c) any other disposition of property of the company effected by the company.

235. INSOLVENCY LAW REFORM DISCUSSION PAPER, supra note 1, at para. 424.

236. Related persons would include a director and member of a company and the spouse or other relative of such persons as well as a related company and a beneficiary under a trust of which the company was trustee. Id. at para. 421. To date, the concept has been defined only in relation to insolvent companies.
debtor's affairs by an insider, the relevant period prior to insolvency during which transactions would be subject to avoidance under the proposed Australian legislation would, as in the United States, be longer for related persons (two years) than for those at arm's length (six months).237

Finally, the Australian Law Reform Commission has suggested a substantial reconsideration of the primary defense to preference recovery in a development unique to Australia. Currently, a recipient of a preferential transfer must show both that the creditor had no reason to suspect that the debtor was insolvent at the time of the transaction and that the transaction was in the "ordinary course of business."238 Since proof that the creditor had no reason to suspect the debtor's insolvent normally resulted in the conclusion that the transaction was in the ordinary course of business, the Law Reform Commission concluded that elimination of the "ordinary course of business" aspect of the defense was justified.239 In conjunction with streamlining the requisites of defense for good faith transferees, the Law Reform Commission also proposed that related persons who are recipients of preferential transfers be prevented from utilizing the defense without establishing that the debtor had no intention to prefer such person.240

The Australian Law Reform Commission's suggestions in relation to the guarantor preference statute include both specific substantive changes and alterations resultant from its proposed incorporation into the general preference provision. By bringing the guarantor provision within the general preference statute, the scope of the guarantor statute will be significantly broadened.241 Unfortunately, ambiguity about the relationship between the general preference provision and the guarantor provision may never-

237. Id. at para. 425.
238. See supra notes 31-39.
239. INSOLVENCY LAW REFORM DISCUSSION PAPER, supra note 1, at para. 427.
240. Id. at para. 428. A similar requirement for establishment of the ordinary course of business was proposed in Kyra Nominees Pty. Ltd. v. National Austl. Bank Ltd., 4 A.C.L.C. 400 (W. Austl. 1986). However, the Law Reform Commission concluded that such a requirement, though justifiable for related parties, was particularly severe on non-related person creditors and would not be commercially acceptable if so applied. The Commission suggests that the proper result in Kyra Nominees could be accomplished by requiring such proof for the establishment of the defense only by the related person guarantor, thus allowing recovery against the guarantor in that case while providing a defense for the non-related primary creditor.
241. For example, the proposed definition of transaction, mentioned supra, at note 234, would apply to transactions which would benefit the guarantor. By virtue of this change, transfers which could not be characterized as dispositions of property by the debtor company (as required by the current guarantor statute), but which would nevertheless fall within the broader definition of transactions covered by the general preference section would be subject to the proposed guarantor provision.
theless continue. 242

In addition to the amalgamation of the guarantor provision into the general preference statute, the Australian Law Reform Commission has suggested several substantive changes to the guarantor statute itself. As envisioned, the guarantor statute would apply to all "related party" guarantors and not only to company officers. 243 Additionally, the statute would clarify that recovery would be possible from any such guarantor where a preferential transfer resulted in reduction of potential liability on the guarantee. 244

Despite the positive implications of the Australian Law Reform Commission proposals, preference legislation of Australia (both in current form and under the Law Reform Commission’s draft legislation) lacks clearly articulated direction concerning the appropriate adjustment of rights between a creditor and his guarantor upon recovery of a preferential payment on a debt protected by a guarantee. The same, to a lesser extent, could be said of the United States statute. Clearly, the preference legislation of both countries is principally designed to assure the maximization of the debtor’s estate, as evidenced by provisions allowing direct recovery of the preferential transfer from the guarantor as an alternative to recovery from the primary creditor.

The adjustment of rights between the creditor and his guarantor is often expressed to be properly left to the contract of guarantee

242. For example, the draft guarantor provision, AT4, the text of which is located infra at note 243, applies to preferential transactions “as mentioned in AT3(1).” As AT3(1) sets out the basic ingredients of a preference, the proposed guarantor provision may apply even to “technical” preferences (as opposed to recoverable preferences, those to which no defense applies). Under the current statute, Companies Code § 453(5), “preference” has been interpreted to mean merely a technical preference and not a recoverable preference. Matthews v. Geraghty, 4 A.C.L.C. 727 (S. Austl. 1986). Should the same reasoning apply to the draft legislation, the defenses provided in AT3 would be irrelevant to recovery under AT4.

Likewise, the relationship between the remedies under the guarantor provision and the general preference provision have not been addressed. See von Nessen, Preferential Transfers Antecedent to Insolvency: The Australian Law Reform Commission’s Proposals, 6 COMPANY & SEC. L.J. 128 (1988).

243. Antecedent Transactions Draft Bill, supra note 1, AT4(1) states: Where a preferential transaction as mentioned in sub-section AT3(1) has been made between a company and a creditor in respect of a debt or liability of the company, being a transaction that had the effect of reducing the liability of a related person under a guarantee or otherwise, the liquidator may recover from the related person an amount equal to the amount by which the liability of the related person was reduced. See also INSOLVENCY LAW REFORM DISCUSSION PAPER, supra note 1, at paras. 434-35.

244. Under the current statute, as interpreted by the Law Reform Commission, a discharge of the guarantee is essential in order for the statute to apply. INSOLVENCY LAW REFORM DISCUSSION PAPER, supra note 1, at para. 435.
which governs the rights of the parties thereto.245 This may prove
to be effective where recovery of the preference is effected from a
creditor who has anticipated such an occurrence. Unfortunately,
failure to provide in the contract of guarantee for revival of the
guarantor's liability upon recovery of a preferential payment from
the creditor leaves the creditor recourse upon the guarantee only if
the law governing the guarantee obligations recognizes that a pay-
ment later set aside as preferential cannot effect a valid discharge of
the obligations under the guarantee.

Where a preferential transfer is recovered either from a credi-
tor protected by a guarantee or directly from a guarantor, the judi-
cial adjustment of rights between the creditor and guarantor would
undoubtedly best be accomplished in conjunction with the recovery.
Concurrent judicial consideration of the rights under the guarantee
along with determination of liability for surrender of the preference
could assure that a creditor's right of recourse against his guarantor
would be quickly and efficiently administered if recovery of the
transfer from the primary creditor were required. Alternatively,
comprehensive judicial supervision could assure that the guarantor
would face no greater total liability to both the bankrupt's estate
and the original creditor through direct liability for the preference
than would occur upon the guarantee if recovery of the preference
were accomplished from the original creditor.

While the United Kingdom preference statute retains prefer-
ence liability based upon the intention of the debtor to prefer a credi-
tor,246 it, nevertheless, provides a useful model in relation to
recovery of preferences from creditors protected from guarantees.
In relation to the overall objective of preference recovery, the Insol-
vency Act of 1986 clearly articulates that return to the pre-prefer-
ence position is desired.247 With specific regard to recovery of a
preferential payment to a creditor whose debt is protected by guar-
antee, section 342(e) of the Insolvency Act of 1986 allows recovery
in order to “provide for any surety or guarantor whose obligations
to any person were released or discharged (in whole or in part)
under the transaction or by the giving of the preference to be under
such new or revived obligation to that person as the court thinks
appropriate.”

Although the United Kingdom statute differs significantly
from both the United States and Australian legislation, in this re-

(1964); Nutovic, supra note 143, at 196 n.98.
247. Section 342(e) of the Insolvency Act states that “[t]he court shall, on [the
trustee's application for recovery of a preference], make such order as it thinks fit for
restoring the position to what it would have been if that individual had not given that
preference.”
spect at least it has much to recommend. By providing directly for judicial authority to revive a surety or guarantor's obligation to a creditor, the United Kingdom has avoided the shortcomings encountered in Australia in the case of Commercial Bank of Australia v. Carruthers. Likewise, the ability to revive such liability in the cases of both complete and partial discharge enables recourse against the guarantor in circumstances where even Australia's Companies Code section 453(5) would not apply. Both the articulation of the preference objectives in the United Kingdom statute and its clear legislative confirmation that guarantor/creditor rights should be readjusted in conjunction with preference recovery are admirable, even by comparison to the United States system where judicial utilization of the equity jurisdiction of bankruptcy may accomplish the same result. The failure of the Australian Law Reform Commission to rectify its deficiencies in this regard, however, is particularly dissatisfying.

The review of the Australian preference provisions undertaken by the Australian Law Reform Commission confirms that extensive restructuring of Australia's provisions was necessary, and the adoption of several elements of the United States model by the Law Reform Commission indicates that, in its view, the United States preference provision offers certain features superior to those currently found in Australia. Nevertheless, the United States preference statute is not without its faults. The deficiencies of the preference statute in general, though frequently addressed, are beyond the purview of this article; however, sufficient opportunity for


249. As noted earlier, the current Australian formulation allowing direct liability against a benefited guarantor applies only where there has been a discharge (presumably a complete discharge) of the guarantor's liability by virtue of the preference. See supra note 244. In the United Kingdom, the Insolvency Act 1986 also may be applied directly to guarantors under § 340(3):

For purposes of this and the next two sections, an individual gives a preference to a person if

(a) that person is one of the individual's creditors or a surety or guarantor for any of his debts or other liabilities, and

(b) the individual does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the individual's bankruptcy, will be better than the position he would have been in if that thing had not been done.

250. The Australian Law Reform Commission's Draft Legislation does provide that recovery of a preference from a guarantor reduces his liability on the guarantee. Antecedent Transactions Draft Bill, supra note 1, at AT4(4). No other attempt to correlate the preference recovery to the liability on the guarantee is attempted. In fact, neither subsection AT4(2) nor subsection AT4(4), both of which attempt to prevent double recovery of a preferential transfer, directly addresses adjustment of the obligations of the guarantor to the creditor upon recovery of the preference.
improvement is presented by matters relating directly to the United States regulation of preferential transfers involving guarantors. One noteworthy feature of the United States preference model is 11 U.S.C. § 550. This section, which enables the trustee to recover a preference from either the initial recipient of the transfer or any entity for whose benefit such transfer was made, allows great flexibility in protecting the estate from the effects of a preferential transfer. As might be expected, it is also the breadth of the remedial section which gives rise to its greatest criticisms. The application of section 550 to allow recovery from an arm's length creditor of a transaction which occurred beyond the normal statutory period because of a beneficial effect upon a "related party" is now disfavored.\(^{251}\) Nevertheless, such an application of the remedial section exemplifies the complications which section 550 have presented.

Similarly, the relationship between section 550 and the section 547 exceptions remains somewhat uncertain. For example, section 550 literally applied could allow recovery against a party who is innocent and/or would be protected by the exceptions provided in section 547. Because avoidance under section 547 may be achieved by judging the transaction in relation to a third party (e.g., a benefited creditor as opposed to the initial recipient), the innocence of the recipient and/or the exceptions of section 547 available to him would be ineffective to prevent recovery. Fortunately, it is unlikely that a court exercising equitable jurisdiction would impose liability in such circumstances.\(^{252}\)

More importantly, section 550 may theoretically allow recovery against the less appropriate of the two parties. Where recovery is accomplished from a creditor protected by a guarantee, the guarantor will normally be ultimately responsible to the protected creditor for the increased deficiency on the underlying debt. Alternatively, a benefited creditor, such as a guarantor, may be directly responsible for a preferential transfer in circumstances where involvement of the initial recipient would be desirable. Where, for ease of recovery, the guarantor is chosen as the appropriate defendant for a section 550 action, the guarantor may be prohibited from pursuing a claim in bankruptcy because of the actions of the primary creditor. In both circumstances, the rights of all parties to a guarantee transaction could be afforded proper protection by facilitating or assuring their involvement in the recovery proceedings in a manner similar to that currently provided in the United Kingdom.\(^{253}\)

\(^{251}\) See supra note 223.

\(^{252}\) See 4 COLLIER ON BANKRUPTCY § 550.02 (15th ed. 1983).

\(^{253}\) See the Insolvency Act, 1986, ch. 45, § 342(2) (U.K.), under which orders may be formulated dealing with the property of any person or imposing obligations on any
While procedural protection of the rights of the parties to a guarantee should be afforded upon recovery of a preferential transaction irrespective of the party from whom recovery is actually accomplished, the substantive rights of the parties after recovery deserve greater attention. One positive feature of the United Kingdom statute is its specific provision for a guarantor's claim in bankruptcy upon his surrender of a preference.\textsuperscript{254} The inclusion of this right within the bankruptcy statute eliminates any uncertainty which may arise through reliance only upon equitable principles developed through case law as a basis for such claim. This would seem to be particularly appropriate in the United States where state law may be determinative on such matters.

Finally, the proper regulation of the rights of all parties to a guarantee agreement cannot be properly achieved where the guarantor's right to participate in the bankrupt's estate, either through contribution, reimbursement, or subrogation is prevented by the actions of the creditor. The United States Congress has clearly indicated that equity among competing creditors must be maintained by disallowance of the claim of a co-debtor where the principal creditor's claims would be disallowed,\textsuperscript{255} to prevent improvement of position by a guarantor over a creditor. This objective coincides with the proper adjustment of rights between the parties to a guarantee where the disallowance of a claim is required by the retention of a preference relating to a debt secured by the guarantee. Where disallowance of such a claim is required because of the creditor's action in relation to a debt totally unrelated to the guarantee, however, the policy justification for the disallowance is not as clear.

Notwithstanding possible improvements to the United States preference statute as it relates to guarantors, the regulation of such transactions in the United States has been accepted as offering features worthy of emulation in Australia. Acceptance of the Australian Law Reform Commission's proposals on insolvency should be of interest in the United States for several reasons. Not only do such changes present an opportunity for the curious to observe features of United States law translated into other common law systems, but, more importantly, they may provide insight into modifications which may be desirable in the United States itself. Elimination of the ordinary course of business aspect of the defense to recovery in Australia, for example, may soon present a preference regime, though formulated like that in the United States, much more akin to the fault-based system of the United Kingdom.

\textsuperscript{254} Id. at § 342(1)(g).
Whether this is a desirable change remains to be seen. Likewise, the continued failure of Australia to provide for adjustment of the rights of parties to a contract of guarantee upon recovery of a preferential transfer relating to the guaranteed debt may reinforce the importance of this issue in the United States. Regardless of whether the Australian reform process presents potential solutions worthy of consideration or reveals complications to be avoided, further observation by the United States is warranted because Australian law may soon closely resemble United States preference law.